Equity Derivatives 2020

Contributing editors
Witold Balaban, Rafal Gawlowski, Catherine Lee and Reza Mojtabaee-Zamani

LEXOLOGY
Getting The Deal Through

Publisher
Tom Barnes
tom.barnes@lbresearch.com

Subscriptions
Claire Bagnall
claire.bagnall@lbresearch.com

Senior business development manager
Adam Sargent
adam.sargent@gettingthedealthrough.com

Published by
Law Business Research Ltd
Meridian House, 34-35 Farringdon Street
London, EC4A 4HL, UK

First published 2016
Fifth edition
ISBN 978-1-83862-335-7

Printed and distributed by
Encompass Print Solutions
Tel: 0844 2480 112

Equity Derivatives
2020

Contributing editors
Witold Balaban, Rafal Gawlowski, Catherine Lee and Reza Mojtabaee-Zamani
Latham & Watkins LLP

Lexology Getting The Deal Through is delighted to publish the fifth edition of *Equity Derivatives*, which is available in print and online at www.lexology.com/gtdt.

Lexology Getting The Deal Through provides international expert analysis in key areas of law, practice and regulation for corporate counsel, cross-border legal practitioners, and company directors and officers.

Throughout this edition, and following the unique Lexology Getting The Deal Through format, the same key questions are answered by leading practitioners in each of the jurisdictions featured. Our coverage this year includes new chapters on the Cayman Isands and France.

Lexology Getting The Deal Through titles are published annually in print. Please ensure you are referring to the latest edition or to the online version at www.lexology.com/gtdt.

Every effort has been made to cover all matters of concern to readers. However, specific legal advice should always be sought from experienced local advisers.

Lexology Getting The Deal Through gratefully acknowledges the efforts of all the contributors to this volume, who were chosen for their recognised expertise. We also extend special thanks to the contributing editors, Witold Balaban, Rafal Gawlowski, Catherine Lee and Reza Mojtabaee-Zamani of Latham & Watkins LLP, for their continued assistance with this volume.

LEXOLOGY
Getting The Deal Through

London
July 2020

Contents

Germany

Frank Bierwirth, Dirk Kocher, Axel Schiemann and Vanessa Sekker

Latham & Watkins LLP

OVERVIEW

Typical types of transactions

1 Other than transactions between dealers, what are the most typical types of over-the-counter (OTC) equity derivatives transactions and what are the common uses of these transactions?

Typical issuer equity derivatives products include the following:

- equity swaps to hedge an issuer's obligations in respect of the relevant issuer's employee benefit plan, which entails shares or share price related benefits;
- call options entered into by an issuer to hedge its payment obligations in respect of cash-settled convertibles, known as 'equity neutral' or non-dilutive convertible bond transactions';
- share loans and share repurchase transactions in the context of convertibles to facilitate hedging by investors in convertible bonds; and
- derivative-based share buy-back transactions.

Typical equity derivatives products that allow a shareholder to acquire a substantial position in a publicly traded equity or to monetise or hedge an existing equity position include the following:

- call options, put options, collars, forwards and total return swaps to hedge any equity price risk; and
- margin loans and margin bonds where shares are used as collateral for a leveraged loan bond, usually in the context of an acquisition;

Furthermore, equity derivatives transactions are entered into for general investment purposes or for hedging exposure from investment products issued by banks or funds, such as:

- share basket and index-linked transactions entered into by insurance companies, pension funds, etc;
- equity funds and exchange-traded funds (ETFs) entering into equity derivatives to get a synthetic exposure to a basket of shares or equity index; and
- retail certificates through which investors acquire an equity derivative exposure (eg, share-linked certificates, bonus certificates, express certificates, knock-in and knock-out certificates, index and performance certificates and discount certificates) – the retail equity derivatives market in Germany is one of the biggest retail markets for structured products in the world.

Borrowing and selling shares

2 May market participants borrow shares and sell them short in the local market? If so, what rules govern short selling?

The rules on short selling are set out in Regulation (EU) No. 236/2012 of the European Parliament and of the Council of 14 March 2012 on short selling and certain aspects of credit default swaps, and is supplemented by various delegated and implementing regulations. The short selling rules apply, among others, to shares admitted to trading on a trading venue in the EU irrespective of whether the instruments are traded on such trading venue (except where the principal trading venue of that instrument is in a third country). The Regulation requires that short sales of shares must be covered either by having borrowed the relevant stock or by arranging for such borrowing, or having a locate arrangement with a third party. Uncovered ('naked') short selling of shares is prohibited. In addition, significant net short positions in shares must be notified to the relevant competent authorities if they are equal to at least 0.2 per cent of the issued share capital of the relevant company (and every 0.1 per cent above that) and publicly disclosed if they are equal to at least 0.5 per cent of the issued share capital of the relevant company (and each 0.1 per cent above that). The competent authority is the authority of a relevant member state where the market that is most relevant in terms of liquidity for such shares is located. In Germany the relevant competent authority is the Federal Financial Supervisory Authority (BaFin).

Market-making activities and authorised primary dealers are exempted from these restrictions. While these European provisions are directly applied in all EU member states based on a generally harmonised approach, the regulatory practice of the national competent authorities may differ in detail. In order to mitigate such discrepancies and to provide more transparency, the European Securities and Markets Authority (ESMA) published guidelines on the exemption for market-making activities and primary market operations. In this regard, BaFin announced compliance with ESMA's guidelines, with two exceptions. In BaFin's view, the Short Selling Regulation does not limit the application of the exemption for market-making activities to financial instruments traded on the same trading venue as the market-making activity is conducted in, and, with regard to the product scope, to only shares and sovereign debts. Market participants should also assess whether any further restrictions (including short-selling bans with respect to shares of a particular issuer) imposed by supervisory authorities apply (which is possible in particular for measures protecting the markets).

Applicable laws and regulations for dealers

3 Describe the primary laws and regulations surrounding OTC equity derivatives transactions between dealers. What regulatory authorities are primarily responsible for administering those rules?

