REGULATORY AND TAX FRAMEWORK

Half a century of legal developments in the field of investment funds, a success story

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Today ALFI celebrates its 20th anniversary. At the same time, the investment fund industry, as it is now rightfully referred to, is looking back on close to fifty years of existence.

It was indeed in the late nineteen fifties that the concept of the fonds commun de placement was created by practitioners, guided by pragmatic scholars, cleverly using general concepts of civil law such as that of undivided coproprietorship together with traditional statute such as on agency and depository contracts. An apparent difficulty, arising from the sacrosanct principle of civil law pursuant to which the indivision can only temporarily be extended by contract, was overcome by management regulations providing for open-endedness, allowing unit holders to withdraw at all times.

As there were then in existence neither a specific legal framework nor a statutory basis for supervision, the pioneers of investment funds made use of a system of advanced ruling by the Ministry of Finance. This, on the tax side, protected the fund against potential applicability of income and assets tax on collectivities, while collecting a reduced rate of taxe d'abonnement by reference to the 1929 act governing holding companies. At the same time, this type of ruling afforded some form of control of the promoter's standard, together with providing for safeguard of the fund's assets by the requirement of a major bank as custodian.

Looked at it with todays' eyes, such a system granting tax relief against a minimum of regularity constraint will appear, to the least as pragmatic, leaving a considerable amount to self control.

Historically, it is not without interest that the tax system so used – the original rate of 0,06 per cent, then regarded as minimal, was fixed by a sort of agreement between the Government and the promoter – is at the origin of what is still now applicable by specific law as the taxe d'abonnement. With assets under management of investment funds having increased tremendously – to a level which the pioneers in 1960 could hardly imagine – this tax, although its rate has been repeatedly reduced and, on certain types of assets, completely released, has become a substantial source of Government income and, in the industry's and ALFI's opinion, a cost competition factor which should command further relief.

A similar type of pragmatic approach brought about, at the end of 1966, the creation of the very first Luxembourg investment fund in corporate form.

This type of fund could, unlike the fonds commun de placement, avail itself of a solid corporate framework under the general law governing commercial companies. Moreover, the corporate form of the fund was considered at the time by certain promoters, such as major US banks, as a protection against estate tax in the country where the assets were located, a tax which could have been attracted by the transparency of non-corporate fund.

The tax regime of corporate funds was conveniently based on the 1929 act on holding companies at the rate then applying, and then considered as acceptable, to the taxe d'abonnement. The difficulty that could have arisen from the prohibition of the repurchase or redemption of shares was overcome by allocating to reserves, as opposed to capital, large proportions of the assets contributed.

The early use of the two types of funds – contractual versus corporate - turned out to be a competitive advantage at a time when most other countries offered only one single type, either the contractual type – Germany, Switzerland – or the corporate type – France. Indeed, while for certain promoters the FCP was attractive as a result of fiscal transparency under their home tax regime, other promoters, as already mentioned, were looking for corporate funds as a protection against fiscal transparency.

So far no supervisory legislation was in existence and it is only in 1972, by the Decree of 22nd December concerning the control of investment funds (in part prompted by the threatening IOS collapse), that a first regulation was put in place, providing inter alia for forced liquidation of investment funds and making audit by independent professional experts a specific requirement.

However, the first comprehensive set of legislation, providing for both the legal and the supervisory

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framework of investment funds, came about in 1983 by the act of 25th August of that year. This act, duly guided by the experience then acquired, was the result of a remarkable cooperation between the supervisory authority in charge of securities and the practitioners. For the first time this act provided for a statute governing the FCP while at the same time introducing the société d'investissement à capital variable (SICAV) without excluding other possible legal forms of investment funds such as the SICAF derived from the initial corporate funds. For these the act provided for appropriate exceptions to the restrictions regarding the repurchase of own shares under the second Company Directive. This act, moreover, inaugurated a complete regulatory body of the supervision for investment funds.

The 1983 act was an excellent preparation for the big bang of 1985, the UCITS Directive of 20th December 1985, 85/611. The Directive was transposed into Luxembourg law by the act of 30th March 1988, a transposition which was achieved swiftly as a result of, once again, a remarkable cooperation between the supervisory authorities and the practitioners.

It is highly significant that the 1988 act coincided with the inauguration year of the Association luxembourgeoise des fonds d'investissement, ALFI.

Although the 1990s had already seen a remarkable development in the number of new investment funds and in the increase of assets under management, it is UCITS and its transposition which opened the borders to the whole of the then EC countries, affording the European passport for cross border distribution. On the legal side, the 1988 act also regulated umbrella funds, an institution which had in the meanwhile, once more on a pragmatic basis, developed widely.

UCITS III became the next major step. Whereas at the European level this important instrument, constituted by two separate directives – Directive 2001/107 and Directive 2001/108 – had been a particularly difficult and lengthy affair, Luxembourg again succeeded in achieving the transposition of the two directives within a record time by the act of 20th December 2002, the result of another remarkable cooperation between supervisory authorities and industry.

The 2002 act, in one single step, introduced the two underlying directives, the one dealing with investment powers and restrictions which considerably extends the limits which set by UCITS in 1985, the other one regulating the management of investment funds notably through the institution of management companies. The 2002 act entered in force in two successive steps: while extra-directive funds were brought into force on 1st January 2003, UCITS funds became compulsory on 13th February 2007.

Now the Luxembourg financial centre – and ALFI – await the occurrence of UCITS IV.

Thanks to the experience and expertise gained in close to fifty years, Luxembourg is confident in its continuing successful development as a major international centre for investment funds.