ETF IN LUXEMBOURG, A BRIEF DESCRIPTION OF A FEW BASIC LEGAL CONCEPTS

ETFs are among the latest in a series of successful and booming innovations within the financial industry [2][3]. As an international centre of investment fund expertise and excellence, it was a must for Luxembourg to jump onto the bandwagon of operators servicing these products. This paper will more specifically deal with ETFs qualifying as UCITS within the meaning of the Directive 2009/65/EC [4]. A few introductory paragraphs (describing succinctly what an ETF is and the Luxembourg ETFs' current place in the financial sphere) will be followed by a brief description of how ETFs are generally structured, how to assess the UCITS eligibility of an index underlying an ETF, the main criteria to be fulfilled to list an ETF and how to exempt an ETF from taxation in Luxembourg.

INTRODUCTION

1. There is no legal definition of what constitutes an "ETF", an acronym standing for *Exchange-Traded Fund*. An ETF would then literally designate any investment fund the shares/units of which are traded on at least one stock exchange or similar venue (5). For the purposes of this paper ETF will generally be defined more narrowly as a listed UCITS the investment objective of which is to track a financial index, hereafter simply an "index" (6).

2. Considering the current (7) absence of official statistics, it is difficult to assess the number and size of ETFs in Luxembourg and hence the relative position of Luxembourg compared to the European and US markets. According to ALFI statistics, as at September 2009, the Luxembourg ETF industry had 220 ETFs managed by 9 providers with assets of € 32.5 billion (8). More recent figures collected by *DB Research* show that the assets under management of Luxembourg ETFs have crossed the € 50 billion mark as at 31 December 2010, with the Luxembourg share in Europe remaining stable at approximately 20 to 22% over the past three years. This percentage is expected to increase, however, with the advent of the subscription tax / *taxe d'abonnement* exemption (9).

STRUCTURE

3. The *summa divisio* of ETF structuring consists in substance in distinguishing between direct replication structures, on the one hand, and synthetic replication structures, on the other hand.

4. Direct replication means in substance that index tracking will be achieved via the ETF directly holding a basket of assets which is representative of those underlying the index. This could be qualified as the traditional way of structuring an ETF. In this respect, it is interesting to note that ETFs were initially issuing blocks of shares/units upon *in specie* contribution of a portfolio of the relevant index underlying assets.

5. Luxembourg ETFs qualifying as UCITS which opt for a direct replication structure will have to comply with the investment restrictions set forth in Chapter 5 of either the 2002 or 2010 Luxembourg Laws regarding undertakings for collective investment (10) (hereafter the "**Old UCI Law**" and the "**New UCI Law**", respectively, and together the "**UCI Laws**"). In this context, they will benefit in particular from the relaxed investment limits set forth in Article 44 of the **UCI Laws**, as further clarified by Article 12 of the Grand Ducal Regulation of 28 February 2008 (11) (the "**RGD**") and applicable CESR Guidelines (12).

6. Synthetic replication means in substance that index tracking will be achieved via the ETF entering into derivative transaction(s) with one or more counterparties the underlying of whose derivatives may be the (performance of the) assets underlying the relevant index or the (performance of the) index itself (13). According to the ETF industry, synthetic replication presents key comparative advantages vis-à-vis direct replication. Among others, it is less costly, it may permit a near-perfect track of the index before fees and it allows tax optimisation. When the underlying of the derivative is the index itself, it may further permit exposure to certain assets which would not otherwise be authorised for direct investment by a UCITS (14).

7. Luxembourg ETFs qualifying as UCITS which opt for a synthetic replication structure will also have to comply with the investment restrictions set forth in Chapter 5 of the UCI Laws, but potentially with additional flexibility compared to a direct replication structure. In substance, when the underlying of the derivative is the relevant assets, the ETF will be subject in particular to the first sentence of the third paragraph of Article 42 (3) which means that the provisions referred to above for direct replication will need to be applied by transparency. When the underlying of the derivative is the index itself, the ETF will benefit from the last sentence of the third paragraph of Article 42 (3) and more importantly from the then wider definition of what constitutes an eligible index under UCITS (15).

