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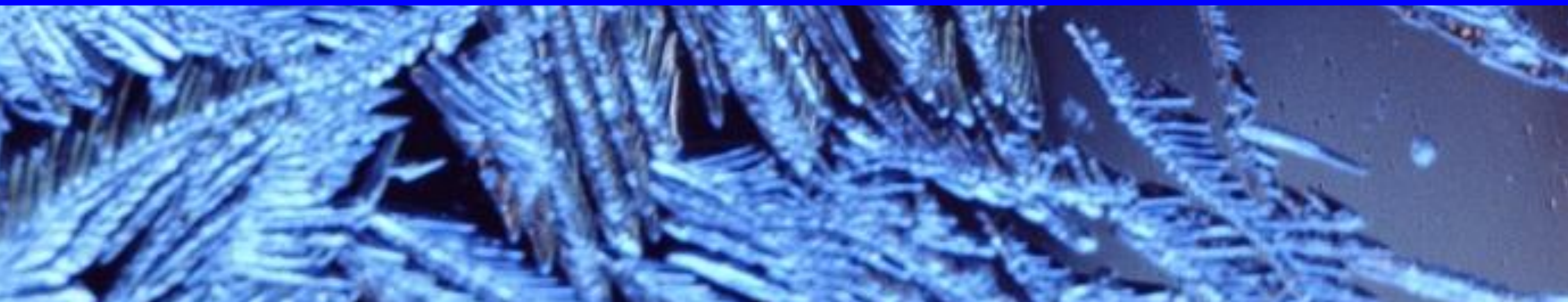

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This publication does not necessarily deal with every important topic nor cover every aspect of the topics with which it deals. It is not designed to provide legal or other advice.

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Banking, Finance & Capital Markets

Fight Against Money Laundering and Terrorism Financing

Law dated 27 October 2010

A new law dated 27 October 2010 entered into force on 7 November 2010 (Mém. A 2010, p. 3172, bill n° 6163). It amends the Luxembourg legislation relating to the fight against money laundering and terrorism financing. The law mainly impacts the Criminal Code, the Criminal Investigation Code, the AML Law[1], the Financial Sector Law[2], the Insurance Sector Law[3] and other laws regulating specific professions.

This law is relevant for finance professionals as it redefines the scope of application of the AML Law, amends certain professional obligations and resets the level and possibilities of sanctions. In order to ensure that all financial institutions, as defined by the FATF[4], are subject to the AML Law, its scope has been extended to professionals or certain professional activities that were previously exempted from anti-money laundering obligations. It will now apply as well to:

- managers and advisers of undertakings of collective investment, risk capital investment companies (SICARs) and pension funds,
- securitisation vehicles (to a limited extent only),
- insurance and reinsurance undertakings as well as their intermediaries when carrying out credit or guarantee operations,
- persons carrying out certain activities enumerated in a new annex to the AML Law as service for a client, and
- foreign professionals providing relevant services in Luxembourg without establishing a branch.

The main other changes include:

- Not only credit institutions and financial institutions, but all professionals falling under the scope of the AML Law have to ensure that their foreign subsidiaries and branches apply AML/TF[5] measures which are at least as strict as those applied in Luxembourg and report to the competent Luxembourg authority if such measures cannot be applied. If the AML/TF rules in the host state of their subsidiary or branch are different from the Luxembourg rules, them the more stringent rules have to be complied with.
- Professionals are obliged to issue a risk analysis of their AML/TF activities in written form.
- The automatic exemption from CDD[6] vis-à-vis clients that are credit or financial institutions as well as the optional exemption from CDD vis-à-vis certain other clients (e.g. listed companies) and in relation to certain products or transactions has been replaced by a revised simplified CDD regime. The professional is not exempted from but may reduce certain CDD measures, namely the identification of the client and beneficial owner, while continuing to monitor the business relationship with the client and to verify that the client still fulfills the requirements to be subject to the simplified CDD regime.
- The regime of enhanced CDD has been improved so that it now applies to correspondent banking relationships as well as to other similar relationships between any professional subject to the AML Law and a respondent institution from any third country outside the EU.
- The notion of politically exposed persons and the scope of enhanced CDD applicable to them has been extended as well.
- The indirect tax authorities (*Administration de l'Enregistrement et des Domaines*) will be in charge of supervising certain professionals (e.g. real estate agents) who are not specifically supervised but subject to the AML Law for the purpose of ensuring compliance with AML/TF legislation.
- The new law more precisely delineates the powers of the CRF[7] and the duties of professionals with respect to the reporting of suspicious transactions or situations. For instance, the scope of the obligation to report suspicious situations has been enlarged to terrorism-financing, the duration of CRF freezing orders has been extended up to a

[1] Law dated 12 November 2004 on the fight against money laundering and terrorism financing
[2] Law dated 5 August 1993 on the finance sector
[3] Law dated 6 December 1991 on the insurance sector
[4] Financial Action Task Force / *Groupe d'Action financière* (FATF/GAFI)
[5] Anti-money laundering and terrorist financing
[6] Customer due diligence
[7] *Parquet du tribunal d'arrondissement de Luxembourg, Cellule de Renseignment Financier*, the department competent for the fight against money laundering and terrorism financing of the Luxembourg state prosecutor

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maximum of 6 months and clients may be informed of freezing orders only with the express prior consent of the CRF.

- The maximum administrative and criminal fines have been increased to EUR 250,000 for administrative fines and to EUR 1,250,000 for criminal fines. The relevant maximum criminal fines for legal persons are quintupled for the first offence and quadrupled for a recurrent offence.

- The general sanction regime under the Financial Sector Law and the Insurance Sector Law has been aligned and revised. Among others things, the range of applicable sanctions has been enlarged (e.g. by introducing the possibility to impose fines for delay in complying with injunction orders of up to EUR 1,250 per day), and professional bans may be pronounced.

In addition, the new law introduces a specific regime for controlling the physical transport of cash and certain bearer instruments and creates a legal framework for the implementation of decisions by the Security Council of the United Nations as well as acts adopted by the EU Council containing prohibitions and restrictive measures vis-à-vis certain countries, political regimes, persons, entities and groups. A Grand-Ducal regulation dated 29 October 2010 has accordingly implemented existing Security Council decisions and EU Council acts in this area. These decisions and acts are annexed to the Grand-Ducal regulation. Ministerial Regulations dated 8 November 2010 and 7 December 2010 have added names to the list of persons, entities and groups against which prohibitions and restrictive measures in financial matters have been pronounced contained in annex I C of the Grand-Ducal regulation to implement underlying new Security Council committee decisions in Luxembourg.

The CSSF[8] has also issued its Circular 10/495 dated 9 December 2010 on the entry into force of the new law. The CSSF indicates therein that it will no longer issue circulars concerning restrictive financial measures. To the same extent, circulars in the past referred to under the heading "Identification and Declaration of Business Relationships with Terrorist Circles" and "Fight Against Terrorism" will no longer be provided. The CSSF however draws the attention of the professionals subject to its supervision to the fact that it has added a new tab on its website http://www.cssf.lu/lbcft-sanctions-financieres/ containing relevant Luxembourg laws and regulations on the fight against money laundering and terrorism financing as well as the international restrictive measures and sanctions in the financial sector and that such professionals may subscribe for an internet-based news service informing of future developments in this area.

Finally, it should be noted that the Luxembourg Parliament has introduced two other new laws (bills n° 6017 and 6168) implementing the Convention dated 29 May 2000 on mutual assistance in criminal matters between the EU Member States and the Convention for the suppression of unlawful acts against the safety of maritime navigation, adopted in Rome on 10 March 1988.

CRF Circular 22/10 - Cooperation with the CRF

On 8 November, the CRF issued its Circular 22/10 to clarify the application of article 5 of the AML Law, obliging persons subject to the AML Law to cooperate with authorities. Such cooperation duty implies the obligation to inform the CRF of suspicious transactions and respond to information requests from the CRF. The new circular has replaced CRF Circular 20/08 dated 12 November 2008 which is now outdated due to the new law dated 27 October 2010 amending, amongst others, the AML Law (please see above).

CSSF Circular 10/476 and Commassu Circular 10/7 – Modification of Main AML/TF Circulars

CSSF Circular 10/476 dated 29 July 2010 amends CSSF Circular 08/387, by deleting the references therein to the list of countries outside the EU/EEA applying equivalent AML/TF measures (such list having been repealed in 2009 by a Grand-Ducal regulation). It also adds supplementary reporting and verification duties for the relevant professionals.

The Commassu[9] Circular 10/7 dated 12 August 2010 amends the Commassu Circular 09/6 and implements measures for professionals subject to its supervision similar to those of CSSF Circular 10/476.

CSSF Circulars 10/484 and 10/486 – Duties of External Auditors

CSSF Circulars 10/484 dated 26 August 2010 amends CSSF Circular 01/27 relating to the practical rules concerning the duties of external auditors of credit institutions with respect to the control of compliance with the AML/TF obligations and the risks encountered and measures taken by the credit institutions in this respect. In a similar way, CSSF Circular 10/486 dated 11 October 2010 amends the corresponding CSSF Circular 03/113

[8] *Commission de Surveillance du Secteur Financier,* the Luxembourg finance sector regulator

[9] *Commissariat aux assurances*, the Luxembourg insurance sector regulator

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applying to the duties of external auditors of investment firms. These circulars are now in effect.