The regulation of OTC derivatives, including equity derivatives transactions, in Germany primarily includes:

- Regulatory requirements at the level of the institution that undertakes licensable trading activities; namely, for establishing and maintaining the relevant business such as licensing requirements and related ongoing prudential requirements (including,

for example, capital adequacy requirements and risk management requirements). These requirements are primarily set out in the Banking Act and relevant European legislation such as the Capital Requirements Regulation (CRR).
- Supervision of the services and trading activities of an institution such as the rules on conduct and product governance, as well as the general market and market infrastructure supervision and transparency requirements to be complied with by all relevant market participants such as disclosure of shareholdings and voting rights, insider trading and market abuse, which are primarily set out in the Securities Trading Act and, with respect to certain matters, in directly applicable EU legislation such as the European Market Infrastructure Regulation (Regulation (EU) No. 648/2012 on OTC derivatives, central counterparties and trade repositories, EMIR), the Securities Financing Transactions Regulation (Regulation (EU) 2015/2365, SFTR), the Market Abuse Regulation (Regulation No. 596/2014, MAR) and the Short Selling Regulation, as well as MiFIR (Regulation (EU) No. 600/2014) and other delegated regulations that, in addition to the relevant provisions of the Securities Trading Act, further implement Directive 2014/65/EU (MiFiD II).

Licensable activities under the Banking Act include financial services such as investment brokerage, investment advisory services, placement business, acquisition brokerage, portfolio management, dealing on own account and certain proprietary trading activities (in all cases if provided on a commercial scale). As regards own account trading, the Banking Act distinguishes between dealing on own account and conducting proprietary business. In particular, market-making activities, dealing on own account as service for third parties and high-frequency trading as a direct or indirect participant of a trading venue qualify as licensable dealing on own account and therefore as financial services requiring a licence. Proprietary business, however, is only deemed to be a financial service requiring a licence if it is conducted on a commercial scale and the respective company belongs to the same group or financial conglomerate to which a CRR institution also belongs. Further, CRR institutions and companies belonging to the same group as a CRR rendering proprietary trading and proprietary business activities are only allowed to do so up to a certain limit of business volume. Otherwise such activities can only be conducted by a financially and legally independent favoured financial trading institution. Furthermore, proprietary trading in shares or equity derivatives undertaken at a commercial scale requires a licence (subject to certain exemptions) if undertaken by a participant of a regulated market or a multilateral trading facility or via direct electronic access to a trading venue. Finally, credit or financial institutions require an additional licence for proprietary trading if they intend to conduct proprietary business alongside their main (licensable) business.

The main legal framework for trading in securities and other financial instruments such as derivatives in Germany is set by MiFID II/MiFIR as transposed into German law by the Securities Trading Act and as supplemented by various German and European regulations (eg, with regard to, among other things, definitions, transparency requirements and exemptions). The Securities Trading Act governs disclosure requirements, product governance rules including organisational and transparency requirements, the reporting regime as well as the respective supervision of BaFin as competent authority and sanctions for breaches of law. Since its entry into force in 2016, the MAR provides a pan-European legal framework for prevention and detection of insider dealing, unlawful disclosure of inside information and market manipulation. In this regard, the Securities Trading Act only complements the rules set out in the Market Abuse Regulation including the application of the MAR rules to commodities and foreign currencies traded on a German stock exchange or on an equivalent EEA market.

In the EU, the G20 commitment on the regulation of OTC derivatives was introduced as part of EMIR, which states obligations on all EU undertakings (including banks, corporates and special purpose vehicles) that enter into derivative contracts, such as interest rate, foreign currency as well as inflation swaps and equity derivatives. These obligations include mandatory clearing of certain OTC derivatives through central counterparties, the implementation of risk mitigation techniques for non-cleared OTC derivatives, such as the exchange of collateral between parties (margin obligations), and the reporting of derivatives to trade repositories. The overall objective of EMIR is to improve transparency and reduce some of the risks associated with the derivatives market, in particular the risk that the insolvency of one derivatives counterparty may spread through the derivatives market, triggering further insolvencies. EMIR has been amended by EMIR REFIT (Regulation (EU) 2019/834 of 20 May 2019), which, inter alia, simplifies some EMIR requirements, especially for small financial and non-financial counterparties, and aims to make supervision more efficient.

As regards the use of securities financing transactions and collateral reuse, the SFTR – supplemented by several implementing and delegated acts – provides for a legal framework of transparency requirements to facilitate monitoring and risk identification. The SFTR sets out, inter alia, reporting rules in respect of details of securities financing transactions (such as securities lending and repo transactions or margin lending transactions) to trade repositories and minimum transparency rules and consent requirements for parties involved in collateral use.

The Benchmarks Regulation (Regulation No. 2016/1011) stipulates a regime for benchmark administrators that ensures the accuracy and integrity of benchmarks and also applies to equity indices across Europe. In addition, a code of conduct for contributors of input data requires the use of robust methodologies and sufficient and reliable data. Users of benchmarks need to establish robust fall-backs and regulated entities may only use registered benchmarks for certain financial products.

The German regulatory authority that supervises compliance with the rules and regulations set out above (and that is the competent authority for purposes of the EU regulations) is primarily BaFin. With respect to the prudential supervision of credit institutions, competent supervisory authorities are BaFin, the German Central Bank and the European Central Bank. Furthermore, ESMA and the European Banking Authority have a guidance and coordination function at EU level.

In respect of share buy-backs and transactions with share issuers, certain restrictions on such share buy-backs (including a buy-back via derivative transactions) apply under the Stock Corporation Act (AktG).

The Civil Code and the Commercial Code set out certain general principles of contract law, which also affect documentation and interpretation of equity derivatives transactions to the extent the governing law of the transaction is German law.

In light of standard market documentation for OTC equity derivatives (the German Master Agreement and ISDA Master Agreement) and the reliance on netting provisions, compliance with the Insolvency Act must be ensured when transactions are entered into with German counterparties.

Entities

4 | In addition to dealers, what types of entities may enter into OTC equity derivatives transactions?

