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Luxembourg Legal Update

September 2011

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Banking, Finance & Capital Markets

Law of 20 May 2011
Financial Collateral, Clearing and Settlement and E-Money Institutions

The Luxembourg Parliament has, by a law dated 20 May 2011, adopted bill N° 6164. The new law amends Luxembourg legislation on financial collateral arrangements, settlement finality and electronic money institutions. The bill is described in more detail in the **January 2011 edition of our Luxembourg Legal Update**, which includes details of the innovations introduced in the new regime for electronic money institutions.
The CSSF has also issued Circular 11/517 dated 5 July 2011 on the entry into force of this new law which provides an overview of its innovations including in particular, and amongst others:

- a new definition of electronic money; and
- a new prudential regime for electronic money institutions aligned with the regime applicable to payment institutions.

CSSF Circular 11/514
Co-Operation by Credit Institutions with Investigating Judge

The CSSF[1] has issued a new Circular 11/514 on the co-operation of a credit institution with the office of the Luxembourg investigating judge. The new circular draws the attention of credit institutions to their new duties of co-operation, introduced into the Luxembourg Criminal Investigation Code[2] by the law dated 27 October 2010 (as to which, please see the **January 2011 edition of our Luxembourg Legal Update**). According to these new provisions, the investigating judge may, in certain circumstances, request a credit institution to provide information and documents relating to business relationships which such credit institution has or has historically had with a specific person who is subject to a criminal investigation. All credit institutions have been asked to provide certain contact details to the office of the investigating judge.

[1] *Commission de surveillance du secteur financier*, the Luxembourg financial sector regulator.
[2] *Code d'instruction criminelle.*

Fight against Money Laundering and Financing of Terrorism

Grand-ducal Regulation of 3 August 2011
Implementation of UN Security Council Decisions

The Grand-ducal regulation dated 3 August 2011 amends the Grand-ducal regulation dated 29 October 2010 by annexing to it two other decisions of the Security Council of the United Nations, thereby implementing them into Luxembourg law and extending the legal framework, created by the law of 27 October 2010 (as to which, please see the **January 2011 edition of our Luxembourg Legal Update**), for the implementation of decisions by the Security Council of the United Nations (as well as acts adopted by the EU Council) concerning prohibitions and restrictive measures in financial matters in respect of certain persons, entities and groups in the context of the combat against terrorist financing.

CSSF Circular 11/516
Jurisdictions List

CSSF Circular 11/516 contains a list of jurisdictions whose AML[3] regime has substantial and strategic deficiencies and a list of jurisdictions whose AML regime is not satisfactory. The Circular reflects and draws the attention of professionals to the new underlying FATF declarations issued in June 2011. CSSF Circular 11/502 (as to which, please see the **May 2011 edition of our Luxembourg Legal Update**) has accordingly been repealed by CSSF Circular 11/516.

CSSF Circular 11/519
AML Risk Analysis Requirement

CSSF Circular 11/519 dated 19 July 2011 clarifies the requirements of the CSSF relating to the AML risk analysis that credit institutions have to perform under Luxembourg AML laws. In this respect, the CSSF requires two different stages to be completed:

- Firstly, the management of the institution must identify the AML risks to which the credit institution is exposed. It should then develop a methodology to categorise these risks. In this respect, the new Circular lists (i) certain characteristics that may provide important information for the analysis and risk assessment of AML, linked to the nature of the clientele (e.g. the geographic origin or sector of activity or profession of the client, or the complexity

[3] Anti-money laundering and counter-terrorism financing.

of the structure that was set up for their benefit), and (ii) certain elements that have to be taken into account concerning the AML risk identification with respect to the offered products and services (e.g. the possibility of opening pass-through accounts, holding mail arrangements for account statements, or providing services to occasional clients).

- Secondly, the management must complete its risk analysis by producing a clear and precise description of the measures taken in order to mitigate the risks identified during the first stage. In this respect, the institution must describe the AML measures put in place at various levels, as described in the circular (e.g. client acceptance process, account blocking system, regular client relationship review process, business relationship termination process, name matching and country matching systems, co-operation with authorities, corporate governance and staff training process). The analysis must also show the number of clients to which enhanced and/or simplified customer due diligence measures are applied and the specifics of the application of such measures.

An additional aim of this circular is to conduct a census of certain key information by means of the self-assessment which each institution will complete in accordance with the AML laws and this new circular. The circular contains further instructions and a link to the website from which the questionnaire can be downloaded, to be completed and returned to the CSSF no later than 30 September 2011.

Ministerial Regulations of 17 June and 25 July 2011
AML measures

Ministerial Regulations of 17 June and 25 July 2011 to the Grand-ducal regulation of 29 October 2010 add thereto the names of certain persons who are subject to restrictive measures and prohibitions under AML laws.

Payment Institutions

CSSF Circular 11/510
Central Administration and Infrastructure of Payment Institutions

The CSSF has issued a new Circular 11/510 specifying the central administration and infrastructure requirements applicable to payment institutions. In particular, the new Circular states that the principles and provisions applying to Luxembourg credit institutions and investment firms as regards central administration and infrastructure now apply *mutatis mutandis* to payment institutions as well.

CSSF Circular 11/511
Periodic Reporting for Payment Institutions

The CSSF has specified in its Circular 11/511 dated 23 May 2011 its requirements as regards periodic reporting of Luxembourg payment institutions to the CSSF. The new Circular sets forth a detailed schedule of information that the payment institutions shall communicate periodically to the CSSF in order to enable it to fulfill its supervisory functions over this new type of regulated entity.

Capital Requirements Directives

CSSF Circular 11/507
Coverage of Securitisation Credit Risk for Banks

The CSSF has published Circular 11/507 dated 28 March 2011 on the Guidelines of the European Banking Authority (the EBA, formerly CEBS) concerning Chapter 2-1 of Part X (points 8-1 to 8-8) of CSSF Circular 06/273, as amended. These Luxembourg provisions implement Article 122a of Directive 2006/48/EC, as amended by the CRD II[4], and concern the capital requirements for securitised credit risks for banks which have exposures within the framework of securitisations as well as minimal conditions applying to credit institutions, other than when acting as originator, sponsor or original lender. The Circular has implemented with immediate effect the new «*CEBS guidelines to Article 122a of the Capital Requirements Directive* » from the EBA in Luxembourg. Article 122a applies not only to transactions that are subject to the Luxembourg law of 22 March 2004 on securitisation, as amended, but also to other Luxembourg transactions which may not be subject to the Securitisation Law but nevertheless qualify as a securitisation for the purposes of Article 122a.

CSSF Circular 11/513
Amendments to Prudential Reporting Regarding Capital Adequacy

CSSF Circular 11/515 dated 6 June 2011 amends the prudential reporting tables as a consequence of the implementation of the CRD II by CSSF Circular 10/475 and of the CRD III[5] by CSSF Circular 10/496 as well as the amendments to reporting standards published by EBA in this area. These modifications will be applicable in Luxembourg as of 31 December 2011.

[4] Directive 2009/111/EC.
[5] Directive 2010/76/EC.

This Circular also draws the attention of credit institutions to the fact that, as of 31 December 2012, uniform reporting forms will apply in the European Union which will be published in the course of 2012, reflecting harmonisation efforts undertaken by the EBA.

CSSF Circular 11/515
Law of 28 April 2011 and New Licence Requirement for Non-EU/EEA Finance Professionals

The CSSF has published Circular 11/515 dated 14 June 2011 on the entry into force, on 9 May 2011, of the law of 28 April 2011 implementing certain parts of Directive 2009/111/EC amending the CRD, certain parts of Directive 2009/14/EC amending the Deposit Guarantee Systems Directive and Directive 2009/49/EC concerning certain publicity obligations for mid-sized companies and their obligation to establish consolidated accounts. The Circular contains an overview of the changes to Luxembourg legislation implemented by this new law. We refer you to the **January 2011 edition of our Luxembourg Legal Update** in respect of such overview (Bill N° 6165).

Circular 11/515 also contains important further specifications as to how the CSSF applies the new licence requirement, introduced under the Financial Sector Law[6] for non-EU/EEA finance professionals which, though they are not established in Luxembourg, come occasionally and temporarily to Luxembourg, notably to take deposits or other repayable funds from the public as well as to provide any other service within the scope of the Financial Sector Law in Luxembourg. More detailed information can be found in this **Client Briefing**.

Impact Assessment of the New Basel III Liquidity Rules

The BCL[7] and the CSSF have, in the first quarter of 2011, jointly conducted a local Quantitative Impact Study (QIS) of the new Basel III liquidity standards, published by the Basel Committee on Banking Supervision (BCBS) in December 2010.

The CSSF published on its website on 16 June 2011 a summary of a presentation given to a conference organised by the Luxembourg Banks and Bankers Association (ABBL), on the results of the QIS in Luxembourg and the expected impact of the new liquidity standards for Luxembourg. The survey was based on data as at 31 December 2010 and the sample of banks was chosen such as to be representative of the Luxembourg financial sector in terms of the total assets, the number of banks, the business models and the size of the banks surveyed. In total, 59 banks (40% of total banks), representing EUR 591bn in assets (77% of the total assets) participated in this survey.