CSSF Circular 10/490 – Jurisdiction List

CSSF Circular 10/490 dated 5 November 2010 contains a list of jurisdictions which AML/TF regime has substantial and strategic deficiencies and a list of jurisdictions which AML/TF regime is not satisfactory. The new circular reflects and draws the attention of professionals to the underlying new FATF declarations issued in October 2010. CSSF Circular 10/469 has been repealed accordingly.

Financial Collateral, Clearing and Settlement and E-Money Institutions - Bill N° 6164

The Luxembourg Parliament is currently examining a bill (Parliamentary document n° 6164/0) amending Luxembourg legislation on financial collateral arrangements, settlement finality and electronic money institutions. The bill will implement directives 2009/110/EC and 2009/44EC.

Financial Collateral

The draft is important for finance professionals and borrowers because, among others things, it clarifies for the purpose of transaction security the validity of certain techniques or practices stipulated in financial collateral arrangements which have previously been widely recognized in legal writing, further strengthening the attractiveness of Luxembourg financial collateral arrangements by confirming:

- the validity of the identification of receivables pledged or transferred to the collateral taker by entering them into a list of receivables provided to the collateral taker in writing,
- that the constitution of financial collateral remains unaffected by rights of substitution or withdrawal of excess coverage by the collateral provider or by its right to give instructions with respect to or to receive the products of the collateral assets,
- the validity of clauses to waive rights of set-off of the collateral provider or its right of recourse against a debtor even in the case of the collateral provider's insolvency, as well as
- the validity of banking secrecy waivers, subject to certain conditions.

The changes to the Financial Collateral Law also concern the perfection requirements for pledges. The Luxembourg legislator, while keeping the technique of de-possession as a perfection mode, has introduced the Anglo-Saxon concept of taking control over the assets given as collateral as a further perfection mode. A pledge over receivables will henceforth be perfected by simple conclusion of the pledge agreement; a notification to the debtor will no longer be required for valid perfection but such notification will avoid that a payment by the debtor to the pledgor could have a liberating effect for the debtor.

Another change is that in certain cases the de-possession of financial instruments will now lead to a waiver by the depositary of its prior ranking pledge over financial instruments where the depositary of financial instruments takes an action in the course of the perfection of the pledge, subject to another arrangement or explicit refusal by the depositary.

The bill further clarifies that the constitution of collateral over receivables implies that the collateral receiver has the right to exercise all rights of the collateral provider relating to the receivables.

With respect to enforcement methods, the bill confirms the validity of clauses providing that the appropriation of pledged assets in case of an enforcement event cannot only be made after the valuation of the pledged assets, but also before, as well as by a third party designated by the pledgee.

Finally, the bill confirms that foreign law collateral arrangements entered into by a Luxembourg party benefit from the same protection against the effects of provisions applicable to insolvency proceedings or any other situation, involving any creditors process as Luxembourg law collateral arrangements, provided they are similar in nature to them.

Settlement Finality

As regards the changes to settlement finality legislation, innovations, include the explicit extension of settlement finality protection to night-time settlements and interoperable systems. In addition, while Luxembourg settlement finality legislation already made use of the option to extent the settlement finality protection to indirect participants of a settlement system which were credit institutions, the bill enlarges the scope of eligible indirect participants to central counterparties, settlement agents, clearing houses or systems operators with a contractual relationship with a participant in a system. The bill further explicitly clarifies that realisable assets that may be provided as collateral security in the context of settlement systems include financial collateral constituted of cash, financial instruments or credit claims (*créances privées*).

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Electronic Money Institutions

The principal innovations introduced by the bill and concerning electronic money institution legislation include the following:

- The definition of electronic money has been simplified and made more neutral from a technological perspective,
- The new prudential regime for electronic money institutions is aligned with the regime applicable to payment institutions. Among other things, (i) the required initial capital will be reduced to EUR 350,000 to lower the entry threshold for this market segment, (ii) the modalities of calculation of permanent own funds have been substantially amended, and (iii) electronic money institutions now have the possibility to exercise activities other than issuing electronic money, such as telecommunications, transport or retail commercial activities.
- The repayment obligations of electronic money institutions have been clarified.

The bill is expected to enter into force on 30 April 2011 for the electronic money institutions provisions and 30 June 2011 for the provisions relating to financial collateral arrangements and settlement finality legislation.

Credit Institutions and PFS[10]

CSSF Paper on PFS Licensing Procedure

The CSSF has published on its website an updated version dated 28 October 2010 of its paper on the PFS licensing procedure. In particular, the CSSF has extended the information required to be filed by a licence applicant by now formally requesting to be provided with a manual of AML/TF procedures for the future PFS.

Questions and Answers (Part II) relating to the PFS categories

The CSSF has also published on its website a new document with 79 "Questions / Answers (Part II) relating to the PFS categories" dated 29 November 2010. This document reflects certain positions taken by the CSSF in the past with respect to (i) general questions concerning all PFS licensing categories, and (ii) the application of the different PFS licensing requirements, divided into questions relating to investment firms, PFS other than investment firms and PFS exercising an activity being connected or complementary to a finance sector activity.

This document is important for finance professionals because it, though non-binding and indicative only, provides more transparency on the administrative practice of the CSSF by publishing new positions or compiling or clarifying some positions published throughout different CSSF Activity Reports or other CSSF publications.

The new Q&A document supplements the 30 "Questions / Answers (Part I) relating to obtaining a PFS licence" of 5 May 2010.

CRD[11] Amendment Implementation and Miscellaneous

Bill N° 6165

The Luxembourg Parliament is currently examining a new bill (n° 6165) which aims to implement (i) certain parts of Directive 2009/111/EC amending the CRD, (ii) certain parts not yet transposed of Directive 2009/14/EC amending the Deposit Guarantee Systems Directive 94/19/EC, and (iii) Directive 2009/49/EC concerning certain publicity obligations for mid-sized companies and their obligation to establish consolidated accounts into Luxembourg law.

The parts of Directive 2009/111/EC that will be implemented by the bill concern the internal governance of the CSSF as well as the obligations of the CSSF relating to risk management and as consolidating supervisory authority on EU level.

The bill also proposes some changes to the Luxembourg law dated 23 December 1998 on the establishment of the CSSF, in particular as regards the role of the CSSF in the context of the EU Regulation n° 100/2009 on credit rating agencies, in respect of supervision of the audit profession and in matters of reception, exchange and transmission of confidential information.

A further part of the bill modifies the Luxembourg law dated 31 May 1999 on the domiciliation of companies. In the future, the termination of a domiciliation contract with companies that are supervised by the CSSF will require the prior notification of the termination to the CSSF within a one month prior to the effective date of the termination.

The bill also aligns the professional secrecy obligations of operators of regulated markets and multilateral trading facilities to those of professionals subject to the Financial Sector Law. It introduces a more complete legal basis for

[10] Professional of the financial sector (PFS) whose regular occupation or business is to exercise a financial sector activity or one of the connected or ancillary activities referred to in sub-section 3 of section 2 of Chapter 2 of Part I of the Financial Sector Law, excluding credit institutions and persons subject to article 1-1(2) of the Financial Sector Law

[11] Capital Requirements Directives 2006/48/EC and 2006/49/EC

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pronouncing administrative sanctions under the Luxembourg Transparency Law[12], notably against persons who do not make major shareholding notifications or publications within the legal deadlines.

Finally, the bill contains some other changes to several Luxembourg laws, including the Financial Sector Law, to increase the quality and readability of these legal texts and to clarify certain technical points. Among other things, the scope of the Financial Sector Law will be widened by applying licence requirements to non-EU/EEA credit institutions and other finance professionals who provide services as such licensable under the Financial Sector Law in Luxembourg on an occasional or temporary basis, i.e. without being established permanently in Luxembourg by way of a branch.

The bill is expected to enter into force in the forthcoming months.

CSSF Circulars 10/475, 10/483 and 10/493 – Own Fund Ratio Computation and New Large Exposure Regime

The partial implementation of the CRD amendment Directive 2009/111/EC in the new bill n° 6165 (see above) is further complemented by CSSF Circular 10/475 dated 20 July 2010 and CSSF Circular 10/483 dated 25 August 2010. These Circulars modify the CSSF Circulars 06/273 and 07/290 on own fund requirements, including in particular the calculation of own fund requirements for credit risks on securitised claims, the calculation of large exposure risks and the definition of own funds. These Circulars also implement Directives 2009/27/EC and 2009/83/EC amending the CRD. Both Circulars have entered into force on 31 December 2010.

The Circular 10/493 dated 7 December 2010 outlines the modifications the CSSF has made to tables B 2.3 and B 6.3 by which banks periodically report information on the concentration of risks or consolidated risks to the CSSF and contains instructions in relation thereto. The reporting changes are a result of the new large exposure regime introduced by Circular 10/475.