OTC equity derivatives are mainly entered into by banks and financial services institutions. In addition, regulated and unregulated funds including ETFs and alternative investment funds, securitisation and repackaging vehicles, insurance companies, pension funds, professional pension schemes and corporates frequently enter into OTC equity derivatives. In addition, retail investors are heavily investing in equity-linked structured products (typically in the form of structured securities), and more experienced retail investors are also trading equity-linked contracts for differences.

Applicable laws and regulations for eligible counterparties

5 Describe the primary laws and regulations surrounding OTC equity derivatives transactions between a dealer and an eligible counterparty that is not the issuer of the underlying shares or an affiliate of the issuer? What regulatory authorities are primarily responsible for administering those rules?

In addition to the primary rules and regulations, specific rules apply to counterparties that are themselves regulated in respect of their investments and transactions activities, such as insurance companies and regulated funds.

The Insurance Supervisory Act (VAG) is the equivalent of the Banking Act for insurance companies and was fundamentally revised in 2016 to implement the Solvency II Directive (Directive 2009/138/EC). When entering into OTC equity derivatives transactions, insurance companies must ensure compliance with the VAG rules in respect of their investments (including investments in equity derivatives), such as the newly introduced capital requirement rules. There are particular rules for investments made in respect of the guarantee assets of an insurance company, which serve as cover for the claims of insured persons under the relevant insurance contracts. For smaller insurance companies, such restrictions are out in the Investment Regulation.

The Investment Code (KAGB) implements several European directives into German law. Whereas the rules for funds investing in transferable securities derive from Directive No. 2014/91/EU for undertakings for the collective investment in transferable securities (UCITS), alternative investment funds are governed by the Directive on Alternative Investment Fund Managers (AIFMD, Directive No. 2011/61/EU). The AIFMD provides for a regulatory framework for alternative funds and investments by such funds, including investments in assets other funds are not allowed to invest in. The KAGB implements this European legal framework into German law, the scope of which also includes the entering into OTC equity derivatives transactions by funds. The relevant requirements differ depending on the type of fund and the investors to which the fund shall be distributed.

The competent German supervisory authority is BaFin and, as regards the guidance and coordination undertaken at EU level, the relevant authorities are European Insurance and Occupational Pensions Authority (with respect to insurance companies) and ESMA (including with respect to funds).

Securities registration issues

6 Do securities registration issues arise if the issuer of the underlying shares or an affiliate of the issuer sells the issuer's shares via an OTC equity derivative?

The issuer may sell either newly created shares or treasury shares. In the case of registered shares (in contrast to bearer shares) being sold, the share register will be updated following notice by the relevant custodian bank of the issuer and the purchaser. As German shares arepredominantly cleared through Clearstream Banking AG, share registers are often updated electronically. In light of equity derivatives transactions, the obligation (or the right) to request a change to the share register only arises with the transfer of the legal ownership of the shares (see section 67 AktG), in other words, the derivative as such is not registered. The registration is decisive for determining voting and dividend rights.

Repurchasing shares

7 May issuers repurchase their shares directly or via a derivative?

The AktG (section 71) allows share buy-backs in the following limited cases:

- if the acquisition is necessary to avoid severe and imminent damage to the company;
- if the shares are to be offered for purchase to the employees or former employees of the company or an affiliated enterprise;
- if the acquisition is made to compensate shareholders in the context of structural measures;
- if the acquisition is made without consideration or made by a credit institution in execution of a purchase order;
- by universal succession;
- on the basis of a resolution of the shareholders' meeting to redeem shares by reducing the share capital;
- if it is a credit institution or financial institution on the basis of a resolution of the shareholders' meeting for the purposes of trading in securities; or
- on the basis of an authorisation of the shareholders' meeting granted for a maximum of five years and defining the price range. Such authorisation may not exceed 10 per cent of the share capital.

The last possibility is most relevant from a practical perspective. In order to enable a share buy-back via derivatives (eg, options or forwards), the shareholders' resolution should be drafted carefully and include corresponding authorisations. The price range defined in the shareholders' resolution may also be determined as a percentage of the then current stock price. A deviation of the purchase price from the fair market value may also have tax consequences. The company can use funds that would also be available for a dividend in order to finance a share buy-back even though there are some differences in detail.

A company may hold up to 10 per cent of its nominal share capital shares as treasury shares. Treasury shares do not carry any rights, such as dividend or voting rights.

A third party acting in its own name but on behalf of the company may acquire or hold shares in the company only if and to the extent the company would permitted to purchase or hold the shares as treasury shares. Share buy-backs are disclosed in the financial statements and reported to the following shareholders' meeting.

The decision to buy back shares will often constitute inside information that triggers restrictions on insider dealing and publication duties of the company. There are no specific rules on share buy-backs via equity derivatives transactions. However, all parties need to comply with the insider dealing and market abuse provisions set out in the Securities Trading Act and MAR. MAR and further European rules will also require an issuer to disclose individual transactions under a share buy-back if it wants to make use of the safe harbour rules.

Risk

8 What types of risks do dealers face in the event of a bankruptcy or insolvency of the counterparty? Do any special bankruptcy or insolvency rules apply if the counterparty is the issuer or an affiliate of the issuer?

The risk dealers face in the event of bankruptcy or insolvency of the counterparty is the credit risk of the counterparty, namely, that the counterparty will not fulfil its payment or delivery obligations under the relevant equity derivative transaction. The time period between an event of default and the termination of the transaction and the related calculation of the close-out amount may also entail market risk. An equity derivative transaction (together with any other OTC derivative transactions of the counterparty under any master agreement it would typically have entered into with a dealer) usually terminates or may be terminated following the occurrence of an insolvency of the counterparty. Under German insolvency law, the general rule is that the insolvency administrator may elect whether to continue the contract or to terminate it. However, equity derivative transactions would typically be subject to a statutory close-out regime that applies upon the opening of German insolvency proceedings to the extent the equity derivative transaction has not already been terminated and closed-out before in accordance with its contractual terms. Equity derivatives transactions are typically documented under a master agreement (eg, an ISDA Master Agreement or the German Master Agreement for Financial Derivative Transactions (often also referred to as the DRV). In these circumstances, all transactions under the DRV will be automatically terminated upon the occurrence of an insolvency event as defined in the DRV and the contractual close-out netting will apply. The same will apply to transactions under the ISDA Master Agreement if automatic early termination was selected in respect of the insolvency of a German counterparty. Whether automatic early termination should be selected with respect to a German counterparty in the case of an English or New York law governed ISDA Master Agreement depends on the type of counterparty and the commercial considerations of the dealer. In general terms, it is recommended by the relevant German industry close-out netting opinion that automatic early termination should be selected if the counterparty is a German corporate. As regards the enforceability of the close-out netting provisions of the DRV and the ISDA Master Agreement in the insolvency of a German counterparty, industry close-out netting opinions have been issued in which any enforceability risks are discussed and any recommendations made.