In June 2010, the BCL published a Luxembourg case study concerning the impact of the Basel III liquidity regulations on the bank lending channel.
The BCL and CSSF have announced a follow-up QIS which will be conducted in the third quarter of 2011, based on data as at 30 June 2011.

Transparency Law

CSSF Press Release 11/20 of 1 June 2011
Naming and Shaming – Publication of List of Luxembourg Issuers in Default of Publishing their Annual Report

The CSSF has announced in a recent press release the publishing of a list of Luxembourg issuers, subject to the Transparency Law[8], in default of publishing their annual report in respect of financial years ending on 31 December 2010 or later. Inclusion on this list will be triggered as soon as the CSSF notes a delay in publication, irrespective of the reasons or origins thereof. The delay is noted on the closest date possible to the first publication of the present list, or to its respective update. The CSSF reiterates that it may also take additional measures where these are necessary in order to ensure compliance with the provisions of the Transparency Law. The list of issuers which failed to publish their annual report will be published on the CSSF's website and will be updated on a regular basis.

CSSF Press Release of 29 June 2011
IFRS Standards – Minimum Information – Issuers subject to Transparency Law

As part of its supervisory functions, the CSSF has analysed compliance by issuers subject to the Transparency Law that have established financial information for 2010 according to IFRS[9] with certain minimum disclosure requirements under IFRS, notably the following standards: IAS 1 "Presentation of Financial Statements", IAS 10 "Events after the Reporting Period" and IFRS 8 "Operating Segments". The CSSF reached the conclusion that the information provided by a significant

[6] Law of 5 April 1993 on the financial sector.
[7] *Banque Centrale de Luxembourg*, the Luxembourg Central Bank.

[8] The law of 11 January 2008 on transparency requirements for issuers of securities, as amended.
[9] International Financial Reporting Standards.

number of issuers did not meet the required standards. The CSSF therefore stresses the importance of certain minimum disclosure requirements that should be included in the financial statements drawn up in accordance with IFRS, in particular regarding the requirements of the above-mentioned standards.

Case Law

Court of Appeal, 16 March 2011
Moral Damage in Case of Disclosure of Confidential Data by a Luxembourg Bank to the Tax Authorities

Luxembourg law requires banks to keep confidential any information confided to them in the course of their professional activity.

In a judgment of 2 April 2003, the 4th chamber of the Court of Appeal[10] held that the bank's obligation of professional confidentiality is an obligation of result. This means that the bank is presumed to be liable for damages caused by any unlawful disclosure of confidential information without the client being required to prove the existence of a fault on the part of the bank. As a consequence, the bank can, in principle, only escape liability by proving the occurrence of an event of force majeure.

In the case underlying the 2003 judgment, confidential information concerning the client of a Luxembourg bank came into the possession of the Belgian tax authorities which consequently adjusted previous tax bills of the client. The question was therefore whether the client had suffered damage as a result of the disclosure. The court held that the debt vis-à-vis the Belgian tax authorities existed notwithstanding the breach of the bank's confidentiality duty. Accordingly, the payment by the taxpayer to extinguish such debt did not constitute material damage. The court however held that the client had suffered a 'moral damage' to the amount of EUR 25,000 caused by the invasion of privacy and the breach of the client's legitimate expectation vis-à-vis the bank to keep the client's information confidential.

The 7th chamber of the Court of Appeal[11] in a judgment dated 16 March 2011 denied the existence of a moral damage in a similar case of unlawful disclosure by a Luxembourg bank to the Luxembourg tax authorities. The court in particular denied the invasion of privacy because the information was owed by the claimant to the tax authorities and the claimant could not prove disclosure to the public of bank data. The court also held that the alleged moral damage of a loss of confidence in the application of banking confidentiality by the bank actually consists only of the disappointment at having to pay taxes owed and is thus not sufficiently specific and autonomous from the tax debt to constitute moral damage.

In light of the arguably diverging decisions of the two different chambers of the Court of Appeal, it remains to be seen how Luxembourg courts will decide in respect of alleged moral damage caused by a violation of the bank confidentiality obligation of a Luxembourg credit institution in the future.

[10] Court of Appeal, 2 April 2003,n°26050
[11] Court of Appeal, 20 March 2011, n°35545.

Corporate, M&A

Legislation

Some significant changes entered into force in the general provisions of Luxembourg corporate law during the period covered by the present newsletter. These changes may affect the activities of Luxembourg companies.

Law of 24 May 2011
Reform of Shareholders' Rights in Shareholders' Meetings of Listed Companies

The law of 24 May 2011 relating to the exercise of shareholders' rights in the shareholders' meetings of listed companies and transposing into Luxembourg law the provisions of Directive 2007/36/EC of the European Parliament and of the Council of 11 July 2007 on the exercise of certain rights of shareholders in listed companies was adopted by the Luxembourg parliament and published in *Memorial* on 27 May 2011.
This law introduces new specific rights for the shareholders of Luxembourg companies whose shares are listed on a regulated market established in a Member State. These rights are in addition those which they already have according to the provisions of the Companies Law.
This law implements measures in Luxembourg which (i) ensure the provision of sufficient and adequate information to shareholders in a timely manner prior to general meetings, notably through modern technologies which offer possibilities to make information instantly accessible (e.g., on Internet websites), and (ii) facilitate the participation of shareholders at shareholders' meetings and voting rights by way of proxy or other electronic means of communication.
The main measures of this law have been described in detail in our previous newsletter, please see the **May 2011**

edition of our Luxembourg Legal Update. This law entered into force in Luxembourg as of 1 July 2011.

Law of 3 August 2011
Reform of Reporting and Documentation Requirements in Cases of Mergers and Divisions of Companies

The law of 3 August 2011 relating to the reporting and documentation requirements in cases of mergers and divisions of companies and transposing into Luxembourg law the provisions of Directive 2009/109/EC of the European Parliament and of the Council of 16 September 2009 amending Council Directives 77/91/EEC, 78/855/EEC and 82/891/EEC, and Directive 2005/56/EC as regards reporting and documentation requirements in case of mergers and divisions, was adopted by the Luxembourg parliament and published in *Memorial* on 12 August 2011.

This law reforms certain information requirements, some of which seemed outdated or excessive, imposed on Luxembourg companies in the framework of mergers or divisions in order to reduce the administrative burden on Luxembourg companies to the minimum needed in order to protect the interests of shareholders.
Thus, this new law has changed the requirements with respect to the written report outlining the draft terms of a merger and setting out the legal and economic grounds for it (in particular the share exchange ratio) which is to be prepared by the management bodies of each of the merging companies. This new law foresees that such reports are no longer required if all of the shareholders and holders of other securities conferring a right to vote of each of the companies involved in the merger process have so agreed.

However, the management bodies of each of the merging companies are now required by law to inform the shareholders of any significant change in the assets and debts of the companies which may occur between the date of publication of the common merger plan of the companies and the date on which the shareholders of each merging company shall vote on the merger project.

In addition, the new law provides that the accounting statement to be drawn up by each of the merging companies and which is to be made available to shareholders at least one month prior to the day fixed for the general meeting which is to decide on the draft terms of a merger shall not be required in certain circumstances. These include (i) if the company publishes a half-yearly financial report in accordance with article 4 of the law of 11 January 2008, as amended, and makes this report available to its shareholders, or (ii) if all of the shareholders and holders of other securities conferring a right to vote of each of the companies involved in the merger have so agreed.

The new law finally offers merging companies with the possibility to publish relevant information/documents related to the merger on their respective Internet websites.

These new measures set out in the law are immediately applicable to Luxembourg companies, with the exception of those Luxembourg companies whose common merger plans have already been published in *Memorial*.

Circulars

RCSL Circular 11/2 of 3 August 2011
Branch Registration Process

The RCSL Circular 11/2 issued on 3 August 2011 by the Register of Commerce provides foreign commercial companies wishing to establish branches in Luxembourg with clarification regarding the documentation required for the registration of such branches with the Register of Commerce. Distinction is made in the circular between foreign companies with regard to the extent of the documentation which is required for the registration of their branches.

i. *Branches opened in the Grand Duchy of Luxembourg by a company which is governed by the laws of another Member State of the European Community and to which Directive 68/151/EEC of 9 March 1968 applies*

According to RCSL Circular 11/2, branches opened in the Grand Duchy of Luxembourg by a company which is governed by the laws of another Member State of the European Community and to which Directive 68/151/EEC of 9 March 1968 applies shall be required to disclose certain information relating to it and its mother company, and in particular the following:

(a) the address of the branch;

(b) details of the activities of the branch;

(c) the register in which the files of the mother company are kept, together with the number under which the mother company is registered with that register;

(d) the corporate name and legal form of the mother company;

(e) the name of the branch, if it is different from the corporate name of the mother company;

(f) the appointment, termination of office and details of the persons who are authorised to represent the mother company in dealings with third parties and in legal proceedings as a company body constituted pursuant to law or as members of any such body;

(g) the appointment, termination of office and details of the persons who are authorised to represent the mother company in dealings with third parties and in legal proceedings as permanent representatives of the mother company for the activities of the branch, with an indication of the extent of their powers.