8. Without prejudice to what is set forth in the above paragraph, Luxembourg ETFs which opt for a synthetic replication structure will also need to comply with the requirements of the last sentence of Article 43 (1) of the UCI Laws regarding counterparty risk exposure as well as all relevant implementing regulations, circulars and guidelines (16). In this context, the ETFs will need in particular to make use of the various accepted and available counterparty risk mitigating measures. The creativity of the financial industry in general, and that of the ETF industry in particular, makes the legal and regulatory problems linked to these arrangements quite interesting, but far exceeds the scope of this paper.

INDEX

9. The three basic conditions for an index to be UCITS eligible (17)(18) is that (i) its composition is sufficiently diversified, (ii) it represents an adequate benchmark for the market to which it refers and (iii) it is published in an appropriate manner. Applicable rules to determine the UCITS eligibility of an index will nevertheless differ whether (paragraph 10, below) the relevant UCITS invests directly or indirectly (via derivative) in the assets underlying the index which the UCITS purports to replicate (hereafter a "**direct or indirect investment**") or whether (paragraphs 11 and 12, below) the relevant UCITS enters into (a) derivative transaction(s) the underlying of which is the (performance of the) index itself (hereafter an "**index investment**").

10. As indicated above, a UCITS replicating an index via direct or indirect investment will remain subject to the investment restrictions and asset eligibility rules set forth in Chapter 5 of the UCI Laws, yet benefiting from the so-called "20%–35%" rule of Article 44 of the UCI Laws. To the extent that the replicated index complies with the conditions of this latter provision, as further implemented by Article 12 of the RGD and the relevant CESR's Guidelines (19), its eligibility will not need to be assessed pursuant to the methodology described under paragraph 12, below.

11. UCITS performing index investment will be subject specifically to the rules set forth in Article 9 of the RGD and relevant CESR's Guidelines (20). In this case, because as indicated under paragraph 6 above the assets underlying the index of reference do not need to comply with the asset eligibility rules set forth in Chapter 5 of the UCI Laws, the UCITS concerned may be indirectly exposed to assets which would not otherwise be authorised as direct investment. Among these assets, one may typically note commodities and hedge funds, e.g.

12. Since 2008, the prior recognition of an index by the CSSF as eligible pursuant to Article 9 of the RGD is no longer required and, as a matter of fact, no longer given. For each index, the CSSF instead requires an executed certification of eligibility which is to be produced on the basis of a detailed description of the (self-assessment) methodology adopted by the relevant UCITS or its management company and which will be implemented to assure that the relevant index qualifies as a financial index under Article 9 of the RGD. This methodology does not need to be submitted individually for each sub-fund. This can hence be done for the UCITS as a whole or even by the management company in respect of all the UCITS it manages. Although the CSSF points out that the qualification of a given index as a financial index is the management company's/UCITS' responsibility, the latter must be able to provide the CSSF *a posteriori*, upon request, with the justification of the stance taken. The above-mentioned executed certification of eligibility must be supplemented by a duly filled out table of eligibility (21) and, upon request from the CSSF, by the full description of the index.

LISTING

13. Listing is seen as an intrinsic feature of an ETF. It is also one of the two conditions which an ETF must imperatively meet in order to benefit from the subscription tax/*taxe d'abonnement*'s exemption (22). Describing the conditions to be fulfilled for each such listing, which vary from one venue to another, would far exceed the scope of this paper. In the following lines, we have opted for a more humble stance. That of describing the few criteria to be fulfilled for listing, but also briefly describing the conditions and methods of listing an ETF on the Luxembourg Stock Exchange ("LxSE").