There are no special insolvency regimes where the counterparty is the issuer of the underlying shares. However, depending on the economics and the overall nature and purpose of the transactions, additional considerations may need to be made in respect of a potential insolvency of the counterparty (which is also the issuer of the underlying shares). Finally, it should be noted that special regimes as regards reorganisation,moratorium, restructuring and resolution apply in respect of an insolvency of credit institutions.

To deal with the credit risk, parties may agree on collateral be provided. As for the ISDA Master Agreement, the DRV provides for standard forms of collateral annexes, including a collateral annex for margin to be provided for EMIR purposes. Under EMIR, counterparties are now obliged to provide variation margin and initial margin to cover the credit risk as well as any operational or settlement risk, and to reflect the risk involved in the fluctuation of the value of an equity derivative transaction and thus to mitigate the risk of any collateral shortfall.

Reporting obligations

9 What types of reporting obligations does an issuer or a shareholder face when entering into an OTC equity derivatives transaction on the issuer's shares?

The issuer is subject to the reporting obligations applying to share buy-backs if derivatives are used for a share buy-back. In addition, the parties to the derivatives transaction may be subject to reporting obligations concerning voting rights notifications and related instruments. This depends very much on the precise structure of the transaction. Any party that holds 3 per cent, 5 per cent, 10 per cent, 15 per cent, 20 per cent, 25 per cent, 30 per cent, 50 per cent or 75 per cent of voting rights of an issuer whose shares are traded on a regulated market has to notify this fact. The same thresholds with the exception of 3 per cent apply to any party that holds financial instruments in relation to such shares. Even financial instruments without physical settlement will often be covered by this regime. Further, reporting requirements may be triggered under the rules of an exchange where the shares are listed as well as under MiFIR if the underlying shares are traded on a trading venue, and the issuer or shareholder is a MiFIR investment firm. Moreover, MAR rules on the disclosure of inside information or safe harbour requirements may require adequate publication or reporting by the issuer. Finally, the usual trade reporting obligations of the counterparties under EMIR and MiFID/MiFIR apply.

Restricted periods

10 Are counterparties restricted from entering into OTC equity derivatives transactions during certain periods? What other rules apply to OTC equity derivatives transactions that address insider trading?

There are no specific periods during which counterparties are restricted from entering into equity derivative transactions in general. Only the usual closed periods defined by MAR apply to managers as parties to such transactions. However, the usual insider trading provisions also apply to equity derivatives transactions.

Legal issues

11 What additional legal issues arise if a counterparty to an OTC equity derivatives transaction is the issuer of the underlying shares or an affiliate of the issuer?

The rules governing share buy-backs apply to such transactions. A violation of these rules may result in the equity derivative transaction being void. Consequently, it is crucial for any party dealing with the issuer itself in any derivatives transaction that the issuer is in compliance with the applicable corporate requirements. Such compliance should not only be ensured via appropriate representations and warranties but also by due diligence.

Tax issues

12 What types of taxation issues arise in issuer OTC equity derivatives transactions and third-party OTC equity derivatives transactions?

There are no specific taxation issues in respect of equity derivatives transactions as such. However, the tax treatment of a share buy-back in issuer OTC equity derivatives transactions needs to be carefully considered. Purchased shares not subject to cancellation have to be reported as assets with the acquisition costs in the commercial balance sheet. The company has to build an (equity) reserve for the shares it has purchased in the same amount. Shares for cancellation may not be reported as assets in the commercial balance sheet. The purchase price is set off against the company's capital. The overall tax consequences depend on the precise structure of the transaction. Capital gains or losses realised on a subsequent disposal are basically exempt from corporate income tax, solidarity surcharge and trade tax but subject to an add back of deemed non-deductible expense, effectively leading to taxation with 1.5 per cent effective tax rate. For credit institutions, financial services institutions and financial enterprises holding the shares in the trading book, the tax exemption will not apply and the normal corporate income tax regime pertains.

Liability regime

13 Describe the liability regime related to OTC equity derivatives transactions. What transaction participants are subject to liability?

The general civil liability regime applies, which in particular includes liability for a breach of contract including ancillary contractual duties and pre-contractual duties. The civil law liability regime may already be applicable at an early stage of a proposed transaction. Even where the relevant engagement terms do not expressly contemplate that any advice be given by a party, a party may in fact provide financial advice, for example, where the circumstances suggest some financial advice (eg, structuring, assisting in modelling the transaction, tailored marketing). In such case, the relevant party needs to provide appropriate advice and must not omit any facts or information that is material for the parties to which such duties are owed. Extensive case law exists in that area and the relevant party is obliged to explore the needs, the knowledge and the experience of the counterparty and suggest the appropriate derivative. Furthermore, the relevant party needs to disclose the risk and rewards associated with the relevant derivative.

In a series of judgments by the Federal Court of Justice and various regional courts in relation to interest rate swaps entered into between a credit institution and a corporate, the courts have further highlighted the conflict of interest for a party to a swap. If a credit institution is a party to a derivative transaction and at the same time a financial adviser (which is almost always the case in non-standard transactions that are outside the 'execution only' business), the credit institution is inevitably in a conflict. Any gain under the derivative is the counterparties' loss, and if the credit institution is structuring the derivative it may structure it in its favour. Consequently, in these scenarios credit institutions (which are also financial advisers) need to disclose to the counterparty any initial negative market value of a derivative transaction for the counterparty to fully evaluate the implicit costs of the transaction. This requirement does not need to be fulfilled if the derivative is a hedging transaction for a connected transaction (eg, a convertible or loan). Although these judgments have mainly been applied in respect of interest rate swaps, it is very likely that the same will apply to any other asset classes, including equity derivatives transactions.