The information listed above must be filed with the Register of Commerce and published in *Memorial*.

ii. Branches opened in Luxembourg by companies which are not governed by the laws of a Member State of the European Community but which are of a legal form comparable with the types of company to which Directive 68/151/EEC applies

According to RCSL Circular 11/2, branches opened in Luxembourg by companies which are not governed by the laws of a Member State of the European Community, but which are of a legal form comparable to the types of companies to which Directive 68/151/EEC applies (*i.e.*, SA, SCA and SARL), are required to file with the Register of Commerce and publish in *Memorial* certain information and, in particular, the following:

(a) the address of the branch;

(b) details of the activities of the branch;

(c) the governing law of the mother company;

(d) the register in which the files of the mother company are kept, together with the number under which the mother company is registered with that register;

(e) the legal form of the mother company, its registered office and object and, at least annually, the amount of subscribed capital if this information is not provided in its constitutive instrument and articles of association;

(f) the corporate name of the mother company;

(g) the name of the branch, if it is different from the corporate name of the mother company;

(h) the appointment, termination of office and details of the persons who are authorised to represent the mother company in dealings with third parties and in legal proceedings as a company body constituted pursuant to law or as members of any such body. The extent of the powers of those persons must be stated, together with whether they may act alone or must act jointly;

(i) the appointment, termination of office and details of the persons who are authorised to represent the mother company in dealings with third parties and in legal proceedings as permanent representatives of the mother company for the activities of the branch, with an indication of the extent of their powers. The extent of the powers of those persons must be stated, together with whether they may act alone or must act jointly.

In addition, the constitutive instrument and articles of association of the mother company, if they are contained in a separate instrument, as well as all any amendments to these documents, must be filed with the Register of Commerce and published in *Memorial*.

iii. Branches opened in Luxembourg by companies which are not of a legal form comparable with the types of companies to which Directive 68/151/EEC applies

According to RCSL Circular 11/2, the constitutive instrument of the mother company, as well as all of the amendments to this document, are the only documents which must be filed with the Register of Commerce and published in *Memorial*.

In such cases, no information related to the branch needs to be filed and published.

CSSF Regulation N°11-01 of 8 July 2011
Audit and Accounting Matters

Since the enactment of the law of 18 December 2009, the CSSF has been in charge of the supervision of the audit profession and has issued several recommendations and circulars in this respect.
On 8 July 2011, the CSSF issued technical regulation N°11-01 relating to the audit profession (repealing the former regulation N°10-01 on the audit profession) whereby (i) it adopts new international accounting rules which shall now be applicable in Luxembourg, (ii) clarifies the scope of certain activities of *réviseurs d'entreprises agréés* and provides some guidance to *réviseurs d'entreprises agréés* with respect to these activities and (iii) adopts a code of deontology for the audit profession.

i. Adoption of international accounting rules (ISA)

According to regulation N°11-01, the following international accounting rules (ISA) are now applicable in Luxembourg with regard to the audit profession as of 1 January 2011.

200–299 General principles and responsibilities

- ISA 200, Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing
- ISA 210, Agreeing the Terms of Audit Engagements
- ISA 220, Quality Control for an Audit of Financial Statements
- ISA 230, Audit Documentation
- ISA 240, The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements
- ISA 250, Consideration of Laws and Regulations in an Audit of Financial Statements
- ISA 260, Communication with Those Charged with Governance
- ISA 265, Communicating Deficiencies in Internal Control to Those Charged with Governance and Management

300–499 Risk assessment and response to assessed risks

- ISA 300, Planning an Audit of Financial Statements
- ISA 315, Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment
- ISA 320, Materiality in Planning and Performing an Audit
- ISA 330, The Auditor's Responses to Assessed Risks
- ISA 402, Audit Considerations Relating to an Entity Using a Service Organization
- ISA 450, Evaluation of Misstatements Identified during the Audit

500–599 Audit evidence

- ISA 500, Audit Evidence
- ISA 501, Audit Evidence — Specific Considerations for Selected Items
- ISA 505, External Confirmations
- ISA 510, Initial Audit Engagements — Opening Balances
- ISA 520, Analytical Procedures
- ISA 530, Audit Sampling
- ISA 540, Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures
- ISA 550, Related Parties
- ISA 560, Subsequent Events
- ISA 570, Going Concern
- ISA 580, Written Representations

600–699 Using the work of others

- ISA 600, Special Considerations — Audits of Group Financial Statements (Including the Work of Component Auditors)
- ISA 610, Using the Work of Internal Auditors
- ISA 620, Using the Work of an Auditor's Expert

700–799 Audit conclusions and reporting

- ISA 700, Forming an Opinion and Reporting on Financial Statements
- ISA 705, Modifications to the Opinion in the Independent Auditor's Report
- ISA 706, Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report
- ISA 710, Comparative Information — Corresponding Figures and Comparative Financial Statements
- ISA 720, The Auditor's Responsibilities Relating to Other Information in Documents Containing Audited Financial Statements

800–899 Specialised areas

- ISA 800, Special Considerations — Audits of Financial Statements Prepared in Accordance with Special Purpose Frameworks
- ISA 805, Special Considerations — Audits of Single Financial Statements and Specific Elements, Accounts or Items of a Financial Statement
- ISA 810, Engagements to Report on Summary Financial Statements

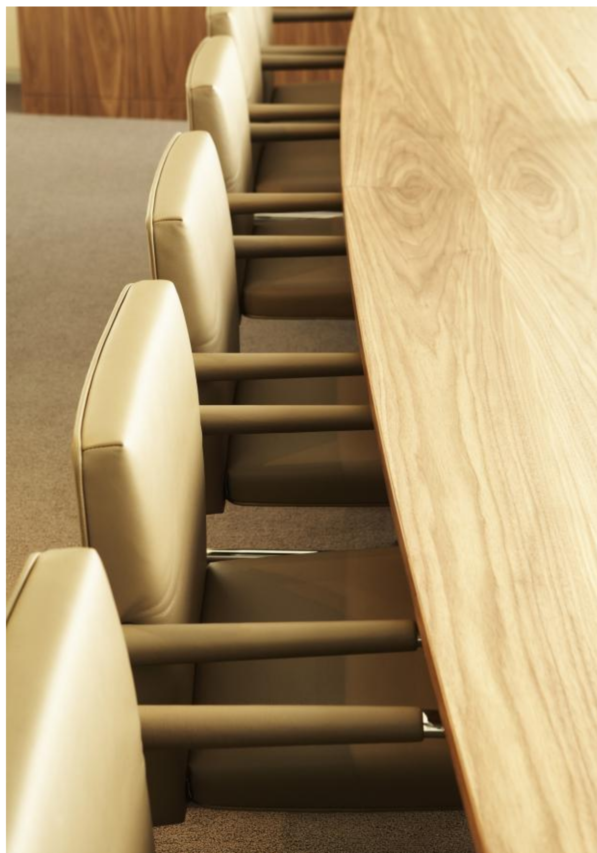
ii. Clarification of the scope of certain activities of réviseurs d'entreprises agréés

The CSSF has also clarified the scope of certain activities of *réviseurs d'entreprises agréés* (*e.g.*, the review of contributions in kind to Luxembourg SAs, the establishment of reports on the merger operations of Luxembourg companies, the establishment of reports

concerning the liquidation of Luxembourg companies) and has provided some guidance to *réviseurs d'entreprises agréés* with regard to these activities.
Thus, regulation N°11-01 now authorizes *réviseurs d'entreprises agréés* auditing the annual accounts of Luxembourg SAs to review the contributions in kind which could be made to such Luxembourg SAs.
It also offers *réviseurs d'entreprises agréés* auditing the annual accounts of Luxembourg SAs with the option to prepare the report on the merger process of the Luxembourg SA.

iii. Adoption of a code of deontology for the audit profession

The CSSF has finally adopted the International Standard on Quality Control (ISQC 1) established by the International Auditing and Assurance Standards Board (IAASB), which is now applicable to the audit profession in Luxembourg. The International Standard on Quality Control (ISQC 1) deals with the responsibilities of audit firms for their system of quality control for audits and reviews of financial statements, and other assurance and related services.
The CSSF has also decided to apply the deontology code adopted on 1 January 2011 by the International Ethics Standards Board for Accountants (IESBA) to the audit profession in Luxembourg.



Funds & Investment Management

Entry into Force of the AIFM Directive and Consultation on Implementing Measures

Entry into Force of the AIFM Directive

On 27 May 2011 the Council adopted the finalised text of the AIFM Directive[12], following the legal-linguistic revision of the draft text of the AIFM Directive as approved by the European Parliament on 11 November 2010. The AIFM Directive was published in the *Official Journal of the European Union* on 1 July 2011 and came into force on 21 July 2011. Member States have two years to transpose its provisions into national law (*i.e.* this process must be completed by 22 July 2013).

Existing EU AIFMs[13] managing EU AIFs[14] will benefit from a transitional period of one year after the transposition deadline to apply for authorisation and comply with the national legislation stemming from the new directive.

The implementation of an EU passport for non-EU AIFs and non-EU AIFMs may occur subject to a decision of the EU Commission two years after the entry into force of the AIFM Directive. Thus, in order to access the markets of EU countries, they will have to comply with the national private placement regimes of the various EU countries for at least the first two years after the transposition deadline. After this two-year transitional period, national private placement regimes and the EU passport system could coexist for at least three further years, after which the national private placement regimes may (but need not) be terminated.

For a detailed analysis of the key provisions of the AIFM Directive, we refer you to the **January 2011 edition of our Luxembourg Legal Update**.