CSSF Circular 10/494 – EFSF Exposure Ratio

The CSSF Circular 10/494 dated 8 December 2010 clarifies that banks, investment firms and management companies subject to own fund requirements under Circular 06/273 and 07/290 may treat exposure on the European Financial Stability Facility ("EFSF") like an exposure on a Luxembourgish central administration having a 0% risk weighting, without the need to prior approval from the CSSF.

CSSF Circular 10/496 and 10/497 CRD III

The CSSF has issued the Circulars 10/496 and 10/497, both dated 22 December 2010, to implement the CRD III[13] into Luxembourg law. The new circulars amend the own fund requirements regime for credit institutions, investment firms and UCITS management companies contained in CSSF Circulars 06/273 and 07/290. The new circulars also modify certain technical points in the Luxembourg own fund requirements regime which do not stem from the CRD III.

The CSSF Circulars 10/496 and 10/497 will enter into force on 31 December 2011 with the following exceptions. The provisions amending the large exposure regime and certain provisions concerning essentially the remuneration policy and the prolongation of certain transitional provisions have already entered into force on 31 December 2010 and 1 January 2011 respectively.

Bill n° 6216

This new bill (n° 6216) deposited with the Luxembourg Parliament implements article 36 of the EU Credit Rating Agency Regulation[14] by extending the CSSF power to impose administrative sanction under the Financial Sector Law with respect to credit rating agencies, persons associated to the activities of credit rating, outsourcing service providers to credit rating agencies, issuers and certain other persons subject to the supervision of the CSSF. Such administrative sanction powers include the possibility to issue injunction or suspension orders and to impose administrative fines on responsible persons.

The bill also implements Directive 2009/49/EC for the insurance sector and Article 1, points 3)a) and 10) of the CRD III.

Case law

Summary Proceedings: enforcement of pledges – Court of Appeal 3 November 2010

Please see Litigation section.

[12] Law dated 11 January 2008 on the transparency obligations concerning information on the issuers whose securities are admitted to trading on a regulated market

[13] Directive 2010/76/EU amending the CRD as regards capital requirements for the trading book and for re-securitizations, and the supervisory review of remuneration policies

[14] Regulation (EC) No 1060/2009 of the European Parliament and the Council on crediting rating agencies

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Banking Secrecy and Beneficial Owner – District Court 19 November 2010

Please see Litigation section.

Priority of Pledges over Criminal Law Seizures – District Court 14 October 2010

The Luxembourg District Court Council Chamber has issued an ordinance dated 14 October 2010 in respect of nullity actions engaged by pledgees against a criminal law seizure order (*saisie pénale*) issued by an investigation judge in the context of international letters rogatory proceedings.

The ordinance confirms that, while the terms of the Financial Collateral Law do not prevent an investigation judge from issuing a seizure order in respect of pledged securities, the validity and enforceability of such pledge is not affected by the seizure order and the seizure order takes fully effect only once the previously perfected pledge expires without being enforced or, in case of an enforcement, only applies to any surplus.

The ordinance is important for finance professionals because it confirms that pledges under the Financial Collateral Law, including pledges of monies or securities credited to an account, remain in principle effective in case of a criminal law seizure which increases the legal certainty in this area.

Corporate, M&A

Legislation

Since our previous legal update, two significant laws have been enacted by the Luxembourg parliament which affect the activities of companies in Luxembourg.

Money Laundering and Terrorism

Please see Banking, Finance and Capital Markets section

Alternative Investment Fund Managers Directive

The firm has prepared a specific **briefing note** which considers the Alternative Investment Fund Managers Directive primarily from the perspective of a private equity house. It focuses on the key issues which may affect the deal teams at a private equity house and on regulatory issues which may affect the operations of a private equity house. Please contact us if you would like a copy of the briefing note. The section on Investment Management in this legal update includes a general discussion of the Alternative Investment Fund Managers Directive.

International accounting principles for companies

The law dated 10 December 2010 introduces new accounting principles in Luxembourg which reflect various EC directives. It offers the possibility for Luxembourg companies to prepare their annual statements using IFRS principles as adopted by the EC Regulation N°1606/2002 of the European Parliament and of the Council dated 19 July 2002 rather than Luxembourg Generally Accepted Accounting Principles ("**GAAP**").

The main new measures introduced by this new law are summarised as follows:

- **Auditor Appointment**

The criteria for the appointment of a *reviseur d'entreprises agréé* have been modified. The accounts of a Luxembourg company will have to be supervised by a *réviseur d'entreprises agréé* if at least two of the following criteria are met on the date of the closure of the financial year :

- balance sheet total: EUR 4.4 million,
- net turnover: EUR 8.8 million, and
- average number of full-time staff employed during the financial year is greater than 50.

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- **Consolidated Accounts**

Revised definition of the criteria for the exemption of the establishment of consolidated accounts. Such exemption will apply if the consolidated accounts do not meet at least two of the three following criteria:

- balance sheet total: EUR 17.5 million,
- net turnover: EUR 35 million,
- average number of full-time staff employed during the financial year is greater than 250.

The appointment of a réviseur d'entreprises agréé will be mandatory and the exemption to establish consolidated accounts would not apply to companies having issued transferable securities (i.e. shares, other securities equivalent to shares, bonds and other forms of securitized debt) that are listed on a regulated market located in a Member State of the European Community.

Bills

The Luxembourg Parliament is currently examing the following bills:

Société par actions simplifiée - Bill n°5730

Bill n°5730 aims (i) to make significant changes to parts of the current legislation relating to commercial companies and (ii) to introduce in Luxembourg a new type of commercial company called a *société par action simplifiée* (simplified joint-stock company).

Shareholder's rights in listed companies - Bill n°6128

Bill n°6128 relates to the exercise of shareholders' rights of listed companies and implements the provisions of the Directive 2007/36/EC of the European Parliament and of the Council dated 11 July 2007.

Sell out and squeeze out process for a Luxembourg SA - Bill n°5978

Bill n°5978 would introduce a sell out and squeeze out process for a Luxembourg public limited company *(société anonyme)* whose shares are or were listed on a regulated market. Shareholders holding 95% of the share capital of the Luxembourg SA may force the repurchase of the remaining shares of the company (the squeeze-out process). Alternatively, minority shareholders may be able to sell of their shares by a shareholder holding at least 95% of the share capital of the company (the sell-out process).

Merger and Split Reporting and Documentation Requirements - Bill n°6227

Bill n° 6227 would reform certain information obligations applicable on Luxembourg companies in respect of merger or a splitting process. The bill proposes to reduce the administrative burdens on Luxembourg companies to the minimum level needed in order to protect the interests of shareholders.

It is proposed to disapply the requirement for a written report by the management bodies of each of the merging companies explaining the draft terms of merger and setting out the legal and economic terms for the merger if all the shareholders and the holders of other securities conferring voting rights of each of the companies involved in the merger agree.

It is also proposed to disapply the requirement accounting statement to be drawn up by each of the merging companies and to be made available to shareholders at least one month prior to the day fixed for the general meeting deciding on the draft terms of merger, is not required if (i) the company publishes half-yearly financial reports in accordance with Article 5 of Directive 2004/109/EC and makes it available to shareholders, or (ii) all the shareholders and the holders of other securities conferring the voting rights of each of the companies involved in the merger agree.

The bill also proposes to offer the possibility to the merging companies to communicate the relevant information/documents related to the merger through their respective Internet websites.

Circular

RCS Circular 11/1

The RCS Circular 11/1 provides foreign companies having established branches in Luxembourg with some clarifications regarding the accounts to be filed with the RCS and published in the Mémorial.

a) Accounts of the branch

All the Luxembourg branches of foreign companies are required to file with the RCS their own annual accounts, but such accounts will (except in the case described below) not be published in the Memorial and will not be publicly available.

Branches opened in Luxembourg by companies which are not governed by the law of a Member State of the European Community but which are of a legal form comparable with the types of company to which Directive

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68/151/EEC applies (i.e. SA, SCA and SARL), and whose annual accounts are not drawn up in accordance with or in a manner equivalent to Directives 78/660/EEC and 83/349/EEC are required to draw up their own annual accounts, in accordance with Luxembourg accounting principles. The branch will need to file these accounts with the RCS (and they will be publicly available) and a reference to this filing will be published in the Mémorial.

b) Accounts of the company

Foreign companies having established branches in Luxembourg are required to file the annual accounts of the company with the RCS. A reference to the filing of said annual accounts with the RCS shall be published in the Mémorial.

Investment Management

Law dated 17 December 2010 on UCIs

The new Luxembourg law dated 17 December 2010 on UCIs[15] was published in the Mémorial A on 24 December 2010 and entered into force on 1 January 2011. The main purpose of the law is to implement the UCITS IV Directive, which makes Luxembourg the first Member State to adapt its legislation with the European requirements (please see our previous legal update).

In addition, the law dated 17 December 2010 introduces other amendments to the current Luxembourg investment fund legislation, including the law dated 13 February 2007 on specialised investment funds. The new law will repeal the law dated 20 December 2002 on UCIs with effect from 1 July 2012 (with the exception of some tax provisions which will be repealed with effect from 1 January 2011, please see Tax section).