14. Although the listing constraints and timing vary from one European exchange to another, on the whole it has mainly become an administrative process. This process may be more demanding and consequently more time consuming in certain Asian venues. This being said, when arranging for the listing of its ETF, a promoter will typically consider the need for at least one dedicated "market maker" (sometimes referred to as "liquidity provider" or "designated sponsor" depending on the venue concerned) committing to providing continuous two-way pricing in a minimum size (the size being typically based on a given number of shares/units). The ETF promoter may also be compelled to arrange (i) for the publication

of so-called iNAV, i.e. "intraday" or "indicative NAV" (which is compulsory in Frankfurt, Euronext Paris and Milan, for example), (ii) for the disclosure of index constituents on a daily basis or with a slight delay (which is also compulsory in Frankfurt, Euronext Paris and Milan, for example) and (iii) as the case may be (such is the case in Milan, for example) shall track a strictly "rules based index", i.e. involving no discretion in its composition.

15. In this context, listing on the LxSE appears to be a lighter process, although in practice any such listing will generally yield very limited actual trading/dealing. The key condition to be admitted on the LxSE is that the securities to be listed must be freely transferable. An issuer applying for listing on the LxSE must submit a file containing, in particular, a duly fulfilled application form (available, www.bourse.lu), a prospectus, its conditional documents, a letter of understanding by which it commits itself to respect the relevant rules laid down in the Rules and Regulations of the LxSE (a template of which is available on the LxSE website) and, as a matter of principle, a confirmation by a recognised clearing system on the acceptability of the securities to be listed. A Luxembourg listing agent will usually be designated to liaise with the LxSE both in relation to the admission process on the LxSE and the various ongoing reporting requirements.

TAXATION

16. Starting from 1 January 2011 ETFs (whether UCITS or not) are exempt from the subscription tax/*taxe d'abonnement*. The key relevant provisions of the New UCI Law (23) do not in fact refer to the term "Exchange Traded Fund" or "ETF" but specify that those undertakings for collective investment, as well as any sub-fund thereof, (i) whose securities are listed or traded on at least one stock exchange or another regulated market operating regularly, recognised and open to the public, and (ii) whose exclusive object is to replicate the performance of one or more indices, are exempt from the subscription tax/*taxe d'abonnement*. The relevant provisions further provide that if several classes of securities exist within the undertakings for collective investment or sub-fund thereof, the exemption only applies to classes fulfilling the condition (i). Finally, it has been appropriately specified (24) that the condition of exclusive objective does not prevent the management of liquid assets, if any, on an ancillary basis by means of placement of securities issued by eligible funds investing in money market instruments and/or deposits, or the use of techniques and instruments used for hedging or for the purposes of efficient portfolio management.

17. The New UCI Law clarifies the term "index" by specifying (25) that an index must represent an adequate benchmark for the market to which it refers and must be published in an appropriate manner. The relevant provisions further provide that additional or alternative criteria may be determined by Grand Ducal regulation. It is interesting to note that the provisions referred to above, when clarifying the term "index", do not refer to Article 41 (1) g) of any of the UCI Laws which discuss the eligibility of "financial indices" as eligible underlying of a financial derivative instrument, or Article 44 (1) which defines the criteria for a UCITS index tracker to exceed the limits of Article 43 (see the Index section above for further developments in this respect). Whereas the latter requires that an index is sufficiently diversified, representative and appropriately published, the definition for the tax exemption only requires that the two last criteria are met, thus potentially allowing undertakings for collective investment having as an objective to track an index which is less diversified than that required by the UCITS requirements to still benefit from the exemption. ■

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2 *"Since the introduction of the first ETF in the form of Standard & Poor's Depository Receipts (SPDRs) in 1993, ETFs have become popular investment vehicles in the financial markets. Interest in ETFs among institutional and private investors has grown enormously in recent years."* (http://www.alfi.lu/setting-luxembourg/exchange-traded-funds).

3 In the 7 May 2010 issue of Ignites Europe, it states that "*European ETFs have around €173bn of assets under management, and research house Cerulli predicts this figure will reach nearly €400bn by 2013*". This figure was confirmed in the 13 January 2011 issue of Ignites Europe where: "*Mr Michalik [head of Deutsche Bank's ETF arm, db x-trackers] forecasts that European index fund assets will double to over €440m by the end of 2013, according to Portfolio International.*"

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

5 Although mainly focusing on the US ETF market, nevertheless we recommend the following internet page http://en.wikipedia.org/wiki/Exchange-traded_fund and related link to anyone interested in more general "easy to read" information (including historical information) on ETFs.