[12] Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011 on Alternative Investment Fund Managers and amending Directives 2003/41/EC and 2009/65/EC and Regulations (EC) No 1060/2009 and (EU) No 1095/2010
[13] Alternative investment fund managers
[14] Alternative investment funds

ESMA consults on AIFM Directive Implementing Measures

Many details of the AIFM regime are still to be laid down by the EU Commission in level 2 implementing measures. ESMA[15] is currently consulting with stakeholders on its draft technical advice to the EU Commission on the basis of a request of the EU Commission,[16] which was addressed in December 2010 to CESR[17], the predecessor of ESMA.

The Commission's request for advice was divided into four parts:

- general provisions, authorisation and operating conditions;
- depositary;
- leverage and transparency requirements; and
- supervision.

On 13 July 2011, ESMA published a consultation paper of more than 400 pages[18] setting out its proposals for the detailed implementing measures of the AIFM Directive with regard to the first three parts of the Commission's request.

On 23 August 2011, ESMA published a further consultation paper (of 30 pages) setting out its proposals for detailed rules on supervision and third country entities underlying the Alternative Investment Fund Managers Directive (AIFMD), [19] as requested by the fourth part of the Commission's request for advice.

The proposals published in ESMA's consultation paper dated 13 July 2011 cover the following areas:

- General Provisions for Managers, Authorisation and Operating Conditions

  As well as clarifying certain issues regarding the thresholds that determine whether a manager is subject to the AIFM Directive, this section includes topics such as valuation and delegation.

  On the issue of valuation, ESMA sets out draft advice on criteria for the proper valuation of assets by identifying general principles that should guide managers in developing and implementing policies and procedures for a proper and independent valuation of the assets of an AIF. As these are general principles, they can be adapted to the types of asset in which an AIF may invest.

  As far as delegation is concerned, ESMA has been asked to identify the criteria for objective reasons justifying a delegation. Here the proposals set out two options for consultation: the first takes a flexible approach according to which a delegation can be justified where the AIFM can demonstrate that the delegation is done for the purposes of a more efficient conduct of the management of the AIF; while the second option sets out an indicative, non-exhaustive list of criteria to be used when making the assessment.

- Governance of AIFs' Depositaries

  This part of the advice sets out ESMA's proposals on the framework governing depositaries of AIFs. In addition to the advice on the content of the written contract evidencing the appointment of the depositary and the clarification on the depositary's oversight duties, ESMA makes proposals on the key issue of depositary liability. The first element of this relates to the circumstances in which a financial instrument held in custody should be considered as "lost"; this assessment is crucial in determining whether a depositary must subsequently return an asset. ESMA's proposals identify three conditions, at least one of which would have to be fulfilled in order for an asset to be considered lost.

  Another important concept which ESMA's advice aims to clarify relates to which events would constitute external events beyond the reasonable control of the depositary.

  Finally, the advice considers options for the objective reasons that would allow a depositary to contractually discharge its liability, such as legal constraints that give the depositary no choice but to delegate its custody duties to a third party.

- Transparency Requirements and Leverage

  One of the key objectives of the AIFM Directive is to help prevent the build up of systemic risk. With this aim in mind, ESMA's proposals cover several

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[15] European Securities and Markets Authority
[16] Provisional request to CESR for technical advice on possible level 2 measures concerning the future directive on alternative investment fund managers (Ref. Ares(2010)892960 - 02/12/2010)
[17] Committee of European Securities Regulators
[18] Consultation Paper - ESMA's draft technical advice to the EU Commission on possible implementing measures of the Alternative Investment Fund Managers Directive (Date: 13 July 2007, ESMA/2011/209)
[19] Consultation Paper - ESMA's draft technical advice to the EU Commission on possible implementing measures of the Alternative Investment Fund Managers Directive in relation to supervision and third countries (Date: 23 August 2011, ESMA/2011/270)

issues related to leverage e.g. the definition of leverage, how it should be calculated and in what circumstances a competent authority should be able to impose limits on the leverage a particular manager may employ. Given the wide range of funds covered by the AIFM Directive and the diverse nature of the assets in which such funds invest, ESMA considers it appropriate to prescribe two different calculation methodologies for the leverage (commitment and gross methods) as well as a further option that can be used by managers on request and subject to certain criteria.

The AIFM Directive also aims to increase transparency of AIFs and AIFMs. In this context, ESMA's advice specifies the form and content of information to be reported to competent authorities and to investors. The advice also addresses the content and format of the annual report to be prepared for each AIF. In this regard, ESMA's approach has been to recognise the existence of national and international accounting standards already in place and to develop a compatible framework.

The proposals published in ESMA's consultation paper dated 23 August 2011 cover the following areas:

- Supervisory Co-operation and Exchange of Information

  With a view to ensuring the smooth functioning of the new requirements, the AIFMD puts in place an extensive framework regarding supervisory co-operation and exchange of information. ESMA's draft advice focuses on the relationships between EU competent authorities and third country authorities. ESMA envisages that the arrangements should take the form of written agreements, allowing for exchange of information for both supervisory and enforcement purposes. The agreements should also impose a duty on the third country authority to assist the relevant EU authority where it is necessary to enforce EU or national legislation. Finally, ESMA considers it important that the arrangement make provision for the exchange of information for the purposes of systemic risk oversight.

- Delegation of Portfolio or Risk Management Functions to Third Country Entities

  This part of the advice sets out ESMA's proposals on the additional requirements to be applied when AIFMs delegate the portfolio or risk management functions to an undertaking in a third country. The proposals focus on the content of the written agreement to be put in place with the competent authority of the third country which, under ESMA's proposals, would have to allow for access to information, the possibility of on-site inspections of the entity to which functions are delegated and the carrying out of enforcement actions in the case of a breach of the regulations.

- Assessment of Equivalence of Third Country Depositary Frameworks

  Under the AIFMD, the depositary of the fund may be established in a third country, subject to certain conditions. In this section of the advice, ESMA sets out its proposals on the elements to be taken into account when assessing whether the prudential regulation and supervision applicable to a depositary established in a third country:

  i. has the same effect as the provisions of the AIFMD; and

  ii. can be considered as effectively enforced.

ESMA has identified a number of criteria for this purpose, such as the independence of the relevant authority, the requirements on eligibility of entities wishing to act as depositary, the equivalence of capital requirements and the existence of sanctions in the case of violations.

Concerning the arrangements to be put in place with third country authorities in general, ESMA notes its preference for a single agreement to be negotiated by ESMA in each case in order to ensure consistency and avoid a proliferation of bilateral agreements. ESMA has also identified two documents produced by the International Organisation of Securities Commissions (IOSCO) as benchmarks for the written agreements.

Responses to the consultation papers are due by 13 September 2011 (consultation paper dated 13 July 2011) and 23 September 2011 (consultation paper dated 23 August 2011) respectively. In light of the feedback received from respondents, ESMA will finalise its advice to the EU Commission in time for submission by 16 November 2011.

EU Commission's Consultation on New Regime for Venture Capital Funds

On 15 June 2011, the EU Commission launched a consultation setting out policy options for the creation of an

internal market for venture capital in the EU. According to the EU Commission, the immediate priority is to enlarge the geographical base in which venture capital funds can raise and invest capital.

Background

Improving Conditions for SMEs to Access Venture Capital Financing

Venture capital (which can be defined as providing equity finance to companies that are generally very small and young, often innovative start-ups, with strong growth potential) is generally considered as an important source of financing and support for innovative SMEs that encounter difficulties in accessing bank loans or listing on stock exchanges (since venture capital provides finance to companies with promising but untested business models that are confronted with high levels of uncertainty as regards their future prospects). According to the EU Commission, the development of venture capital funds will improve SMEs' access to finance, and thus their opportunities to grow and expand. Venture capital thus helps to drive innovation, economic growth and job creation. It has also a lasting effect on the economy as it mobilises stable investment.

At EU level, however, the fragmentation of markets for venture capital is considered to be an issue that requires immediate action. Venture capital funds face problems reaching the critical mass they need to spread their portfolio risk and cover their costs. Apart from the cultural or linguistic constraints, venture capital funds that intend to raise funds and invest on a cross-border basis in the EU are confronted with two problems: the fact that they do not benefit from a real internal and integrated market (pieces of legislation are missing) and the fact that, in certain cases, they claim to face problems of double taxation. This is the reason why the EU Commission's consultation focuses on the creation of an internal market for venture capital. As announced in the EU Commission's Communication on the Single Market Act (see IP/11/469), the immediate priority is to enlarge the geographical base in which venture capital funds can raise and invest capital. The EU Commission's goal is to achieve a real internal market for venture capital funds in the EU and reduce tax barriers to the greatest extent possible. In this way, venture capital funds would benefit from economies of scale and specialised sector specific expertise would emerge.

Interaction with the AIFM Directive

Managers of venture capital funds are covered by the so-called AIFM Directive since venture capital would fall under the generic category of alternative investment. Therefore, according to the AIFM Directive, EU managers of EU venture capital funds with assets under management above EUR 500 million will be able to benefit from the EU passport provided by the AIFM Directive as of its implementation by Member States (i.e. as of 22 July 2013). EU Managers under that threshold will not benefit from the EU passport as of 22 July 2013 unless they decide to make use of the "opt-in" procedure envisaged in the AIFM Directive, in which case they will have to comply with the full set of obligations and requirements therein.