We also refer you to the **September 2010 edition of our Luxembourg Quarterly Update** relating to investment funds for an analysis of the main changes introduced by Bill 6170 (as passed into the Law of 17 December 2010) and for a summary of its transitional and amending provisions. For the sake of completeness, the new law replicates almost all the provisions of Bill 6170, except article 31 (regarding the determination by CSSF regulation of the modalities for the creation of participating shares or similar securities) which has been deleted. The other articles of the new law have been renumbered accordingly.

[15] Undertakings for collective investment

AIFM Directive on the Rails

Following eighteen months of intense debate, the European institutions reached an informal agreement on a compromise text for the Alternative Investment Fund Managers Directive[16] in late October 2010 ("**AIFM Directive**"). On 11 November 2010, the European Parliament's plenary session in Strasbourg formally adopted the compromise text by 513 votes to 92 with 3 abstentions. The text now also requires the Council's formal approval, which is expected to be given by April 2011 after completion of its legal-linguistic revision. The finalised AIFM Directive, which will be substantively identical to the compromise text, shall then enter into force on the 20th day following its publication in the Official Journal of the European Union.

The overarching objective of the AIFM Directive is to create, for the first time, a comprehensive and secure framework for the supervision and prudential oversight of alternative investment fund managers ("**AIFMs**") in the European Union. It aims at establishing common requirements governing the authorisation and supervision of AIFMs in order to provide a coherent approach to the related risks and their impact on investors and markets in Europe. To this aim, the AIFM Directive provides a framework capable of addressing systemic risks taking into account the diverse range of investment strategies and techniques employed by AIFMs.

Below is a brief overview of some of the key provisions in the text of the AIFM Directive.

Scope

Subject to the exceptions set forth below, the AIFM Directive will apply to:

- all European AIFMs which manage one or more alternative investment funds ("**AIF**") irrespective of whether the AIF is a European AIF or a non-European AIF;
- all non-European AIFMs which manage one or more European AIFs; and

[16] Directive of the European Parliament and of the Council on Alternative Investment Fund Managers

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- all non-European AIFMs which market one or more AIFs in the European Union irrespective of whether the AIF is a European AIF or a non-European AIF.

The AIFM Directive defines the AIFM as any legal person whose regular business is managing (i.e. performing at least portfolio management or risk management services to) one or more AIFs, being any collective investment undertaking, including investment compartments thereof:

- which raises capital from a number of investors, with a view to investing it in accordance with a defined investment policy for the benefit of those investors; and
- which does not require authorisation pursuant to the UCITS IV Directive[17].

Full Exemption

Notwithstanding the above, the following entities will not be subject to the AIFM Directive:

- holding companies as defined in the AIFM Directive;
- institutions which are covered by the IORP Directive[18], including, where applicable, the authorised entities responsible for managing IORP and acting on their behalf referred to in article 2(1) of the IORP Directive or the appointed investment managers pursuant to article 19(1) of the same directive, in so far as they do not manage AIFs;
- supranational institutions, such as the World Bank, the International Monetary Fund, the European Central bank, the European Investment Bank, the European development finance institutions and bilateral development banks, the European Investment Fund, other supranational institutions and similar international organisations, in case such institutions or organisations manage one or several AIFs in so far as those AIFs act in the public interest;
- national central banks;
- national, regional and local governments and bodies or other institutions which manage funds supporting social security and pension systems;
- employee participation schemes or employee saving schemes; and
- securitisation special purpose entities as defined in the AIFM Directive.

Partial Exemption

In addition, the provisions of the AIFM Directive will not apply to AIFMs in so far as they manage one or more AIFs whose sole investors are (i) the AIFM, (ii) the parent undertakings or the subsidiaries of the AIFM or (iii) other subsidiaries of those parent undertakings, provided that none of those investors itself is an AIF.

Limited Authorisation

Finally, without prejudice to any stricter rules adopted by Member States, AIFMs which either directly or indirectly through a company with which the AIFMs are linked by common management or control, or by a substantive direct or indirect holding, manage portfolios of AIFs whose assets under management:

- do not exceed a total threshold of EUR 100 million including any assets acquired through the use of leverage; or
- do not exceed a total threshold of EUR 500 million when the portfolio of AIFs consists of AIFs that are not leveraged and have no redemption rights exercisable during a period of 5 years following the date of initial investment in each AIF;

are only subject to (i) registration in their home Member State and to (ii) certain disclosure requirements relating to the monitoring of systemic risk, but will not benefit from any of the rights granted under the AIFM Directive unless they choose to “opt in”, in which case the entire directive shall apply.

General Operating Conditions and Organisational Requirements

The AIFM Directive introduces general operating conditions to be satisfied by AIFMs, including rules of good conduct, rules on remuneration policies, conflicts of interest, risk management function and risk management (requiring AIFMs *inter alia* to define a maximum level of leverage to be employed on behalf of each AIF they manage), liquidity management and investments in securitisation positions (limiting such investments to securitisation positions in which the originator, the sponsor

[17] Directive 2009/65/EC dated 13 July 2009 of the European Parliament and of the Council on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS)

[18] Directive 2003/41/EC dated 3 June 2003 the European Parliament and the Council on the activities and supervision of institutions for occupational retirement provision

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or the original lender retains a net economic interest of not less than 5%).

AIFMs will have to observe organisational requirements similar to those imposed by the MiFID Directive[19]. In addition, the AIFM Directive requires the assets of AIFs to be valued at least annually by an external valuer meeting certain conditions or by a functionally independent internal valuer. If the AIF is of the open-ended type, such valuations and calculations shall also be carried out at a frequency which both is appropriate to the assets held by the fund and its issuance and redemption frequency. If the AIF is of the closed-ended type, such valuations and calculations shall also be carried out in case of an increase or decrease of the capital by the relevant AIF.

European Passport

The AIFM Directive introduces for the first time a genuine "single market framework" for this sector, which will allow AIFMs to "passport" their services throughout Europe on the basis of a single authorisation. A European AIFM managing European AIFs will automatically enjoy the passport, i.e. once a European AIFM will be authorised under the AIFM Directive in one Member State and complies with the rules of the directive, this manager is entitled upon notification to manage or market European AIFs to professional investors throughout the European Union without having to meet any additional criteria.

For non-European AIFMs and European AIFMs managing non-European AIFs, the possibility to benefit from the passport may (but need not) be introduced 2 years after the final transposition date of the AIFM Directive (i.e. approximately in 2015) by the European Commission acting upon positive advice from ESMA[20], provided that ESMA considers that there are no significant obstacles regarding matters such as investor protection, market disruption and distortion in competition and issues a favourable opinion in that respect.

The AIFM Directive introduces an authorisation and supervision mechanism to appoint the supervisory authority of one European Member State as the home supervisor of the non-European AIFM managing and/or marketing AIFs in the European Union (the Member State of reference) who will be responsible for compliance and marketing related obligations under the AIFM Directive.

[19] Directive 2004/39/EC of the European Parliament and of the Council dated 21 April 2004 on markets in financial instruments amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC

[20] European Securities and Markets Authority

The choice of the Member State of reference will depend on the Member State in which the AIFs are established and the Member States in which the AIFs are principally marketed. ESMA will be required to advise on the appropriateness of the choice.

The AIFM Directive also provides a range of provisions to ensure effective coordination between the Member State of reference, the Member States where the AIFs are marketed and the third country where the non-European AIFM and, as the case may be, the non-European AIF is established. ESMA is given peer review powers to ensure that the authorisation is consistent across the European Union.

National Private Placement Regimes

The deferral of the implementation of a true European passport for all AIFMs and all AIFs in the European Union means that national private placement regimes will remain the standard way for non-European AIFs and non-European AIFMs to access European countries for at least the first 2 years after the final implementation date of the AIFM Directive (i.e. from 2013 to 2015).

However, non-European AIFMs relying on national private placement regimes will be subject to the AIFM Directive transparency requirements and its specific obligations with regard to AIFs acquiring control of non-listed companies and issuers, if applicable, while European AIFMs relying on the national private placement regimes for the marketing in the European Union of non-European AIFs will be subject to full compliance with the directive, except that a lighter regime shall apply with regard to depositaries. There will also need to be cooperation arrangements in place relating to systemic risk oversight between the jurisdiction of the non-European AIFM and the European jurisdiction into which the AIF is to be marketed without a passport. For a European manager seeking to market non-European AIFs without a passport, again cooperation arrangements will need to be in place between the State of the AIF and the Member State into which the AIF is to be marketed.

After the first 2 years transitional period and as mentioned above, the European passport may (but need not) be extended to the marketing of non-European AIFs by European AIFMs and to non-European AIFMs by means of delegated acts by the European Commission, following positive technical advice from ESMA. Both national private placement regimes and the passport system could then coexist for at least 3 additional years (i.e. until 2018 assuming the passport becomes available to such AIFMs

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in 2015), after which the national private placement regimes may (but need not) be terminated, again following ESMA's favourable technical advice. To be clear, if the passport regime for non-European AIFMs and European AIFMs marketing non-European AIFs in the European Union is not activated, then national private placement regimes will not be terminated.

Reverse Solicitation

Reverse solicitation was taken out of the scope of the European Commission's initial proposal. Under the adopted text of the AIFM Directive, private placement regimes and the European passport are mechanisms dealing with active marketing only. Therefore, passive acceptance of European investors' money will not set any obligations for non-European AIFMs under the AIFM Directive in motion.