If a party provides information about the underlying share issuer, it may be liable under the prospectus liability regime. Even if the information is drawn from publicly available sources, the party that makes available such disclosure about the issuer of the shares needs to ensure that the information is comprehensive and no material information is missing that would render the information provided as misleading or false.

Once the parties have entered into the transaction, the contractual arrangements apply and the liability is usually limited to breach of contract or violation of applicable rules and obligations.

This liability regime applies to all transaction participants. As a rule of thumb, the less experienced a counterparty is (particularly if it is a retail investor), the higher the requirement for disclosure and information.

Stock exchange filings

14 What stock exchange filings must be made in connection with OTC equity derivatives transactions?

There are no stock exchange filings in respect of OTC equity derivatives transactions, unless as a result of such transaction a counterparty becomes the shareholder. Subject to the general European and German regulatory requirements under MAR and other European or German regulatory law, and depending on the rules of the exchange in relation to shares, notification may be required if the transaction affects the price, the liquidity or the company as such. In addition, the rules governing the notification of voting rights and financial instruments apply even though, under such rules, the filing is not to the stock exchange.

Typical document types

15 What types of documents are typical in an OTC equity derivatives transaction?

The German OTC market predominantly uses the ISDA Master Agreement or the DRV. The equity derivatives transactions will then be documented by confirmations that set out the economic terms of the transactions. In addition, the confirmation refers to a standard set of definitions used with equity derivatives. Under the ISDA Master Agreement these are the 2002 ISDA Equity Derivatives Definitions or, though rarely used, the 2011 ISDA Equity Derivatives Definitions. Under the DRV, a similar set of definitions is available, which is the (equity) securities derivatives addendum. These definitions deal with the mechanics of exercising an option, valuations, market disruptions, extraordinary events, and share and index adjustment events (eg, merger events and tender offers). Furthermore, the EMIR-compliant collateral arrangements are documented under the collateral addendum for variation margin. There will also be a collateral addendum for initial margin that has, however, not been published yet. In addition, an EMIR addendum is available in which EMIR requirements (other than the margin requirements) are addressed.

In the case of cleared OTC derivatives, the terms and conditions of the relevant derivatives (once accepted for clearing) are set out in the standardised terms and conditions (as applicable to the relevant type of derivative) published by the relevant central counterparty (ie, Eurex Clearing AG, which is the German central clearing counterparty for derivatives). The retail equity derivatives market, which enables retail investors to invest in structured securities, utilises a retail prospectus, which is approved by BaFin for public offers and listing purposes. The EU Prospectus Regulation (No. 2017/1129) entered into force on 20 July 2017, and has been fully applied from 21 July 2019.

Furthermore, product manufacturers of equity derivative products to be sold to retail investors need to produce a short disclosure document, the favour 'key information document', based on Regulation (EU) No. 1286/2014 of the European Parliament and of the council on key information documents for packaged retail and insurance-based investment products.

Legal opinions

16 For what types of OTC equity derivatives transactions are legal opinions typically given?

If transactions are entered into under an ISDA Master Agreement or a DRV, parties usually rely on the relevant industry opinion. However, these opinions mostly cover netting of transactions only and do not deal with any specific enforceability or capacity issues of a specific transaction. In the case of an equity derivatives transaction (which, for instance, relates to a share buy-back) the counterparty (not being the issuer) may require a capacity and compliance opinion to ensure the validity of the transaction. Capacity opinions are also given with respect to regulated or other private or public companies or entities that have a restricted, special or public company objective.

Hedging activities

17 May an issuer lend its shares or enter into a repurchase transaction with respect to its shares to support hedging activities by third parties in the issuer's shares?

This is generally possible within the limits of the share buy-back rules. However, careful structuring is required in light of the relevant transaction. If an issuer enters into a repurchase transaction with a counterparty, the company will acquire them again after maturity of the repo and may have a security arrangement in place. Consequently, the company needs to comply with the 10 per cent restriction on holding of treasury shares (including the shares subject to the repo).

The analysis, however, depends on the details of the documentation of the specific transaction: If the shares are subject to a loan granted by the issuer and there is no security arrangement, the borrower is likely to be seen as shareholder and the issuer acquiring them again upon maturity may also require a shareholders' authorisation.

Securities registration

18 | What securities registration or other issues arise if a borrower pledges restricted or controlling shareholdings to secure a margin loan or a collar loan?

If the shares are freely transferable, there are no specific securities registration requirements. However, depending on the details of the documentation, a disclosure of voting rights or financial instruments may apply under the Securities Trading Act, MiFID/MiFIR, MAR and EMIR.

Borrower bankruptcy

19 | If a borrower in a margin loan files for bankruptcy protection, can the lender seize and sell the pledged shares without interference from the bankruptcy court or any other creditors of the borrower? If not, what techniques are used to reduce the lender's risk that the borrower will file for bankruptcy or to prevent the bankruptcy court from staying enforcement of the lender's remedies?

The position of the lender in the bankruptcy of a German borrower depends on the type of security interest created over the shares. Usually, the relevant shares and the custody account are pledged in favour of the margin lender. Such German law pledge agreement (assuming the account is located in Germany) is usually structured as a financial collateral arrangement within the meaning of the European Financial Collateral Directive. Under German law, an appropriation right applies to fungible securities falling under the financial collateral regime pursuant to section 1259 of the Civil Code, and an enforcement privilege for financial collateral is provided for in section 166(3) of the Insolvency Code. Consequently, the margin lender will be able to appropriate the shares without the involvement of the insolvency administrator (provided that the requirements of section 1259 of the German Civil Code and section 166(3) of the Insolvency Code are fulfilled). In addition, a German pledge may be enforced by way of a private sale or a public auction.

Market structure

20 | What is the structure of the market for listed equity options?