However, it seems that the AIFM Directive is not always the ideal instrument for the promotion of the cross-border activity of venture capital in the EU. The objective of the Single Market Act in relation to venture capital and the objectives that inspired the AIFM Directive are different. Whereas the goal of the Single Market Act is to increase the access of innovative SMEs to venture capital finance, the AIFM Directive aims at increasing transparency, ensuring the oversight of AIFMs and facilitating the monitoring of systemic risk in the field of the AIFs, in line with G20 commitments. Since venture capital was not at the focal point of the AIFM rules, the EU Commission deems that the AIFM Directive requirements are not tailored for venture capital managers and that it would seem to be disproportionate to require venture capital managers to comply with the strict requirements of the AIFM Directive in exchange of the passport.

Policy Options

The EU Commission has considered several options to create an internal market for venture capital in the EU. First, Member States could mutually recognise the existing national frameworks of venture capital funds. The EU Commission endorsed this proposal in December 2007, but in December 2009 noted in its Summary Report on cross-border venture capital in the EU that so far this process had not yet contributed to a reduction of the fragmentation of venture capital markets.

In light of this, the EU Commission considered two legislative alternatives. The first option would entail re-examining the suitability of the AIFM Directive in relation to certain venture capital funds. The second option would consist in creating a tailor-made system as a stand-alone initiative.

Content of the EU Commission's Consultation

The EU Commission's consultation document presents the core elements of a possible EU legislative framework (and outlines what could be the broad contours of an EU passport) for venture capital funds that would achieve the desired objectives (i.e. raising capital freely throughout the EU from professional investors and investing in innovative SMEs).

Voluntary Registration with a Competent Authority

The consultation suggests that any EU approach to venture capital funds and their managers should be based on voluntary adherence by the latter. Venture capital funds would remain subject to national rules. However, the EU approach would introduce the opportunity for venture capital managers to benefit from an "EU passport". Venture capital managers asking for a specific "EU registration" with the competent authority of the Member State where it is established (or, alternatively, with ESMA) would be able to operate in the other 26 Member States. This registration would then have to be recognised automatically by the competent authorities of the other Member States. The manager would not have to perform any other administrative obligations.
The registration would cover both the manager and all the funds it manages and there would be no need to apply for a separate registration for the manager and each fund.

Simple Notification Procedure

To ensure that the Member States' competent authorities are at least informed of the activities of the managers (who are entitled to operate throughout the EU on the basis of an EU passport) and their funds while in their territory, the EU Commission proposes to create a simple system of notification. Once the manager is registered, the home Member State's competent authority would notify this fact to the competent authorities of other Member States.

Restriction for Retail Investors

Venture capital funds covered by the proposed EU passport system would only be offered to professional investors as defined by the MiFID Directive and not to retail clients, so that they would not be obliged to comply with the traditional disclosure obligations and requirements linked to investor protection which would imply an offer to retail clients.

Reporting Obligations

In order to avoid creating unnecessary new burdens, venture capital managers would only be required to produce a single annual report including the annual financial accounts and a report of the activities of the financial year for each fund and this report would be made available to investors and competent authorities.

Operating Conditions for Venture Capital Entities

As for the managers of UCITS or AIFs, managers of venture capital funds would be subject to a number of operating conditions (rules of conduct, organisational requirements, experience and good repute of the conducting persons and suitability of the shareholders) to ensure that business is carried out fairly, efficiently, skilfully and in a safe manner. However, to constitute an appropriate EU level framework for venture capital managers, the new rules would consider an approach lighter than that for UCITS and AIFs.

Legal Form of the Venture Capital Funds

Venture capital funds would be entitled to adopt any of the legal forms traditionally used in the different Member States. In some countries, venture capital funds would be constituted as common funds, as unit trusts or as investment companies.

Investment Focus on SMEs

The EU passport would benefit funds that invest or commit to invest the majority of their assets in SMEs. The rest of the assets of the fund would exist solely in cash or cash equivalents. Venture capital funds though will be allowed to include in their portfolio minor stakes in other types of asset.

Determination of the Scope of the Activities of Venture Capital Funds

Precise and accurate parameters need to be developed to delineate what a venture capital fund is, since the proposed EU passport would be conditioned to the fulfilment of these criteria. The consultation lists some criteria that may be helpful in distinguishing venture capital funds that would fall within the scope of this initiative relating to (i) the description of the activity and (ii) the description of the venture capital investment strategy. The consultation also gives a definition by exclusion of certain types of investments (e.g. venture capital funds may not invest in companies that are traded on a secondary

market, in financial entities, other funds or financial instruments).

Third Country Entities

As Non-EU venture capital funds could help to boost economic growth and job creation in the EU, the EU Commission suggests it could be positive for the EU economy to provide for an open venture capital market.

Impact on Other Pieces of EU Legislation

The new legislative framework for venture capital funds may have an impact on the AIFM Directive. As a result, the interaction of the new regime on venture capital with the AIFM Directive and its consequences should be clarified in order to provide legal certainty.

Next Steps

The consultation asked for stakeholders' input on this initiative by 10 August 2011. The results, together with an impact assessment, will serve as a basis for a legislative proposal on EU rules for venture capital that the EU Commission intends to put forward by the end of 2011.

ESMA Consults on Guidelines for UCITS ETFs[20] and Structured UCITS

On 22 July 2011 ESMA, exercising its mandate under the ESMA Regulation[21] to work towards a co-ordinated approach to the regulatory and supervisory treatment of new or innovative financial activities, published a discussion paper in view of consultation with stakeholders on guidelines for UCITs ETFs and structured UCITS.[22] This discussion paper is motivated by the risks associated with the increasing practice to adopt complex portfolio management techniques in the management of UCITS. ESMA considers that the existing requirements are not sufficient to take account of the specific features and risks associated with UCITS ETFs and structured UCITS. The discussion paper suggests possible measures that could mitigate the risks following from complex products being made available to retail investors described as UCITS.

Possible measures put forward in relation to ETFs include:

- Identifier: ETFs should be required to identify themselves as such by their name, instrument of incorporation, prospectus and marketing material.
- Index-tracking issues: The prospectus for index-tracking UCITS ETFs should contain a clear, comprehensive description of the index to be tracked and the mechanism used to gain exposure to the index.
- Synthetic ETFs: The information provided to investors in the prospectus of synthetic ETFs should at least include information on the underlying of the investment portfolio or index, the counterparty, the type of collateral which may be received from the counterparty and the risk of counterparty default and its effect on investor returns.
- Securities lending activities: The prospectus should inform of the intention to engage in securities lending, the risks thereof, collateral policy, fees and connected parties.
- Actively managed ETFs: Where an ETF is actively managed, investors should be clearly informed of that fact and of the risks arising from its investment strategy.
- Leveraged ETFs: The leverage policy and the risks associated with it should be clearly disclosed to investors.
- Redemption rights: ETFs should be required to give all investors, including those who acquire units on the secondary market, the right to redeem their units directly from the fund.

Possible measures put forward in relation to structured UCITS include:

- Total Return Swaps: Both the UCITS fund's investment portfolio that is swapped and the instruments underlying the swap to which the UCITS fund gains exposure should comply with the relevant diversification rules of the EU directives and regulations.
- Strategy indexes: More guidance is needed on the criteria of index eligibility, in particular as regards the frequency of rebalancing the index and the manner in which the index must fulfil the criterion of being an adequate benchmark for the market to which it relates.

[20] Exchange-traded funds

[21] Regulation (EU) N° 1095/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Securities and Markets Authority)

[22] Discussion Paper - ESMA's policy orientations on guidelines for UCITS Exchange-Traded Funds and Structured UCITS (22 July 2011, ESMA/2011/220)

Responses to this discussion paper are due by 22 September 2011. In light of the feedback received, ESMA will develop a consultation paper on proposed guidelines for UCITS ETFs and structured UCITS.

EU Commission Consultation on Social Investment Funds

On 13 July 2011, the EU Commission launched a consultation on possible EU measures to support social businesses through investment funds. The consultation document seeks in particular the views of stakeholders on an appropriate legal framework for investment funds investing in social businesses and investors.
The consultation paper characterises social businesses as those targeting social, ethical or environmental goals as their primary corporate objective and placing the achievement of social impacts above the delivery of financial returns, without, however, being purely philanthropic endeavours with no economic element.

The legal frameworks for investment funds provided by the UCITS and AIFM Directives may not be appropriate for investment funds investing in social businesses. The UCITS Directive's requirements on diversification, liquidity and eligible assets may limit its effectiveness for investments in social businesses. With AIFs aiming, as a general rule, at professional investors, the AIFM Directive may not achieve the pondered retailisation of social investment funds.

The Commission's consultation therefore aims to explore whether a new, bespoke social investment fund framework might be more effective at channelling funds to social businesses and, if so, what specific measures it might need to contain. Such specific framework may *inter alia* relate to the timeframe for redemptions, risk diversification, eligible assets and strategies, asset valuation, investor participation, risk management, the duties of the depositary, and remuneration and cost structures.

The consultation ends on 14 September 2011. The Commission aims introduce a legislative proposal on social investment funds by the end of 2011.