Use of Leverage by Hedge Funds

AIFMs managing leveraged AIFs, such as hedge funds, are subjected by the AIFM Directive to detailed disclosure requirements regarding their use of leverage, which may be restricted by the competent authorities of the AIFM's home Member State.

Asset Stripping by Private Equity Funds

The AIFM Directive includes a number of provisions which are intended to deter private equity investors from attempting to take control of a company solely in order to make a quick profit. With a view to mitigate risks to the long-term health of companies linked to "asset stripping", the AIFM will be obliged to use its best efforts to prevent distributions, capital reductions, share redemptions and/or the acquisition of its own shares by the company which would breach net asset or profit tests prescribed by the directive, for 2 years following the acquisition of control – defined as more than 50% of voting rights for non-listed companies.

The AIFM Directive also introduces safeguards to increase the transparency of this type of investment towards the employees of the companies acquired and to address potential risks to portfolio companies acquired by private equity AIFs. In particular, the directive imposes information and disclosure requirements of significant holdings by private equity AIFs. In the event of acquisition of control, AIFMs are required to ensure that the AIF discloses relevant information in relation, for example, to the intentions with regard to the future business of the company and the likely repercussions on employment, and to the financing of the acquisition.

Depositary

AIFMs must ensure that each AIF managed by them appoints a single depositary, which may be a credit institution, investment firm or another entity satisfying certain requirements. The depositary shall in the case of European AIFs be established in the home Member State of the AIF and may, in the case of non-European AIF, be located in the AIFM's home Member State or Member State of reference, as the case may be, or subject to certain requirements in the third country where the AIF is established.

Although the exact scope of depositary liability remains to be agreed in the Level 2 implementing measures (see sub-section "Entry Into Force and Implementing Measures" below), the range of responsibilities of depositaries has been significantly increased. Depositaries will be responsible for overseeing/monitoring the AIF's activities (these monitoring duties being similar to the current UCITS rules) and ensuring that the AIF's cash and assets are appropriately protected. They will be held to a high standard of liability in the event of a loss of assets and the burden of proof will reside with the depositary.

The AIFM Directive also establishes a robust mechanism for the delegation of depositary functions and regulates carefully the circumstances under which liability can be transferred to a sub-depositary. In particular, in case of delegation of the depositary's functions, the depositary must provide a written agreement which allows the AIF or the AIFM to claim damages against the delegatee. This should ensure that at no point in the chain will liability be irretrievably lost. In addition, the AIFM Directive ensures that AIF investors are closely informed of the potential delegation of liability.

Transparency Requirements

Transparency requirements introduced by the AIFM Directive include requirements on annual reports to be made available by AIFMs, on information that must be disclosed to investors, and on reporting to competent authorities, including *inter alia* as regards the use of leverage.

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Entry Into Force and Implementing Measures

Entry into Force

The AIFM Directive will enter into force on the 20th day following its publication in the Official Journal of the European Union, following which Member States will have a two-year period to incorporate its rules into national laws (i.e. by 2013).

Grandfathering Provisions

AIFMs performing activities under the AIFM Directive before its final impementation date by Member States (i.e. 2 years after the entry into force of the directive) must fully comply with the AIFM Directive and shall, as the case may be, submit an application for authorisation within 1 year of that date unless either of the following grandfathering provisions applies:

- AIFMs that manage closed-ended AIFs before the final implementation date which do not make any additional investments after the final implementation date are not required to submit an application for authorisation under the AIFM Directive; or
- AIFMs that manage closed-ended AIFs whose subscription period for investors has closed prior to the entry into force of the AIFM Directive and have a fixed term which expires at the latest 3 years after the final implementation date may continue to manage such AIFs without needing to comply with the AIFM Directive except for the provisions relating to the annual report and, where relevant, the provisions on the obligations for AIFMs managing AIFs which acquire control of non-listed companies and issuers, or submit an application for authorisation under the AIFM Directive.

In addition, the provisions on the notification procedures will not apply to the marketing of shares or units of AIFs that are subject to a current offer to the public under a prospectus that has been drawn up and published in accordance with the Prospectus Directive[21] before the final implementation date as long as such prospectus is valid.

Finally, while the AIFM Directive generally requires AIFM managing European AIF to ensure that the AIF's depositary is located in the AIF's home Member State, the competent authorities of the home Member State of the AIF, or in case where the AIF is not regulated the competent authorities of the home Member State of the AIFM, may allow a European credit institution established in another Member State than the AIF's or AIFM's home Member State, as the case may be, to be appointed as a depositary until 4 years after the date of implementation of the AIFM Directive.

Implementing Measures

The AIFM Directive makes provision for a very extensive set of implementing measures covering a wide range of topics. On 2 December 2010, the European Commission sent a provisional request for assistance to CESR on the content of these implementing measures. To structure the work, the European Commission divided the provisional request for assistance into four sections:

- Part I covers general provisions of the AIFM Directive, authorisation of and operating conditions for AIFMs;
- Part II covers provisions relating to depositary requirements;
- Part III covers provisions relating to transparency requirements and leverage; and
- Part IV, finally, covers provisions relating to the supervision of AIFMs, including third country AIFMs.

The advice is to be delivered by 16 September 2011, in order to allow the European Commission to deliver the full package of implementing legislation at the latest 1 year before the end of the transition period for the directive.

On 3 December 2010, CESR[22] issued a call for evidence seeking stakeholders' input in relation to such provisional request for assistance. CESR has invited input to assist it and its successor, ESMA, in the development of draft advice on the content of the implementing measures. In particular, CESR has invited evidence on:

- which categories of investment managers and investment funds should fall within the scope of the AIFM Directive in different jurisdictions;
- which of the topics that will be covered by the implementing measures would be most appropriately adopted in the form of regulations or directives; and

[21] Directive 2003/71/EC of the European Parliament and of the Council of 4 November 2003 on the prospectus to be published when securities are offered to the public or admitted to trading (as amended)

[22] Committee of European Securities Regulators (which has been replaced by ESMA on 1 January 2011)

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- any useful sources of data and statistical evidence from which CESR could benefit in the preparation of its advice.

CESR has extended the deadline for responses to its call for evidence. Responses are now due by 14 January 2011.

CSSF Regulations n°10-4 / 5

Two separate regulations (n°10-4 and n°10-5) have also been adopted by the CSSF in view of the implementation of the Level 2 legislation adopted by the European Commission on 1 July 2010 (i.e. Directive 2010/42/EU regarding fund mergers, master-feeder structures and notification procedures and Directive 2010/43/EU regarding organisational requirements, conflicts of interests, conduct of business, risk management and the content of the agreement between a depositary and a management company). The CSSF regulations have also been published in the *Mémorial* A on 24 December 2010 and entered into force on 1 January 2011.

Clifford Chance is preparing a Client Briefing discussing the new legislative framework for Luxembourg UCIs.

Luxembourg Quarterly Update Relating to Investment Funds and Other Investment Vehicles

A special Newsletter dedicated to investment funds and other investment vehicles has been published in December 2010. Amongst other things, the themes developed in this Newsletter deal with:

- some recent developments impacting the UCITS industry, including the forthcoming UCITS revision (UCITS V) and the proposed change to the MiFID non-complex classification currently applicable to UCITS;
- the new task force on asset management set up by the Centre for European Policy Studies;
- the entry into force of the revised Prospectus Directive;
- the latest initiatives relating to PRIPs[23];
- the establishment of the new European financial supervisory architecture; and
- some selected legal and regulatory developments affecting Luxembourg investment vehicles such as the extension of the list of eligible collateral under CSSF Circular 07/308.

For further information please **click here.**

CSSF Circular 10/494 – EFSF Exposure Ratio

Please see Banking, Finance and Capital Markets section.

Litigation

Legislation

New judicial procedures concerning public contracts

On 1 December 2010 a new law introducing specific procedures of judicial review in respect of public contracts entered into force[24].

Luxembourg law requires public institutions wishing to award and enter into a public contract to follow the procedure foreseen by the public contracts legislation[25]. For "large-scale" public contracts[26], special rules will apply. The same applies for public contracts concerning water, energy, transport and postal services[27].

If a tenderer considers that the legislation on public contracts has been infringed in awarding a public contract, he may claim the annulment of unlawful acts of the public institution before the Luxembourg administrative jurisdictions. The law also foresees the possibility for the claimant to request from the President of the Administrative Court, sitting in summary proceedings, a stay of execution of the challenged decision or a safeguarding decision[28].

Nevertheless, if the public contract in question is a "large-scale" contract or a contract concerning water, energy, transport and postal services, the aggrieved tenderer benefits from a particular judicial review procedure established by the abovementioned law.