The market for listed equity options is dominated by Eurex Exchange, the derivatives exchange operated by Eurex Frankfurt AG, a subsidiary of Deutsche Börse AG. The equity option market of Eurex covers options on over 500 stocks from 13 countries. Participants are able to access all the components of the Euro Stoxx 50 and Stoxx Europe 50 indices, as well as most components in the Stoxx Europe 600, Stoxx Europe Large 200, Stoxx Europe Mid 200 and Stoxx Europe Small 200 indices.

Governing rules

21 | Describe the rules governing the trading of listed equity options.

The main rules governing the trading of listed equity options on Eurex include the Exchange Act as the overall statutory framework, the Exchange Rules, and the Trading Conditions of Eurex as well as the Eurex Contract Specification Rules. The Exchange Rules provide for, among others:

- the general rules on the electronic trading system and general trading rules (eg, in respect of position limits and market integrity);
- the role of the central counterparty;
- the admission of trading participants and their ongoing obligations;
- the suspension or exclusion of participants from trading and the termination of the admission to trading;
- access to the trading system;
- time of trading and price determination; and
- pre- and post-trade transparency.

The Trading Conditions govern the types of contracts and strategies that can be traded, the conclusion and cancellation of trades, the various types of orders, etc. The details of the contracts traded are specified in the Eurex Contract Specifications for Futures Contracts and Options Contracts. The clearing of listed equity options traded on Eurex is governed by the Eurex Clearing Conditions.

Trading of equity options on Eurex range from one to 5,000 shares and is available in euros, Swiss francs, US dollars and pounds sterling. The contracts have a maturity of up to 12, 24 and 60 months. Eurex establishes a daily settlement price of all listed equity options. These prices are determined through a binomial model taking into account dividend expectations, current interest rates or other payments, if necessary. The options can be offered American-style (ie, the option can be exercised on any trading day during the lifetime of the option) as well as European-style, which can only be exercised on the last trading day of the lifetime of the relevant option. The option premium is payable in full in the currency of the respective contract one business day after the trade day.

TYPES OF TRANSACTION

Clearing transactions

22 | What categories of equity derivatives transactions must be centrally cleared and what rules govern clearing?

The clearing obligation under Regulation (EU) 648/2012 on OTC derivatives, central counterparties and trade repositories (EMIR) requires that all OTC derivative contracts within scope are subject to mandatory clearing and must be cleared with a central counterparty (CCP) that is authorised under EMIR (or that is recognised under EMIR for non-EU CCPs). Currently, EMIR does not mandate for the clearing of equity derivatives. The specific classes of products that are within scope of the mandatory clearing obligation under EMIR are set out in the Annex to the EMIR Delegated Regulation and cover standardised and liquid products (including certain interest rate swaps and credit default swaps). While it is contemplated that equity derivative products will become clearable in the future, the equity derivatives market is already pre-dominantly exchange-based. As a result, equity derivatives that remain traded OTC are generally bespoke products and, therefore, are unlikely to easily meet the standardisation and liquidity requirements for clearable products under EMIR.

Exchange-trading

23 | What categories of equity derivatives must be exchange-traded and what rules govern trading?

In Germany, equity derivatives are currently not required to be traded on an exchange. Following the clearing obligation under EMIR, Directive 2014/65/EU (MiFiD II) and Regulation (EU) No. 600/2014 (MiFIR) introduced a mandatory trading obligation for certain derivative transactions. Broadly, the trading obligation applies to a class of derivatives that is traded on at least one admissible trading venue and there is sufficient liquidity in the trading of such class of derivatives. The trading obligation does not currently apply to equity derivatives.

If, however, equity derivatives are traded on an exchange, the exchange rules governing the trading of these derivatives depend on the relevant market segment. On the regulated market, the admission to trading and the trading on the exchange are governed by the Exchange Act and the legal framework of the relevant derivatives exchange, which, in case of Eurex, include the Exchange Rules, the Trading Conditions and the Eurex Contract Specifications as well as the Clearing Conditions. In respect of non-regulated markets, the exchanges have set up terms and conditions governing the trading on these markets.

Collateral arrangements

24 | Describe common collateral arrangements for listed, cleared and uncleared equity derivatives transactions.

Uncleared equity derivatives are subject to the bilateral collateral arrangements of the parties. Usually, parties collateralise their transactions under an ISDA collateral support annex or the equivalent German Master Agreement for Financial Derivative Transactions (DRV) collateral addendum or the DRV collateral addendum for variation margin for compliance with the margin requirements under EMIR. Any transaction will be valued and a shortfall or excess will be determined on a net basis. The parties are required to transfer relevant collateral to cover any shortfall or reduce any excess. Under the DRV collateral addenda, the collateral is transferred by way of an outright collateral transfer, allowing the collateral taker to reuse the collateral.

The collateral arrangements for cleared OTC derivatives and listed derivatives are set out in the legal framework of the relevant clearing house. The Clearing Conditions of the German central counterparty, Eurex Clearing AG, provide for two different margin methodologies that may be applied to a relevant liquidation group as well as different margin types depending on the relevant class of transactions. In general terms, both initial and variation margin must be posted.

Exchanging collateral

25 | Must counterparties exchange collateral for some categories of equity derivatives transactions?

As regards OTC equity derivatives that are not cleared by a central counterparty, the general margin requirements under EMIR apply. Under EMIR, variation margin and, subject to a phase-in, also initial margin must be exchanged between financial counterparties (broadly, credit institutions, insurance undertakings, undertakings for the collective investment in transferable securities, alternative investment fund managers, etc) and between financial counterparties and counterparties that are above the clearing threshold (NFC+). This means that most of the non-financial counterparties (ie, corporates) are not subject to the margin requirements of EMIR. The initial margin requirement currently applies to financial counterparties and NFC+ that each have outstanding OTC derivatives trades in an aggregate volume of €750 billion, but this threshold is expected to be significantly reduced as from 1 September 2020. Most derivatives transactions are in scope for the variation and initial margin obligations, although single stock equity options and index options remain out of scope for a transitional period (while this transitional period formally ended on 4 January 2020, it was proposed to be extended by one year and, until the extension is formally adopted, the European regulatory authorities have encouraged regulatory forbearance).