Legislation

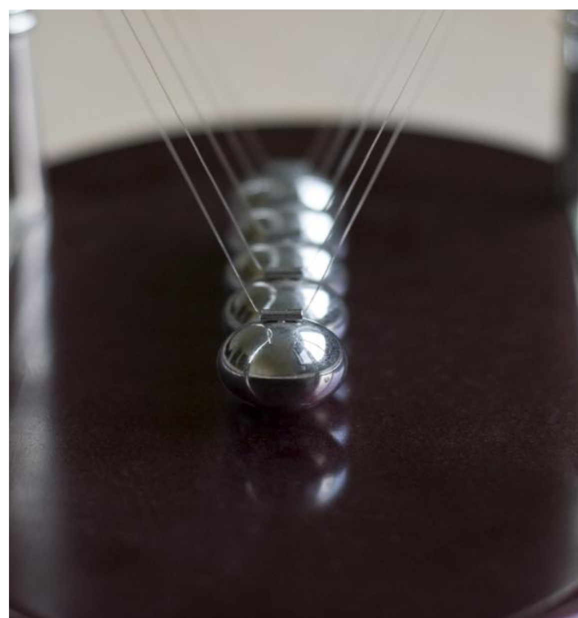
Bill N°6318
Amending the SIF Law

Bill N°6318, which was adopted by the Luxembourg Government Council on 1 July 2011, was introduced on 12 August 2011. The bill amends the SIF Law[23] in order, in particular, to implement the AIFM Directive and also puts forward further amendments to the SIF Law.

In view of the implementation of the AIFM Directive, the bill *inter alia* introduces new rules regarding the delegation of tasks to third parties by a SIF[24] or its management company and requires SIFs to design and implement a risk management process, as well as specific rules aimed at minimising the risk of conflicts of interests.

The bill puts forward further amendments to the SIF Law relating to the approval and supervision of SIFs. In particular, SIFs will need to obtain the CSSF's approval before being launched. Equally, the persons in charge of the management of the investments of the SIF need to obtain the CSSF's prior approval.
Furthermore, the bill proposes to extend to SIFs certain options introduced by the law of 17 December 2010 on undertakings for collective investment, including allowing a compartment of a SIF with multiple compartments to subscribe for, acquire and/or hold securities of other compartments of the same SIF under certain conditions.

The new amended SIF Law shall enter into force on the first day of the month following its publication in the *Memorial*. A transitional period for existing SIFs is provided for as regards the implementation of a risk management process and conflict of interests policy, which shall be due by 30 June 2012, as well as with regard to the new delegation regime, which shall be complied with by 30 June 2013.



[23] Law of 13 February 2007 relating to specialised investment funds
[24] Specialised investment fund

Litigation

Legislation

Law of 24 May 2011
Services in the (EU) Internal Market

On 30 May 2011, the law of 24 May 2011 on services in the internal market entered into force. The law implements the Directive 2006/123/EC of the European Parliament and of the Council of 12 December 2006 on services in the internal market[25], which aims at eliminating barriers that prevent or slow down the development of services between Member States, in particular barriers to the freedom of establishment for providers in Member States and barriers to the free movement of services as between Member States.

The law applies to services provided by service providers that have their establishment either in the Grand Duchy of Luxembourg or in another Member State. However, it does not apply to a certain number of specific services such as non-economic services of general interest, financial services, electronic communications services and networks, services in the field of transport, services of temporary work agencies, healthcare services, audiovisual services, gambling activities, activities which are connected with the exercise of official authority, social services, private security services, and services provided by notaries and bailiffs. In addition, it does not apply to the field of taxation.

Amongst other items, the law provides for the simplification of procedures and formalities to access to a service activity and to the exercise thereof. In that regard, the law foresees the setting up of so-called points of single contact (*guichets uniques*) which will have to be implemented by the Government. Through these points of single contact, which will be physical and also electronic, the service providers will be able to complete all procedures and formalities needed for access to their service activities in the Grand Duchy of Luxembourg (e.g. declarations, notifications or applications necessary for authorisation from the competent authorities, etc).

Regarding freedom of establishment for service providers, the Law provides that the access to, and the exercise of a service activity may not be subject to an authorisation unless the following conditions are satisfied: (i) the authorisation scheme does not discriminate against the service provider in question, (ii) the need for an authorisation scheme is justified by an overriding reason relating to the public interest and (iii) the objective pursued cannot be attained by means of a less restrictive measure. The authorisation schemes need, in addition, to be based on criteria which preclude the competent authorities from exercising their power of assessment in an arbitrary manner.

Regarding free movement of services, the law expressly provides, as a principle, that free movement of services from a Member State may not be limited/restricted and that the access to a service activity or its exercise may not be subject to requirements which do not respect the principles of non-discrimination (with regard to the nationality of the service provider), of necessity (in relation to public policy, public security, public health or the protection of the environment) and of proportionality (meaning that the requirement must be suitable for attaining the objective pursued, and must not go beyond what is necessary to attain that objective). The Law also expressly prohibits several specific requirements such as, for instance, the obligation on the provider to have an establishment in the territory of the Grand Duchy of Luxembourg or banning the provider from setting up a certain form or type of infrastructure in the Grand Duchy of Luxembourg, including an office or chambers, which the provider needs in order to supply the services in question.

Furthermore, the law also contains different provisions aiming at protecting the interests of the recipients of services, in particular, provisions relating to non-discrimination, pre-contractual information that needs to be made available to those recipients, professional insurance and warranties.

Given its international perspective, the law provides for a series of measures relating to administrative cooperation between relevant Luxembourg authorities and the different authorities of the Member States in order to ensure the supervision of providers and the services they provide. Finally, the law sets up a specific judicial procedure allowing professional groups or associations that are duly accredited in this respect to institute proceedings before the judge who presides in the chamber of the District Court sitting in commercial matters, in order to obtain the cessation of any infringement to the Law or regulations implementing it and which affect the collective interests of the consumers. This court action is instituted and dealt with through the same procedure rules as those governing summary proceedings.

[25] This Directive is commonly known, at least in its initial draft version, as the "Bolkestein Directive".

Law of 10 July 2011
Obstruction of Justice

A new law, dated 10 July 2011, introduces the offence of obstruction of justice.

The law introduces a new article 140 into the Criminal code; paragraph 1 of this article makes it an offence, punishable by a prison term of one to three years and by a fine ranging from EUR 251 to EUR 45,000, *"for anybody, having knowledge of a crime for which it is still possible to prevent or limit its effects or where the perpetrators of such crime are liable to commit new crimes that could be prevented, not to inform the judicial or administrative authorities thereof."*

Until this amendment to the Criminal code, Luxembourg did not know the offence of obstruction of justice. While civil servants had (and still have) a specific obligation to inform the State Prosecution Service of certain offences of which they become aware in the course of their duties, the general public was under no such obligation. This has now changed.

It is important to note that the scope of the new article 140 of the Criminal code only encompasses "crimes". Luxembourg criminal law recognises a three-tier categorisation of offences, and crimes is the term used for the most serious offences[26]. The term "crime" in the meaning of article 140 of the Criminal code must therefore be understood in its technical sense, meaning any offence punishable by a prison term of at least 5 years[27]. Consequently, article 140 of the Criminal code does not create an obligation on the general public to denounce any offence of which they become aware, but expressly only foresees sanctions for not denouncing *crimes*. The category of "crime", in this sense, is however, wider than might be sometimes expected. Thus, forgery, and the use of forged documents (*faux et usage de faux*), is a *crime* (Article194 of the Criminal code).

In addition, for non-denunciation of a crime to be punishable, it is required that either (i) it is still possible to prevent or limit the effects of the crime committed, or (ii) the perpetrators of the crime are liable to commit new crimes that could be prevented. It remains to be seen how case law will interpret these conditions.

In the parliamentary procedure leading to the enactment of the Law, arson was used as an example to illustrate what the Law intends to achieve in terms of "limiting the effects of a crime"; in this case, by informing the authorities of the existence of a fire in a timely manner, the damage can be limited[28]. It was also stated that the aim of the Law was not so much to prevent crimes as to limit the potential consequences thereof.

Paragraph 2 of article 140 provides specific exemptions for certain family members and partners of perpetrators or accomplices. An exemption is also provided for persons subject to professional secrecy and which are fall within the scope of article 458 of the Criminal code. However, none of these exemptions apply to crimes committed on minors, which therefore must be denounced by anybody who becomes aware of such crimes. The law also introduces criminal sanctions for tampering with evidence (new article 141 of the Criminal code).

Case Law

Court of Appeal, 2 February 2011
The termination of a Broker Agreement

Two parties were bound by a broker agreement (*apporteur d'affaires*) stipulating that the broker will be paid a commission for each new client he brings and 33% of the income generated by those clients, even if the broker would bring no additional new clients.
The agreement also provided that it was initially concluded for a period of one year, and then renewed every year unless one of the parties would terminate the agreement by giving 6 months' notice. The principal had subsequently terminated the agreement with effect on an anniversary date, in compliance with the agreed notice period, but without justifying its decision.