[23] Packaged retail investment products

[24] Law dated 10 November 2010 on the reviews concerning public contracts. This law implements the Directive 2007/66/CE with regard to improving the effectiveness of review procedures concerning the award of public contracts

[25] Law dated 25 June 2009 on public contracts and Grand-Ducal Regulation dated 3 August 2009 implementing said law. The public bodies concerned by this law are the "contracting authorities" as defined in article 2 of the law on public contracts

[26] Please refer to articles 21 and 22 of the law on public contracts

[27] These particular rules have been coordinated on the European level by European Directives the 2004/17/CE and 2004/18/CE

[28] Articles 11 and 12 of the law dated 21 June 1999 on proceedings before the administrative jurisdictions

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This law foresees that the agreement resulting from the awarding of the public contract cannot be entered into before the expiry of a period of 10 days, starting from the date of the communication of the award by fax or by electronic means. If other means of communications are used, the period is extended to 15 days. This period of time allows the tenderer to bring a claim before the President of the Administrative Court for any interim measures necessary to redress the alleged infringement of EU or national law concerning public contracts, or to prevent any other damage to tenderer's is interests.

The law specifies that the President of the Administrative Court is allowed to suspend the procedure for entering into the public contract in question. He may also remove the specifications in all the documents relating to the procedure of entering into the contract. This review has a suspensive effect and the contracting authority must postpone, as the case may be, the calling for bidders, the award, or the entering into of the agreement until notification of the order to be handed down by the judge.

Besides, the law foresees that a public contract may be declared as "ineffective" by the President of the District Court, sitting as in summary proceedings, in cases where certain formal requirements foreseen by the law have not been respected.

This may be the case, for instance, if a contract is made without prior publication of a notice in the Official Journal of the European Union; if the agreement has been concluded notwithstanding the introduction of a recourse before the administrative judge or if the contract has been made further to a global agreement concluded in infringement of the law. If the judge decides that the contract is ineffective, the consequences of such ineffectiveness are left to his discretion. He will in particular have the power to retroactively cancel all the contractual obligations concluded further to the award.

The law foresees nevertheless certain cases where the President of the District Court will not be able to declare a public contract ineffective. The law specifically foresees that the President of the District Court has the possibility not to declare the contract ineffective, even if it was entered into illegally, if he considers that there are urgent reasons of general interest requiring that the effects of the contract be maintained.

The law also empowers the judge to impose alternative penalties on the contracting authority or on the contracting entity, such as financial penalties in certain circumstances.

Case law

Free transfer of an agreement- Court of Appeal 4 March 2009

Further to this decision, transfers of agreements have become an independent institution that parties may freely use and which has full effect.

Since the publication of the Civil code, legal authors and case law focused on whether a contract can be freely transferred. Indeed, the Civil code is silent on this matter and only lays down the principles applicable to transfers of receivable debts. However, in a recent decision, the Luxembourg Court of Appeal stated that "if an agreement concluded *intuitu personae* can only be transferred with the seller's consent or at least without warning or prior notice, the transfer of an agreement not based on the consideration of the co-contracting party is free, unless if excluded when negotiating the first agreement."[29]

The Court also stated that the transfer of an agreement results in:

- replacing a party by a third party in the contractual relation and
- transferring to the third party the function of co-contracting party, and therefore all the rights and obligations related to it.

The parties are not required to fulfill the formalities of notification provided for in article 1690 of the Civil Code. Nevertheless, such a substitution, in theory, produces effects only for the future (except if agreed otherwise), as the transferee is not involved in the rights and obligations prior to the transfer.

Breach of contract may create liabilities towards third parties – Court of Appeal 9 October 2008

Agreements only produce effects between contracting parties. In principle, third parties to the agreement cannot claim the enforcement of obligations stated therein nor can they be required to perform obligations thereunder. Consequently, courts have usually ruled that third parties were not able to argue for one party's liability based on its contractual obligations under the agreement.

In a recent decision however, the Luxembourg Court of Appeal has ruled that *"a third party to an agreement may, on the basis of liability in tort, refer to a breach of contract,*

[29] "*Si un contrat conclus intuitu personae ne peut être transmis qu'avec l'accord du cédé ou du moins sans avertissement ou avis préalable, la cession d'un contrat non basé sur la considération de la personne du cocontractant est libre, sauf si elle est exclue lors de la négociation du contrat initial*"

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provided that this breach has caused damage to it"[30]. In the case at hand, the judge authorised a person to claim the liability of his contractor's subcontractor for the damage caused by the subcontractor during the construction work done in the name of the contractor.

This Luxembourg case law echoes a decision of the plenary meeting of the French Supreme Court *("assemblée plénière de la Cour de Cassation")*[31].

Under this new case law, French courts have recently considered for instance, that a third party to a shareholders' agreement could use the breach by one of the shareholders of an obligation provided in this agreement, to request the defaulting shareholder to repair the damage the third party suffered. In another case, a parent company was held to be entitled to summon the co-contracting party of its subsidiary which had wrongfully terminated the concession agreement with its subsidiary, to which the parent company was a third party.

Summary Proceedings: enforcement of pledges – Court of Appeal 3 November 2010

In case of dispute over the ownership or the possession of movable property, the judge sitting in summary proceedings may, in case of urgency, appoint a receiver to keep such property pending judicial decision.[32] One of the conditions for such an order by the judge sitting in summary proceedings is the existence of a "serious dispute" between the parties as to the ownership or the possession of assets. The summary jurisdictions in Luxembourg had the opportunity to highlight the necessity of this condition in two recent disputes in which the pledgor petitioned the judge to appoint a receiver over the pledged assets and to clarify that a pledgor may not use this route to block the enforcement of a pledge.

In the first case[33], a bank had granted a loan which was guaranteed by a pledge over shares in a company. When the debtor defaulted, the bank enforced the pledge but the debtor challenged the enforcement asking for a third party holder. The Court of Appeal rejected the claim because "*the judge for summary proceedings must be limited to considering whether the dispute concerning the ownership of the shares (…) is serious or not. (…) By appropriating the shares, the bank has acted pursuant to the contractual provisions and in accordance with the law. [The debtor] does not claim an apparent right (of ownership) over the contentious shares. Therefore, there is no serious dispute concerning the ownership or possession of the shares*".

In the second case[34], the pledgor requested the appointment of a receiver because he considered that the debtor had fully paid off his debt to the pledgee. The pledgee contested and argued that he still had a conditional claim against the debtor and a right to retain the pledge until its claims would be definitely settled.

The judge sitting in summary proceedings rejected the pledgor's request for appointment of a receiver, by highlighting that there was no element in the file that would lead to admit that the pledged assets were not the property of the pledgor. Hence, there was no dispute as to the assets' ownership.

Banking Secrecy and Beneficial Owner – District Court 19 November 2010

Luxembourg law, and in particular the AML law, requires banks to ask for specific information about the beneficial owners holding bank accounts or entering into bank intermediary transactions.

In a recent decision, the District Court of Luxembourg ruled on banking secrecy versus beneficial owners. The Court started by stating that "*the beneficial owner is not considered as a third party in respect of information concerning his relation with the holder of the account/client of the professional of the financial sector, and banking secrecy cannot be opposed to him with respect to this information*[35].

According to the Court, PFS may therefore disclose to the beneficial owner that he has been named by a client of the bank as beneficial owner of the client's account and assets. The same applies to information disclosed relating to the nature of the economic relation or the relation of control between the client and the beneficial owner. The Court nevertheless added that banking secrecy is enforceable against the beneficial owner as regards the balances and transactions made on the account held by the client. The Court also admitted that heirs of a deceased beneficial owner were entitled to obtain the production of this information before court.

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[30] "Un tiers à un contrat peut invoquer, sur le fondement de la responsabilité délictuelle, un manquement contractuel dès lors que ce manquement lui a causé un dommage"

[31] Supreme Court France (Pl. M.), 6 October 2006, n° 05-13255

[32] Article 932 of the New Code of Civil Procedure and article 1961 of the Civil code

[33] Court of Appeal, 6 June 2009, n°34674

[34] District Court., 6 May 2010, n°128384

[35] "*Le bénéficiaire économique n'est pas à considéré comme tiers par rapport aux renseignements qui concernent justement sa relation avec le titulaire du compte/client du professionnel du secteur financier, et le secret bancaire ne peut lui être opposé en ce qui concerne ces renseignements*"

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Debt Waiver – Administrative Court 29 November 2010

Please see Tax section.

Tax Unity - Administrative Court 2 December 2010

Please see Tax section.

Commercial activity - Administrative Court of Appeal 16 December 2010

Please see Tax section

Employment

Case law

An employee has to immediately inform his employer of his sickness in order to benefit of the protection against dismissal.

The Labour Code[36] provides that an employer is not entitled to terminate the employment contract of his/her employee, even in case of gross misconduct, if the employee is on sickness leave.

This prohibition however only applies under the cumulative condition that (i) the employee has informed the employer on the first day of his absence of his/her sickness and (ii) has provided at latest on the third day of absence to the employer a medical certificate confirming the sickness and the foreseeable duration of the sickness leave.

Luxembourg courts have already held on several occasions in the past that the protection against dismissal does not apply if the employee has omitted to inform his/her employer of his/her sickness on the first day of absence and limited himself/herself only to send a medical certificate within the 3 days delay. In addition, the Luxembourg courts also held that it is not sufficient that the medical certificate is posted by the employee on the third day of absence or even before, but in order to benefit from the protection against dismissal, the employee must ensure that the employer has received the medical certificate at latest on the third day of absence.