For cleared OTC derivative transactions and listed derivatives margin requirements apply under the applicable clearing conditions. The Clearing Conditions of the German central counterparty, Eurex Clearing AG, provide for two different margin methodologies that may be applied to a relevant liquidation group as well as different margin types depending on the relevant class of transactions. In general terms, both initial and variation margin must be posted.

LIABILITY AND ENFORCEMENT

Territorial scope of regulations

26 | What is the territorial scope of the laws and regulations governing listed, cleared and uncleared equity derivatives transactions?

The laws and regulations governing listed, cleared and uncleared equity derivatives transactions do not have a uniform territorial scope. Whether the relevant German or European legislation applies to cross-border transactions in which non-German or non-EU parties participate hinges on criteria differing depending on the legislative objective of the relevant law. For example, financial licence requirements under the Banking Act apply if the provider of the financial services is providing the services through a physical presence in Germany or – even in the absence of a place of business in Germany – targets the German market in order to offer its services repeatedly and on a commercial basis to companies or persons having their registered office or ordinary residence in Germany. Licence requirements for proprietary trading activities generally also apply if the trading activities are conducted as a participant of a regulated market or a multilateral trading facility or via direct electronic access to a trading venue. In contrast, the Short Selling Regulation applies irrespective of where and by whom the relevant financial instrument is traded, to all financial instruments admitted to trading on a trading venue in the EU. Some legislation (eg, Regulation (EU) 648/2012 on OTC derivatives, central counterparties and trade repositories (EMIR)) addresses the direct, substantial and foreseeable effect in the EU or whether the purpose of the transaction is aimed at evading the obligations under EMIR.

Registration and authorisation requirements

27 | What registration or authorisation requirements apply to market participants that deal or invest in equity derivatives, and what are the implications of registration?

Market participants may require a banking or financial services licence or a 'European passport' based on a licence held in another EU/EEA member state, depending on their activities in the equities derivatives market. If a licence has been obtained in Germany, the relevant entity would be subject to ongoing supervision by the Federal Financial Supervisory Authority (BaFin). Where the European passport is used, for mere cross-border services the relevant entity would be mainly supervised by the competent authority of its home member state but certain German regulatory requirements may still apply.

Reporting requirements

28 | What reporting requirements apply to market participants that deal or invest in equity derivatives?

The issuer is subject to the reporting obligations applying to share buybacks if derivatives are used for a share buy-back. In addition, parties to the derivatives transaction may be subject to reporting obligations concerning voting rights notifications and related instruments. This depends very much on the precise structure of the transaction. Any party that holds 3 per cent, 5 per cent, 10 per cent, 15 per cent, 20 per cent, 25 per cent, 30 per cent, 50 per cent or 75 per cent of voting rights of an issuer whose shares are traded on a regulated market has to notify this fact. The same thresholds with the exception of 3 per cent apply to any party that holds financial instruments in relation to such shares. Even financial instruments without physical settlement will often be covered by this regime.

Counterparties to equity derivatives transactions are subject to the EMIR trade reporting requirements and counterparties to securities financing transactions are obligated under SFTR to report details to every conclusion, modification and termination of recognised securities financing transactions within the working day following the respective event.

Furthermore, investment firms are subject to the transaction reporting requirements under Regulation (EU) No. 600/2014 (MiFIR) and both financial counterparties and non-financial counterparties must comply with the reporting requirements relating to OTC derivative transactions under article 9(1) EMIR.

Legal issues

29 What legal issues arise in the design and issuance of structured products linked to an unaffiliated third party's shares or to a basket or index of third-party shares? What additional disclosure and other legal issues arise if the structured product is linked to a proprietary index?

There are no specific legal requirements that apply to this type of product except for the requirements for packaged retail and insurance-based investment products, which in particular include the obligation to prepare a key information document (as set out below).

However, the general regulatory requirements are to be considered. The sale of structured products in Germany, even if sold by the issuer itself, may constitute a licensable activity under the Banking Act. Further, any public offer of such products or any listing on a regulated market would require a prospectus be drawn up and approved by BaFin (or notified by another EU/EEA competent authority to BaFin under the European Passport) and such prospectus must, among other things, include disclosure of various information in respect of the underlying and its weighting in the basket, or in respect of any underlying index (including as to whether the index constitutes a benchmark under Regulation (EU) 2016/1011 of 8 June 2016 on indices used as benchmarks in financial instruments and financial contracts or to measure the performance of investment funds and amending Directives 2008/48/EC and 2014/17/EU and Regulation (EU) 596/2014 (the Benchmark Regulation)).

In the case of index-linked products, the issuer may be regarded as administrator or user of an index depending on whether the index is a proprietary index or provided by a third party. In both cases, additional regulatory requirements under the Benchmark Regulation are triggered, which, in case of the administrator (including third-country administrators whose indices are used in the EU), involves a rather onerous application requirement for authorisation.

Further, the product governance rules of Directive 2014/65/EU (MiFiD II), as implemented into the German Securities Trading Act, are to be complied with by a manufacturer and distributor of the structured product (such as the definition of a target market).

Moreover, in case of equity derivative products to be sold to retail investors, product manufacturers need to produce a short disclosure document, the favour 'key information document', based on Regulation (EU) No. 1286/2014 of the European Parliament and of the Council on key information documents for packaged retail and insurance-based investment products.

Liability regime

30 Describe the liability regime related to the issuance of structured products.

The applicable liability regime depends on the type of structured product and in particular whether it is issued in the form of a structured security or not.

The general liability regime may apply in respect of the structured product (ie, an error of the product or the covenants or representations provided by the issuer of the relevant product). This regime is based on the principles related to breach of contract.

A further liability regime exists in respect of wrong or insufficient disclosure as regards the underlying risk or the mechanism of the relevant structured product. This favoured 'prospectus liability' may be established on the basis of section 8 et seq of the Securities Prospectus Act, if a prospectus under the EU Prospectus Regulation has been drawn up. A similar regime (though typically less relevant for market standard structured products) applies to instruments that are not securities in terms of the EU Prospectus Regulation but for which a prospectus needs to be drawn up under the Investment Code. If a relevant disclosure, information or marketing document has not been drawn up under any of these two regimes, an issuer may still be liable for any information provided to investors under the prospectus liability regime established by case law.