The agent who was thus deprived of the agreed commission, summoned the principal to court claiming that this termination was unfair. The Court of Appeal dismissed this claim[29.]. To do so, the Court started by recalling that the misuse of rights is a sub-category of contractual bad faith[30]. If, as in the present case, the agreement provides the right for a party to unilaterally terminate the agreement, and if the party does so according to the contractual conditions, the termination of the agreement only makes this party liable in case of misuse of rights when using this right, respectively each time that its behaviour is motivated by bad faith.
However, the agent does not prove bad faith by putting forward, in order to illustrate misuse of rights, the sole fact

[26] In French, by ascending order of seriousness : *contraventions – délits - crimes*
[27] Article 1 in combination with articles 7 and 8 of the Criminal code.
[28] Doc. Parl. 6138[4] p.5
[29] Court of Appeal, 2 February 2011, n°35151
[30] Article 6-1 of Civil code defines the misuse of rights as "*Any action or fact manifestly exceeding, with the intention of a person, by his means or by the circumstances in which he intervened, the normal exercise of a right*"

that the principal had used his right of unilateral termination without providing grounds, where giving grounds was not required by the agreement.

District Court, 17 February 2011
Economic Crisis and *force majeure*

A bank had granted a loan to a company. As the debtor did not comply with the repayment schedule, nor the agreed reimbursement scheme afterwards, the bank summoned it to court for reimbursement of the entire debt. Before the Court[31], the company referred to the crisis affecting in particular Greece to justify the drastic reduction of sales it experienced and that further to these problems, which it claimed were unpredictable, irresistible and external to its will, it found itself in a difficult financial situation which no longer allowed it to follow the reimbursement scheme. It claimed it was exempted from its contractual obligations because of *force majeure*.

The Court has nevertheless rejected this argument stating that, in contractual matters, the irresistible nature of the event causing *force majeure* consists of an impossibility of performance, which must be distinguished from difficulty of performance or even from performance more expensive than expected, and which must be complete and permanent and not temporary or partial.

However, in the case at hand, the non-execution of the debtor's contractual obligations was just temporary and not permanent, and the company had specified that it would resume the reimbursement of the loan as soon as the Greek economic situation improved. Therefore such a crisis does not fulfil the requisite criterion of the irresistibility to be put forward by the company as a case of *force majeure*.

District Court, 4 March 2011
Conditions for Granting Extra Time for Payment

In principle, a debtor must honour its commitment by the deadline foreseen by the law or in the parties' agreement. If no deadline is given, the payment must take place immediately. The Civil code nevertheless entitles the judge to grant to the debtor limited extra time for payment, and to postpone the commencement of proceedings, if the debtor's position justifies it[32].
In a recent decision, the Court[33] recalled that granting such extra time was an exceptional and optional means which the law permits in order to help an unfortunate debtor by postponing or spreading his debt over a period of time. This means must be used in moderation; the text of the Civil code states that the judge must use "this power with a great reservation", the principle being that the debtor must fulfil an obligation by the due date or immediately.

Moreover, the judge will only accept to grant such a grace period if the debtor is likely to be able to pay off his debt in full by the expiry of the deadline, which assumes that the debtor submits to the court an estimation of the future development of his financial situation and according to this estimation indicates the required duration of the extra time requested.

In the case at hand, the debtor had not provided any supportive documents, he had given no precise indications on his current financial situation – which he had only described as being "catastrophic" – nor did he give an indication on the future development of his situation. The Court therefore rejected his request for a grace period.

District Court, 5 April 2011
Conformity of the French Law on Insolvency with the Luxembourg Public Order

A bank had granted a loan to an individual. As the debtor did not comply with his repayment deadlines, the bank terminated the loan and enforced the salary assignment which had been granted to it.

The debtor disputed the fact that he was still liable for the debt and requested the cancellation of the assignment. He argued that he was bankrupt in France[34], where he lives, and that the assignment notification had been made after the completion of this bankruptcy by a decision of the Court of Thionville. According to the debtor, the French Commercial code excludes the right for creditors to instigate individual proceedings after the completion of the bankruptcy[35].

The bank requested that no account of the effects of the French insolvency proceedings be taken because the French law provisions conflict with Luxembourg international public order, in the sense that they extinguish the right of individual proceedings and constitute a despoliation of creditors' rights. As a general rule, the law

[31] Luxembourg District Court, 17 February 2011, n°131845

[32] Article 1244 par. 2 of Civil code and article 232 of New Civil Procedure Code

[33] Luxembourg District Court, 4 March 2011, n°134954

[34] Article L. 670-1 of the French Commercial Code foresees that French reorganisation and liquidation proceedings are applicable to natural persons who are not traders, domiciled in the departments of Moselle, Bas-Rhin and Haut-Rhin, allowing therefore an individual to become "bankrupt"

[35] Article L-643-11 of the French Commercial Code

applicable to insolvency proceedings and its effects is the law of the Member State where the proceedings are opened. The applicable law governs, in particular, the effects of the insolvency proceedings on individual proceedings and creditors' rights after the completion of the insolvency proceedings[36].

Nevertheless, the jurisdictions of a State may refuse to take into consideration insolvency proceedings opened in another Member State or to enforce a decision taken in the framework of insolvency proceedings opened in another Member State if to do so would produce effects manifestly contrary to its public policy[37]. According to the Court, this exception to enforcement can only be admitted if the decision to be rendered would offend, in an unacceptable manner, the legal system of the State in which enforcement is sought, because it would undermine a fundamental principle or right acknowledged in that State[38].

However, the Court considered that, even though the creditor would not be able to recover its claim and his capital would therefore be diminished by that same amount (and thus affect its right of property, a fundamental right acknowledged in Luxembourg) the French Commercial code did not despoil it as it does not fail to appreciate its claim but only prohibits any individual execution measure after the completion of the liquidation. According to the Court, the French Commercial Code does not therefore offend the Luxembourg public policy in an unacceptable manner.

[36] Articles 4.1. and 4.2. of the Council Regulation (EC) n° 1346/2000 of 29 May 2000 on insolvency proceedings
[37] Article 26 of the Council Regulation (EC) n° 1346/2000 of 29 May 2000 on insolvency proceedings
[38] The judgment refers to the decision "Eurofood" - CJCE, 2 May 2006, File C-341/04

Tax

EU Directives and foreign regulations

EU Directives – EU Savings Directive

At the meeting of the ECOFIN Council held on 12 July 2011, the ECOFIN Council took note of the European Commission's recommendation to negotiate changes to agreements signed in 2004 with Switzerland, Liechtenstein, Monaco, Andorra and San Marino on the taxation of savings income. Those agreements provide for measures equivalent to those set forth in the EU Savings Directive. The negotiations aim at including a specific provision in the agreements related to the exchange of information upon request – which is in line with the OECD standards of 2002 – between these countries and the European Union.
Concurrently, the Luxembourg Ministry of Finance made public the tax revenue collected in Luxembourg in the context of EU Savings Directive. Luxembourg shared with the other EU member states about EUR 123 million in May 2010 and EUR 98 million in May 2011.

FATCA

On 14 July 2011, the US Treasury Department and the Internal Revenue Service (IRS) issued Notice 2011-53, which includes dates by which foreign financial institutions and US withholding agents must apply the rules in the Foreign Account Tax Compliance Act (FATCA). Based on Notice 2011-53, the implementation of FATCA has been postponed until 2014 (FATCA provisions were supposed to be effective on 1 January 2013). For more detailed information on the timeframe for the implementation of the FATCA provisions, please refer to our **Client Briefing** dated July 2011.

On 21 June 2011, the Luxembourg Ministry of Finances, in response to a question from a Luxembourg MP, confirmed its awareness of the practical issues arising from the application of FATCA and stated that it supports the recent actions undertaken by the Council of the European Union towards US authorities. The Ministry also added that it is the intention of Luxembourg to further discuss this subject on a bilateral basis with US representatives.

Swiss German Agreement on Cross Border Taxation

On 10 August 2011, Germany and Switzerland concluded a tax agreement relating to Swiss assets of German tax

payers. Further to this agreement, a 26.375% withholding tax would apply to any saving income derived by German taxpayers and paid by a Swiss paying agent. Existing assets located in Switzerland would be subject to a retroactive lump sum taxation levied by the Swiss authorities or alternatively German taxpayers may agree to the disclosure of their accounts to the German authorities. Concurrently, both authorities agreed upon an exchange of information process (formally limited to 999 cases for the next 2 years).

According to the press release of the Federal Finance Department (DFF), this agreement will be signed by both governments in the next few weeks and could enter into force at the start of 2013. On 26 August, the Swiss and UK authorities agreed on a similar final withholding tax on saving income. These agreements would undoubtedly impact how EU member states approach and apply the Savings Directive.

Tax Treaties

Approval of New Double Tax Treaties and Additional Treaty Protocols

On 16 July 2011, the Luxembourg Parliament ratified new double tax treaties with Barbados and Panama, and amended existing treaties with Japan, Portugal, Hong Kong, Sweden and San Marino. The new and amended double tax treaties include specific articles on the exchange of information upon request that are in line with the OECD international standards on tax information exchange. The amendment to the double tax treaty with San Marino entered into force as at 5 August 2011 (the exchange of information between Luxembourg and San Marino will be applicable to tax years commencing during or after January 2012).

Double Tax Treaty with Barbados

The following points of interest are worth mentioning with regard to the double tax treaty with Barbados:

- There is no withholding tax on dividends paid by a company resident in one contracting state if the beneficial owner is a company (other than a partnership) resident in the other state holding directly at least 10% of the share capital of the paying company for an uninterrupted period of 12 months prior to the decision to distribute dividends. Such an exemption would apply to any Barbados company benefiting from the treaty (i.e. tax resident according to the said treaty).