A non-compliance with these rules has the consequence that the employee will not benefit of the protection against dismissal foreseen by the Labour Code, but does not mean *ipso facto* that the non-compliance with these rules will necessarily constitute a valid reason for the employer to terminate the employee's employment contract. Depending on the specific circumstances, non-compliance with the above-mentioned rules will enable the employer to terminate the employment contract (although the latter is on sickness leave) if he has other valid grounds to do so (such as for instance underperformance, internal reorganization, economic reasons, etc).

In a recent decision[37], the Court of Appeal had to decide whether this obligation to inform the employee on the first day of absence of the sickness also applies in case of a prolongation of the sickness leave. In the case submitted to the Court of Appeal, the Labour court had previously ruled that in case of prolongation, the employer had to assume, when the employee did not return to work, that he was still sick, and hence decided that the termination of the employment contract that had been notified to the employee at the end of that day was illegal.

The Court of Appeal overruled this decision, and held that the employer has no obligation to assume the reasons of absence of his employee, but the employee has, even if he is returning from sickness leave, to comply with the information obligations foreseen by the Labour Code, and hence must inform his/her employer immediately on the first day of prolongation of his sickness leave. In the present factual background, it was not the first time that the employee did not inform the employer of his absence

[36] Article L.121-6 of the Luxembourg Labour Code

[37] Court of Appeal, 20 November 2008

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for sickness reasons within the delays foreseen by the Labour Code. Given this specific circumstance the employer was entitled to terminate the employment contract with immediate effect for grave misconduct.

Conjunctural bonus and early old age pension *("pension de vieillesse anticipée")*

The Collective Bank Bargain Agreement[38] foresees that the bank employees are entitled to a conjunctural bonus (or "June Bonus"), which is payable on 15 June of the relevant year if their employment contract is not "subject to a notice of termination on that date".

Luxembourg case law held in the past, in several decisions, that the employer does not have to pay the June Bonus if the employment contract of the relevant employee has been terminated prior to the 15 June, i.e. if the employee sent his/her resignation letter, or if the employer sent the termination letter prior to 15 June (even though the notice period and hence the employment relationship only expire after that date).

In a recent case, the Labour court of Luxembourg-City had to decide whether the same case law also applies in the event of an employee informing his employer of his/her decision to benefit of a early old age pension ("pension de vieillesse anticipée") prior to 15 June, while the starting date for this "pension de vieillesse anticipée" was after 15 June. The employer argued that as the early old age pension was not granted automatically, and as the employee had to apply for it and hence to inform his/her employer that he/she wished to end the employment relationship and to benefit of this "pension de vieillesse anticipée", the case law existing in relation to the termination of employment contracts should apply.

The Labour court of Luxembourg-City however refused[39] to endorse this position in a recent decision. On the contrary, it decided that the determining element is the date on which the "pension de vieillesse anticipée" starts, as i.a. the employee always has the right to renounce to his/her application until that date. Hence, as in the case submitted to the Labour court the employee only applied for a "pension de vieillesse anticipée" as from 30 June (despite the fact that the employee informed his/her employer prior to 15 June of his/her decision to benefit of this "pension de vieillesse anticipée"), the court ruled that the June Bonus was to be paid.

Constructive dismissal

The Labour Code[40] foresees that if an employer decides to unilaterally amend, in a material way, the existing employment conditions of an employee, he has to comply with the rules governing dismissals, i.e. except in case he can justify serious reasons which make it necessary to implement this change immediately, the employer will have to notify by registered mail the material change with the same notice period as the one which would be applicable had he decided to terminate the employment contract. He must, in addition, be able to justify this unilateral material change with valid reasons.

If the employee does not accept this material change, and the reasons provided by the employer, the employee may resign and in this case, his/her resignation will be considered as constituting a dismissal (concept of constructive dismissal).

Traditionally, the Luxembourg courts ruled that although this resignation will be considered as a dismissal notified by the employer, the employee is not entitled to the payment of a statutory severance indemnity ("indemnité de départ légale"), but only to damages, in case the labour courts came to the conclusion that the material change was not based on valid reasons. The courts considered indeed that this requalification of the resignation into a dismissal was based on a legal fiction, while the payment of a "indemnité de départ légale" was only foreseen by the Labour Code in case of a dismissal notified *ab initio* by the employer.

In a recent decision, the Supreme Court[41] overruled the decision of the Court of Appeal that had refused to grant to an employee an "indemnité de départ légale", who had resigned, and who had challenged his employer's decision to unilaterally amend the existing employment conditions, estimating that this unilateral change in his employment conditions was based on valid reasons. The Supreme Court overruled this decision and decided that even if the unilateral change in the employment conditions was based on valid reasons, the employee was entitled to the payment of the "indemnité de départ légale" for the reason that article L.121-7 LC foresees that the resignation of the employee, who does not accept the change in his employment conditions, constitutes a dismissal and that hence the employee must benefit of the statutory provisions governing dismissals and hence of the "indemnité de départ légale".

[38] Article 23.D.2 of the collective bargain agreement applicable to bank employees
[39] District Court 22 February 2010, n°701/09
[40] Article L.127-3 of the Luxembourg Labour Code
[41] Supreme Court, 18 June 2009, n° 38/09

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Enforceability of the contractual provision foreseeing that the employer has to comply with a notice period of 4 years

The Luxembourg Labour courts held in the past on several occasions that if the parties to an employment contract can foresee that the employer has to comply with a longer notice period than the statutory one when he decides to terminate the employment contract[42], this longer contractual notice period nevertheless must be proportional. A contractual provision foreseeing a longer notice period was not enforceable if considered to constitute an unreasonable limitation of the employer's right to terminate his employee's employment contract. The Labour courts have previously ruled that this right of dismissal is a right of public order, and hence any contractual provisions which limits this right in an excessive manner is null and void.

In a recent decision, the Supreme Court[43] overruled the decision of the Court of Appeal that had considered (on basis of the above-mentioned case-law) that a contractual provision foreseeing a notice period of 4 years which had to be observed by the employer was not enforceable. The Supreme Court held that this contractual provision was more favourable for the employee than the statutory provisions of Luxembourg law and hence not null and void, but to the contrary enforceable against the employer.

[42] But to the contrary, an employee can never be obliged to comply with a longer notice period than the statutory one when he decides to resign, as said contractual provisions would be null and void for constituting a contractual provision which is less favorable for the employee than the statutory provisions.

[43] Supreme Court, 28 May 2009, n° 33/09

Tax

General

Introduced before the Parliament on 30 July 2010, the law relating to new tax measures for Luxembourg has been enacted (see our last legal update relating to the bill n°6166, *projet de loi portant introduction des mesures fiscales relatives à la crise financière et économique*). As a follow-up with our previous legal update, we would like to draw your attention to the fact that several changes have been made to the initial bill which was commented on in the last legal update. The current non exhaustive list of changes is set out below:

Measures applicable to companies

- **Corporate Income Tax rate** : whilst the corporate income tax should remain the same (i.e. at a rate of 21% when profits exceed EUR 15.000 per annum), the contribution to the unemployment contribution will be increased from 4% to 5%. This would result in a combined rate of 22,05% (compared to the current rate of 21,84%). Subject to the municipal business tax rate remaining unchanged, the aggregate income tax rate for Luxembourg companies having their registered office in Luxembourg City will therefore be 28,80%.

- **Minimal tax Charge** : a minimal EUR 1,500 taxation will be levied on all unregulated entities subject to corporate income tax (i.e. impôt sur le revenu des collectivités) if its total assets are comprised of more than 90% of financial assets, securities and cash at banks (financial assets being defined according to the Luxembourg accounting classification, i.e. plan comptable normalisé compte n°23 Immobilisations financières, n°50 Valeurs mobilières, n°51 Avoirs en banques…). In respect of a Luxembourg tax group (i.e. intégration fiscale), only the top company will be subject to this minimal taxation.

- **Bonus Taxation** : so-called ‘golden handshakes’, severance payments and leaving bonuses exceeding EUR 300,000 will no longer be deductible for an employer (i.e. the exceeding portion). The law also provides for an anti-abuse measure which tackles payments spread over several years aiming to circumvent the ceiling of EUR 300,000.

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- **Investment Tax Credits** : investment tax credits are also improved. To foster investments which enhance entrepreneurial competition, the law increases the global and complementary investment credit to 7% and 13%, respectively (3% on the part exceeding the first portion over EUR 150,000). In respect of Investment tax credit, please see the ECJ case law section.
- **Environmental Investment Amortization** : the tax regime allowing a depreciation for some environmental friendly investments will be improved. In order to encourage investments that benefit the environment or that improve energy efficiency, the maximum special depreciation rate will increase from 60% to 80%.

Measures applicable to individuals

- **Marginal Tax rate** : A new marginal tax rate of 39% will be introduced (for those earning in excess of EUR 41,793 – or EUR 83,586 in case of collective taxation) and the unemployment contribution will be increased from the current 2.5% to 4% (and 6% for those earning in excess of EUR 150,000 for tax payers in class 1 / 1A and EUR 300,000 for tax payer in class 2).
- **Crisis Contribution** : In addition, a special crisis contribution of 0.8% will be levied on all types of income (namely income from employment - *revenu professionnel* -, substitution income - *revenu de remplacement* - and income from wealth - *revenu du patrimoine* -) in 2011 and 2012 but this will only apply to those earning more than the minimum basic salary.

