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AVOCATS À LA COUR

Newsletter September 2007

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1. EC Directive 2007/16/EC of 18 March 2007 implementing the UCITS Directive as regards the clarification of certain definitions and CESR guidelines of March 2007 concerning eligible assets for investments by UCITS

On 19 March 2007, following over two years of consultation and cooperation within the Committee of European Securities Regulators (CESR), the European Commission (the "Commission") adopted a directive (the "Directive") to clarify certain concepts and definitions of eligible assets in the meaning of Council Directive 85/611/EC, as amended' (the "UCITS Directive"). On the same date CESR has issued its final advice on eligible assets to complement this Directive.

The directive 2001/108 of the European Parliament and Council of 21 January 2002 amending the UCITS Directive, which broadened the scope of the eligible investments for UCITS, merely defined *transferable securities* from a legal-formal point of view. As a result, this definition was potentially applicable to a wide range of instruments with various characteristics, features and different levels of liquidity. The definitions of *money market instruments* ("MMIs"), *financial derivative instruments* ("FDIs"), *financial technique and instruments* and *financial indices* also needed clarifications. Considering the permanent evolution and creation of new and innovative financial instruments, the uncertainty as to whether a specific instrument was eligible in the meaning of the UCITS Directive had grown amongst the market participants.

In order to ensure a uniform application of the UCITS Directive and to help Member States to develop a common understanding as to whether a given asset category is eligible for a UCITS, the Directive aims at providing competent authorities and market participants with clarifications on certain terms defined in the UCITS Directive through basic criteria permitting to assess whether or not a class of financial instrument is covered by such defined terms. By elucidating such basic criteria, the Directive does not establish an exhaustive list of eligible financial instruments and transactions, but CESR's advice complementing the Directive, specifically refers to certain type of instruments and should therefore clearly by read in conjunction with the Directive.

The main teachings of the Directive may be summarized as follows:

The Commission sets several criteria to determine whether a security may qualify as a "**transferable security**", such as the limitation of the potential loss to the amount invested, its liquidity, its reliable valuation, the appropriate information relating thereto, its negotiability, its compliance with the objective/policy of the relevant UCITS and the capture of its risk by the UCITS risk management process. The security's admission to trading on a regulated market provides a presumption of liquidity and negotiability unless the UCITS possesses information that leads to another conclusion. The liquidity can be appreciated at the portfolio level. The Commission

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concludes that the following type of instruments would fall under the definition of transferable securities: (a) the units of closed ended funds (whatever their nature), provided that they meet the criteria of a transferable security, that the closed ended funds are subject to certain corporate governance mechanisms, and provided that they are managed by an entity subject to national regulation for the purpose of investors protection; (b) asset backed securities, provided that they meet the criteria of transferable securities and if they are backed by, or linked to the performance of other assets. The look through approach is only applicable where a transferable security (or money market instrument) embeds a derivative and the Directive clarifies in its Article 10. situations in which that is the case (to be considered in conjunction with CESR's advice on the same Article specifying the nature of certain instruments, such as CDOs).

The Commission also determines the criteria applicable to money market instruments ("**MMI**"), defined by Article 1 (9) of the UCITS Directive. A MMI must be understood as an instrument (i) having an initial or residual maturity of less than 397 days, or (ii) that undergoes regular yield adjustments in line with money market conditions at least every 397 days or (iii) the risk profile of which corresponds to that of instruments complying with (i) or (ii)above. The Commission also further explains the concept of liquid instruments with a value which can be accurately determined at any time and establishes a presumption of liquidity where the relevant MMIs are admitted to or dealt in on a regulated market.

The underlyings of financial derivative instruments ("**FDIs"**) may be (i) any of the eligible assets for a UCITS, (ii) interest rates, (iii) foreign exchange rates or currencies and (iv) financial indices. Also, the Commission specifies that credit derivatives are considered as eligible assets provided that they allow the transfer of credit risk of an asset referred to under (i) to (iv) above, that they comply with the criteria applicable to OTC FDIs, that they do not result in the delivery of non permissible assets for UCITS, and that their specific risks are adequately captured by the UCITS risk management process. The Commission also gives guidelines on the valuation principles to be followed in relation to OTC FDIs and confirms that FDIs on single commodities remain forbidden.