- Profits realised by a Barbados permanent establishment are not taxable in Luxembourg (exemption method).

Double Tax Treaty with Panama

The following points are noteworthy with respect to the double tax treaty with Panama:

- The withholding tax rate on dividends paid by a resident of one contracting state to a resident of the other state is reduced to 5% if the beneficial owner of the dividend is a company (other than a partnership) holding directly at least 10% of the share capital of the paying company.

- Profits realised by a Panama permanent establishment are not taxable in Luxembourg (exemption method).

Interpretation of the Luxembourg-Korea Double Tax Treaty

On 16 May 2011, the Republic of Korea's Ministry of Strategy and Finance indicated that SICAVs/SICAFs are not eligible for treaty benefits under the Korea-Luxembourg tax treaty. This declaration of the Korean ministry clarifies the current position of the Republic of Korea with respect to the double tax treaty entered into between Korea and Luxembourg.

Exchange of Information between Luxembourg and Turkey

The protocol relating to the exchange of information between Luxembourg and Turkey came into force on 14 July 2011 and will be applicable to tax years commencing as from January 2011.

General Luxembourg Developments

Bill on Mutual Assistance for the Recovery of Tax

On 29 July 2011, the Luxembourg government approved the bill implementing the EU Directive on Mutual Assistance in Recovery of the Tax Claims. This directive amends and improves mutual assistance between European Union member states with respect to the recovery of tax claims, facilitating the exchange of information and allowing a member state to recover tax claims for the benefit of other member states.

The main points of interest in this directive are the following:

- Substantial extension of cases where mutual assistance between member states can take place. Under this directive, mutual assistance can indeed take place for any type of taxes levied by a member state.

- Banking information can be exchanged within the framework of the assistance for tax recovery.

- Improvement of communication between member states by the introduction of standardised documents for the notification of decisions / actions (related to tax claims) taken by a member state.

- Introduction of a *de minimis* rule whereby the directive only applies for the recovery of tax claims for an amount higher than EUR 1,500.

Clarification of German Cross-Border Tax Position

Over the past months, there have been uncertainties on the tax position of German cross-border workers, *i.e.* German residents employed by a Luxembourg employer. In a nutshell, the uncertainties result from the position taken by the German tax authorities in Trier in which German cross-border workers are taxable in Germany for the working days in which they physically worked in Germany and a third country (this would also include *"non productive"* workdays such as sick leave, holidays, training sessions, conferences, etc.). This position deviates from the previous well-established practice according to which German cross-border workers paid wage taxes only in Luxembourg.

The Luxembourg and Germany mutual agreement dated 26 May 2011 clarifies the tax regime applicable to German cross-border workers. This mutual agreement allocates the taxing rights between Germany and Luxembourg for salaries and similar remunerations earned by German cross-border workers. The mutual agreement states that:

- if a German cross-border worker physically works less than 20 aggregate working days per year in Germany or in a third country, and if the salaries associated with this work are taxed in Luxembourg, Germany exempts these salaries from German taxation;

- if a German cross-border worker physically works in aggregate more than 20 days per year in Germany or in a third country, a salary split must be done and each day worked in Germany or in a third country is subject to tax in Germany. German cross-border workers must in this case file a tax return in Germany.

On 21 June 2011, the Luxembourg Ministry of Finance confirmed that non "*productive days*" spent outside of Luxembourg (e.g. training sessions, conferences, etc.) must be taken into account for the computation of the twenty working day limit. Vacation (including public holidays) and weekends are not taken into account. The Ministry of Finance also indicated that the new agreement does not modify the current rules applicable to social security contributions.

Bill N°6305
Amending the SPF Law

After the abolition of the Holding 1929 regime, Luxembourg introduced a specific vehicle for private asset management: the *société de gestion de patrimoine familial* or SPF (which is governed by the law dated 11 May 2007).

Exempt from Luxembourg corporate income tax, municipal business tax and net wealth tax, this vehicle is only subject to a 0.25% annual subscription tax levied quarterly on its share capital and share premium (this is increased by any potential outstanding debt exceeding eight times the sum of its share capital and share premium). This annual subscription tax is, in any case, capped at EUR 125,000. Concurrently, an SPF is not subject to double tax treaties and cannot benefit from the EU Parent Subsidiary Directive.

However, an SPF can be denied this beneficial tax regime, if the vehicle receives more than 5% of its dividend income during a particular accounting year from non-resident companies which are:

- not listed on a stock exchange; and

- not subject to any tax similar to Luxembourg income tax, i.e. a tax of least 10.5% assessed on a basis computed according to rules similar to those which are applicable in Luxembourg.

This anti-abuse rule was criticised by the European Commission which formally argued that the 5% limit infringes on the fundamental freedoms provided for by the

EU Treaty in a letter to the Luxembourg authorities dated 9 February 2010.

As a direct result of this EU position, on 15 July 2011, the Luxembourg government released a bill amending the SPF law abolishing the 5% limit. In other words, if this draft law is passed, an SPF would keep its tax-exempt status regardless of what dividend it receives (*e.g.* 100% of its profits could be derived from non-listed low-taxed subsidiaries).

VAT Free Zone

On 14 July 2011, the Luxembourg parliament passed the VAT free zone law (adopted bill N°6266). Any goods stored in the VAT free zone warehouse would not be subject to VAT payments. This new law is in line with the government efforts to promote Luxembourg as a logistics center within continental Europe.

Case Law

Administrative Court, 13 July 2011
Net Wealth Tax Reserve

Under paragraph 8a of the Net Wealth Tax Law, Luxembourg companies do not have to pay net wealth tax for a particular year if they allocate an amount equivalent to 5 times the net wealth tax due to a non-distributable reserve. In this respect, if this net wealth tax reserve is maintained for 5 years, the tax does not become due. Alternatively, if it is distributed during the five-year period, the net wealth tax becomes retroactively payable.

In the case at hand [39], a Luxembourg company allocated funds to the net wealth tax reserve for 2004, 2005 and 2006 in order to benefit from the abovementioned regime. In 2006 it migrated to Italy keeping the net wealth tax reserve in its accounts after the migration. Subsequently, it merged with another Italian company.

As from the migration, the Luxembourg tax authorities retroactively denied the benefit of the net wealth tax reduction, as the company was no longer a Luxembourg resident subject to net wealth tax. The Luxembourg company argued against this assessment stating that such treatment is contrary to the principle of freedom of establishment within the EU as a Luxembourg company merging with another Luxembourg company would have still benefited from the net wealth tax reduction.

[39] Administrative Court, 13 July 2011, n°27380

On 13 July 2011, the Luxembourg Administrative Tribunal asked the European Court of Justice for a preliminary ruling as regards the compatibility of paragraph 8a of the Net Wealth Tax Law with the freedom of establishment.

Administrative Court, 14 July 2011
Luxembourg Participation Exemption Regime

For the tax authorities, equity warrants (*bons de souscription d'actions*) are not eligible for the participation exemption regime (see article 166 of the Luxembourg Income Tax Law and Grand-Ducal Decree of 21 December 2001). According to the tax authorities, equity warrants cannot be assimilated to a shareholding falling into the scope of the participation exemption regime. Hence, they considered that capital gains linked to the disposal of equity warrants cannot be assimilated to an income deriving from a participation (*revenu de la participation*) which could have benefited from the participation exemption regime.

The Luxembourg Administrative Court[40] confirmed this view and considered that capital gains deriving from the disposal of equity warrants cannot benefit from the participation exemption. For the Administrative Court, equity warrants only grant a right to subscribe to newly issued shares but cannot be assimilated to a shareholding.

Court of Appeal, 16 March 2011
Moral Damage in Case of Disclosure of Confidential Data by a Luxembourg Bank to the Tax Authorities

Please see **Banking, Finance & Capital Markets** section.

Danish Tax Ruling 27 June 2011
Concept of Beneficial Ownership

In many countries, tax authorities are paying more attention to who could be regarded as the beneficial owner of dividend and interest payments. This trend could create uncertainty with respect to withholding taxes (*e.g.* tax authorities could deny withholding tax reductions / exemptions if the recipient of interest or dividend is not considered to be its beneficial owner).

Recent Danish case law illustrates this trend. On 27 June 2011, the Danish tax authorities issued a ruling in which they considered that dividends distributed to a Luxembourg company from its Danish subsidiary could be subject to withholding tax because the Luxembourg company did not qualify as "beneficial owner". This

[40] Administrative Court, 14 July 2011, n°27243/27244

approach was based on the fact that the Luxembourg parent company was to distribute the dividends to its shareholders and thus would not be the final beneficiary of the dividend. Based on the specific factual background, the Danish tax authorities considered that the Luxembourg company was a mere "conduit" company and maintained that the Luxembourg company's sole purpose was to enable the evasion of withholding tax.

The Danish tax authorities took this position despite the absence of contractual or other legal obligations of the Luxembourg company to distribute the received dividends (even if such re-distributions could be anticipated). The Danish tax authorities also did not take into account that the Parent Subsidiary Directive does not contain a requirement concerning “beneficial ownership". However, they acknowledged that, to the extent that dividend would ultimately flow to entities resident in an EU member state, withholding tax could be reduced or waived.

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