UCITS IV

On 17 December 2010, the law relating to the implementation of UCITS IV Directive has been enacted. Please refer to our last legal update for more details (the main tax points being (i) the non taxation of capital gains realised by non Luxembourg resident investors in UCI, (ii) the specific exemption of foreign UCI managed by a Luxembourg management company and (iii) the subscription tax exemption for tracker funds).

Highly Qualified Workers tax regime

On 31 December 2010, the tax authorities issued a circular (L.I.R. 95/2) detailing the deductibility of expenses linked to the secondment of highly qualified workers in Luxembourg as well as potential tax benefit for the said secondees.

For further information please **click here.**

EU Directives

EU Savings Directive – UCITS and asset test

The impact of the EU Savings Directive on income arising from distributions and redemptions/refund/sale of shares or units of Luxembourg UCITS are mainly based on an "asset test" approach. As of 1st January 2011, if a UCITS invests directly or indirectly, more than **25%** (40% before 1 January of 2011) of its assets in debt claims, income arising from the redemption/refund/sale of units or shares of such UCITS are characterized as interest. The *de minimis* rule whereby dividends paid by a Luxembourg UCITS are not characterized as interest to the extent that the UCITS invests, directly or indirectly, less than 15% of its assets in debt claims remains unchanged.

Directive on administrative cooperation in direct tax matters – the ministers of finance of the EU reached a political compromise on 7 December 2010

One of the main purposes of the directive is to establish the **exchange of information upon request** as a general principle of exchange of information within Europe in direct tax matters. The directive will implement a regime of exchange of information, which is largely influenced by OECD works. The conditions for the exchange of information upon request under the directive are indeed almost the same as those foreseen in the recent bilateral agreements entered into / renegotiated by Luxembourg (those agreements are already in line with OECD internationally agreed standard).

Consequently, as Luxembourg has already concluded with most of the EU Member States bilateral tax treaties including an OECD compliant provision for the exchange of information upon request, the entry into force of the directive will not significantly impact the situation in Luxembourg with regards to the exchange of information with other EU Member States.

Based on the directive, the tax authorities of a Member State may have to exchange information concerning a particular taxpayer when requested by another Member State and may also have to make the necessary inquiries to obtain such information. Even if the objective of the directive is that the exchange of information takes place to the widest possible extent, it is forbidden for a Member State to conduct "fishing expeditions" in another Member State or to request information that is unlikely to be relevant to the tax affairs of a given taxpayer. A Member State should however not refuse to transmit the information because it has no domestic interest or

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because the information is held by a bank or by other financial institutions.

The exchange of information upon request will apply to cross-border relations within Europe as from 1 January 2013 (prior exchange of information may take place based on double tax treaties concluded by Luxembourg including an exchange of information provision in line with the OECD principles).

Moreover, the new directive deals with the **automatic exchange of information** between Member States. Automatic exchange of information should begin as from 1 January 2015 and may apply only for some categories of income (employment income, director's fees, income from certain life insurance products, pension, ownership of and income from immovable property). Each Member State may choose three categories of income for which automatic exchange of information will apply. It is worthwhile to note the two following points:

- The automatic exchange of information can only concern data / information that is already available to the tax authorities. In other words, the tax authorities may not request from a third party (e.g. a bank) to provide information on a taxpayer in order to automatically communicate the information to foreign tax authorities.
- The directive does not target savings income in the meaning of the EU savings directive (Council Directive 2003/48/EC). The automatic exchange of information under the new directive has no impact on the "transitional period" provided for by the savings directive. Luxembourg may therefore continue to apply the withholding tax regime to income entering into the scope of the savings directive.
- The directive does not prevent Luxembourg to maintain its bank secrecy as an instrument of protection of the private life.

Tax Treaties

Applicable as from January 2011

Amongst several new treaties that have recently been concluded, the following new agreements are applicable as of 1 January 2011 for taxes withheld at source and to any fiscal year beginning on / or after 1 January 2011 for other income and wealth taxes:

- **Monaco** : the double tax treaty between Luxembourg and Monaco signed on 27 July 2009.

For further information please **click here.**

- **Qatar** : the double tax treaty between Luxembourg and Qatar signed on 3 July 2009.

For further information please **click here.**

- **Armenia** : the double tax treaty between Luxembourg and Armenia signed on 23 June 2009.

For further information please **click here.**

- **Bahreïn** : the double tax treaty between Luxembourg and Bahreïn signed on 6 May 2009.

New tax treaty signed

- The double tax treaty between Luxembourg and **Panama** has been signed on 7 October 2010 and aims to improve the competitiveness of Luxembourg industry and, at the same time complying with the international standards for the effective exchange of information, as set out by the OECD.

Reminder : Swiss-Luxembourg amendments

On 25 August 2009, Luxembourg and Switzerland have signed a protocol amending the Luxembourg- Swiss double tax treaty, originally signed on 21 January 1993. This protocol includes the provision regarding the exchange of information upon request in line with the OECD model convention.

In addition, the protocol softens the conditions for benefiting from withholding tax reduction / exemption on dividends. Accordingly, dividend payments may be subject to no or a reduced 5% withholding tax if the recipient holds more than 10% of the share capital of the paying company (vs prior required 25% holding) during 2 years. Concurrently, the exemption is also extended to dividends paid to pension funds.

Case law

Debt Waiver – Administrative Court 29 November 2010

Recent case law relating to debt waivers - *gain d'assainissement* - has disclosed the conditions required by the tax authorities. The tax authority position is that if all (or at least the majority of) creditors waive their receivables, the waivers are deemed to benefit from the exemption provided for by the article 52 of the Luxembourg income tax law. Alternatively, a single creditor waiver should be further analysed in the light of its objective to determine if the said article is applicable. In the present case law, it should be underlined that,

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surprisingly, the taxpayer did not formally claim for the application of the article 18 of the Luxembourg income tax law (i.e. *notion d'apport caché*).

Tax Unity – Administrative Court 2 December 2010

The Luxembourg court confirmed on 1 December 2010 their position on horizontal tax unity denying the application of article 164bis of the Luxembourg income tax law to sister companies. In addition, the Luxembourg court did not refer to the European Court of Justice for a preliminary ruling based on discrimination.

Commercial activity – Administrative Court of Appeal 16 December 2010

The Luxembourg Court confirmed its position according to which any foreign limited liability company having a Luxembourg permanent establishment is subject to Municipal Business Tax whatever activity it renders in Luxembourg (e.g. non commercial activity). It denies the application of the "isolated analysis" (i.e. *Isolierende Betrachtungsweise*) for Municipal Business tax purposes and clarifies the impact of double tax treaties in Luxembourg (treaties do not create any autonomous right to tax and do not jeopardize the domestic tax qualification of income).

Investment Tax Credit – ECJ 22 December 2010

Further to our last legal update (see our comments on Tribunal Adm. 8 June 2010, n°25669), the European Court of Justice issued a ruling on the Luxembourg investment tax credit. Based on the free movement of capital , the ECJ clearly states that the benefit of the Luxembourg tax credit for investments could not be denied to a Luxembourg company "on the sole ground that the capital goods, in respect of which that credit is claimed, are physically used in the territory of another Member State" (see Tankreederi I SA, ECJ C-287/10).

VAT on payments and transfers - ECJ 28 October 2010

On 28 October 2010, the European Court of Justice delivered a ruling relating to the VAT treatment of certain payment-related services. The ECJ confirmed that, in order to be exempt, a service must, when viewed broadly, form a distinct whole, fulfilling the specific, essential functions of a service within the exemption applicable to "transactions concerning payments and transfers". Concurrently, the ECJ ruled that "debt collection" extended to any financial transaction to obtain payment of a pecuniary debt.

For further information please **click here.**

Indirect taxes - VAT

Reorganization of the Luxembourg VAT authorities

A ministry regulation (*règlement ministériel*) dated 4 November 2010 modified the Luxembourg VAT office allocations. As of 2011 the VAT office allocation will not be determined geographically (as it is the case currently) but on the basis of the activity carried out. It should be highlighted that a single VAT office will be competent for all entities carrying out a financial activity.

VAT forms

As of 2011, the indirect tax authorities will no longer send hard copies of VAT forms to taxpayers. Taxpayers will have to download such forms on the web site of the indirect tax authorities (www.aed.lu) to abide by their compliance obligations.

Luxembourg VAT law changes as of 2011

The Luxembourg law dated 17 December 2010 amended the Luxembourg VAT law by implementation of certain recent EU Directives (2008/8/EC, 2009/69/EC, 2009/162/EU and 2010/66/EU) aiming at (i) clarifying certain provisions related to the "VAT package" in relation to the place of supply of cultural, artistic, sporting, scientific, educational, entertainment or similar activities, such as fairs and exhibitions, including the supply of services of the organisers of such activities, (ii) amending the definitions of supply of electricity and gas and adding to these heat or cooling energy in the context of the determination of the place of supply of such goods and (iii) amending certain provisions as to imports in the context of the fight against tax evasion linked to imports.

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