Finally, detailed and extensive case law exists in relation to the misselling of structured products in Germany. Sellers of structured products need to comply with the principles established by courts in respect of providing appropriate financial advice to investors.

Other issues

31 What registration, disclosure, tax and other legal issues arise when an issuer sells a security that is convertible for shares of the same issuer?

A company requires shareholder approval or authorisation for issuing convertible instruments. Convertibles are treated as a form of securitisedequity derivative and are financial instruments for purposes of MiFID II, the Securities Trading Act and the Banking Act. As convertible bonds typically are tradable securities, any public offer or listing on a regulated market is subject to the European Prospectus Regulation.

Depending on the details of the documentation, a convertible may be regarded as a financial instrument that needs to be disclosed under the rules described in 'Reporting obligations'. This depends very much on the precise structure of the transaction. Any party that holds 3 per cent, 5 per cent, 10 per cent, 15 per cent, 20 per cent, 25 per cent, 30 per cent, 50 per cent or 75 per cent of voting rights of an issuer whose shares are traded on a regulated market has to notify this fact. The same thresholds with the exception of 3 per cent apply to any party that holds financial instruments in relation to such shares. Even financial instruments without physical settlement will often be covered by this regime. Further, reporting requirements may be triggered under the rules of an exchange where the shares are listed as well as under MiFIR if the underlying shares are traded on a trading venue, and the issuer or shareholder is a MiFIR investment firm. Moreover, MAR rules on the disclosure of inside information or safe harbour requirements may require adequate publication or reporting by the issuer. Finally, the trade reporting obligations under MiFID/MiFIR may apply.

32 What registration, disclosure, tax and other legal issues arise when an issuer sells a security that is exchangeable for shares of a third party? Does it matter whether the third party is an affiliate of the issuer?

Exchangeable bonds are regarded as equity derivatives or securities, depending on the scope of the relevant regulations, and no specific rules apply in that respect. They are financial instruments for purposes of MiFID II, the Securities Trading Act and the Banking Act. Depending on the details of the documentation, an exchangeable bond may be regarded as a financial instrument that needs to be disclosed, or a relevant trade in such financial instrument may need to be reported, in accordance with the Securities Trading Act, MiFID/MiFIR, and MAR. As exchangeable bonds typically are tradable securities, any public offer or listing on a regulated market is subject to the European Prospectus Regulation.

If the third party is an affiliate of the issuer, the issuer may require shareholder approval or authorisation.

UPDATE AND TRENDS

Recent developments

33 Are there any current developments or emerging trends that should be noted?

The SFTR has been phased in and credit institutions and investment firms have been subject to the SFTR obligation since 11 April 2020. Other counterparties such as central counterparties and central custodians, UCITS, AIFs and insurance companies will become subject to the SFTR over the coming months, with the SFTR also being applied, as from 11 January 2021, to non-financial counterparties. Otherwise, there are no updates at this time.

LATHAM & WATKINS

Frank Bierwirth
frank.bierwirth@lw.com

Dirk Kocher
dirk.kocher@lw.com

Axel Schiemann
axel.schiemann@lw.com

Vanessa Sekker
vanessa.sekker@lw.com

Frankfurt Office
Die Welle
Reuterweg 20
60323 Frankfurt am Main
Germany
Tel: +49 69 6062 6000

Hamburg Office
Warburgstrasse 50
20354 Hamburg
Germany
Tel: +49 40 41 4030
www.lw.com

Other titles available in this series

Acquisition Finance
Advertising & Marketing
Agribusiness
Air Transport
Anti-Corruption Regulation
Anti-Money Laundering
Appeals
Arbitration
Art Law
Asset Recovery
Automotive
Aviation Finance & Leasing
Aviation Liability
Banking Regulation
Business & Human Rights
Cartel Regulation
Class Actions
Cloud Computing
Commercial Contracts
Competition Compliance
Complex Commercial Litigation
Construction
Copyright
Corporate Governance
Corporate Immigration
Corporate Reorganisations
Cybersecurity
Data Protection & Privacy
Debt Capital Markets
Defence & Security Procurement
Dispute Resolution
Distribution & Agency
Domains & Domain Names
Dominance
Drone Regulation
e-Commerce
Electricity Regulation
Energy Disputes
Enforcement of Foreign Judgments
Environment & Climate Regulation
Equity Derivatives
Executive Compensation & Employee Benefits
Financial Services Compliance
Financial Services Litigation
Fintech
Foreign Investment Review
Franchise
Fund Management
Gaming
Gas Regulation
Government Investigations
Government Relations
Healthcare Enforcement & Litigation
Healthcare M&A
High-Yield Debt
Initial Public Offerings
Insurance & Reinsurance
Insurance Litigation
Intellectual Property & Antitrust
Investment Treaty Arbitration
Islamic Finance & Markets
Joint Ventures
Labour & Employment
Legal Privilege & Professional Secrecy
Licensing
Life Sciences
Litigation Funding
Loans & Secured Financing
Luxury & Fashion
M&A Litigation
Mediation
Merger Control
Mining
Oil Regulation
Partnerships
Patents
Pensions & Retirement Plans
Pharma & Medical Device Regulation
Pharmaceutical Antitrust
Ports & Terminals
Private Antitrust Litigation
Private Banking & Wealth Management
Private Client
Private Equity
Private M&A
Product Liability
Product Recall
Project Finance
Public M&A
Public Procurement
Public-Private Partnerships
Rail Transport
Real Estate
Real Estate M&A
Renewable Energy
Restructuring & Insolvency
Right of Publicity
Risk & Compliance Management
Securities Finance
Securities Litigation
Shareholder Activism & Engagement
Ship Finance
Shipbuilding
Shipping
Sovereign Immunity
Sports Law
State Aid
Structured Finance & Securitisation
Tax Controversy
Tax on Inbound Investment
Technology M&A
Telecoms & Media
Trade & Customs
Trademarks
Transfer Pricing
Vertical Agreements

Also available digitally

lexology.com/gtdt

an LBR business

ISBN 978-1-83862-335-7