6 For the avoidance of doubt, it is understood, however, that Luxembourg laws and regulations do, as a matter of principle, allow for the set-up of other types of ETFs.

7 This is likely to be changed with the specific exemption of the *taxe d'abonnement* which ETFs may benefit from after 1 January 2011.

8 http://www.alfi.lu/setting-luxembourg/exchange-traded-funds. Please note that those statistics cover Luxembourg ETFs in general and are not limited to ETFs qualifying as UCITS.

9 Please refer to the section Taxation below for more developments on this matter.

10 The Luxembourg Law of 20 December 2002 regarding undertakings for collective investment as amended and the Luxembourg Law of 17 December 2010 regarding undertakings for collective investment, respectively. For a non-official English translation of the latter, please connect to http://www.ehp.lu/uploads/media/Loi_OPC_Law_UCI_2010.pdf.

11 Grand Ducal Regulation of 8 February 2008 relating to certain definitions of the Old UCI Law and implementing Directive 2007/16/EC of 19 March 2007 (also known as the *Eligible Assets Directive*) implementing the UCITS Directive 85/611/EEC as regards the clarification of certain definitions. This Grand Ducal Regulation currently refers to the Old UCI Law only. We assume, however, that it will equally apply to the New UCI Law.

[12] *CESR's guidelines concerning eligible assets for investment by UCITS* – March 2007 (Updated September 2008), Ref.: CESR/07-044b.

[13] Article 41 (1)(g) of the UCI Laws.

[14] Please refer to the section Index below for more developments on this matter.

[15] Please refer to the section Index below for more developments on this matter.

[16] In this regard, one will consider among others Article 8 of the RGD, Circular CSSF 07/308 of 2 August 2007 re *Rules of conduct to be adopted by undertakings for collective investment in transferable securities with respect to the use of a method for the management of financial risk, as well as the use of derivative financial instruments;* Circular CSSF 08/356 of 4 June 2008 re *Rules applicable to undertakings for collective investment when they employ certain techniques and instruments relating to transferable securities and money market instruments*, as well as Sections 8.4.2. and 8.4.3. of Chapter II of the CSSF 2008 Annual Report. One should also consider Chapter VI of CSSF Regulation 10-4 and *CESR's Guidelines on Risk Measurement and the Calculation of Global Exposure and Counterparty Risk for UCITS* – 28 July 2010, Ref.: CESR/10-788.

[17] It should be noted that a given index does not need to comply with the rules described in this section if, in substance, the UCITS exposing itself to that index (and in spite of the exposure to that index) remains in line with the "ordinary" investment restrictions set forth in Chapter 5 of the UCI Laws and in particular the so-called "5%–10%–40%" rule.

[18] As indicated below in the Taxation section, there is no match between a UCITS eligible index and an index eligible to benefit from the exemption of subscription tax / *taxe d'abonnement*, the definition of the latter index being wider than the former.

[19] *CESR's guidelines concerning eligible assets for investment by UCITS* – March 2007 (Updated September 2008), Ref.: CESR/07-044b.

[20] *CESR's guidelines concerning eligible assets for investment by UCITS – March 2007 (Updated September 2008)*, Ref.: CESR/07-044b *and CESR's guidelines concerning eligible assets for investment by UCITS – The classification of hedge fund indices as financial indices* – July 2007, Ref.: CESR/07-434.

[21] The CSSF has recently issued a compulsory template table of eligibility.

[22] Please refer to the section Taxation below for more developments on this matter.

[23] Article 175 e) of the New UCI Law which is made applicable to funds subject to the Old UCI Law.

[24] Article 176 (5) of the New UCI Law.

[25] Article 176 (4) of the New UCI Law.