Financial indices, whether or not composed of eligible assets, can be considered as eligible financial indices provided that they are sufficiently diversified, that they represent an adequate benchmark for the market to which they refer, and that they are published in an appropriate manner. The Directive sets, in respect of each of these three conditions, specific criteria which need to be fulfilled. Where the financial index complies with these conditions and criteria, there is no need to look through the financial index. CESR's advice illustrates that indices based on financial derivatives on commodities or indices on property may be eligible if they comply with the relevant criteria.

Techniques and instruments relating to transferable securities or MMIs used for the purpose of efficient portfolio management must (i) be economically appropriate

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(realised in a cost effective way) and (ii) entered into for reduction of risk, or reduction of cost, or to generate additional capital or income with a level of risk consistent with the level of risk of the UCITS and the risk must be adequately captured in the UCITS risk management process.

The Directive specifies that EU Member States must adopt by 23 March 2008 the necessary measures to comply with the Directive and such measures must be applied from 23 July 2008.

The CSSF, in its regulatory practice, already now fully applies the provisions of the Directive and the related CESR advice. It is expected that the provisions will be formally implemented later this year or early next year by means of grand-ducal regulation and/or CSSF Circulars.

2. CESR's guidelines of July 2007 concerning eligible assets for investment by UCITS – classification of hedge fund indices as financial indices

In the context of the ongoing discussions on eligible investments by UCITS (see also section 1. on this subject), CESR and the supervisory authorities competent for authorising UCITS in the different Member States had taken the view that, pending the clarification of further requirements, hedge fund indices were not eligible as underlying of financial derivative instruments in which UCITS can invest.

After an active consultation process, CESR has now published guidelines dated July 2007 pursuant to which hedge fund indices are acceptable as underlying of a financial derivative investment if the relevant hedge fund index meets, in addition to the conditions applicable to all financial indices, the following requirements:

- the methodology of the index shall provide for the selection and rebalancing of the components on the basis of predetermined rules and objective criteria;
- the index provider shall not accept payments from potential index components for the purpose of being included in the index;
- the methodology of the index shall not allow retrospective changes to previously published index values (practice known as backfilling).

In addition the UCITS and the UCITS manager must carry out a due diligence including consideration of the quality of the index. In assessing the quality, at least the following factors will need to be taken into consideration:

a) the comprehensiveness of the index methodology comprising information on weightings and classification of components;

b) the availability of information about the index, including information on what the index is trying to represent, whether the index is subject to an

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independent audit, whether the index is published and whether this will affect the ability of the UCITS to accurately calculate its net asset value;

c) matters relating to the treatment of index components including the way the index provider carries out due diligence on the NAV calculation of the index components.

The UCITS must keep records of the due diligence checks carried out.

Ultimately where a UCITS wishes to gain exposure to this type of index, it needs to make an informed assessment on whether the index is an appropriate investment in view of the UCITS' investment objective and policy and risk profile, and the UCITS must be able to justify its decision.

The CSSF, in its regulatory practice, applies CESR's guidelines on the subject.

3. CSSF Circular 07/308 of 2 August 2007 concerning the use of financial derivative instruments and the management of financial risks by UCITS

The CSSF issued on 2 August 2007 a circular 07/308 concerning the "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 risks, as well as the use of financial derivative instruments".

The action to be taken by existing UCITS which make use of financial derivative instruments ("derivatives") is implied by Section V. of the Circular, as described at the end of this summary of the circular.

In the introduction headed "I. **General Provisions**", the CSSF states that UCITS must devote greater efforts and means to risk quantification and oversight because UCITS may, within the scope of their investment policy, use derivatives, which was not the case before the implementation of UCITS III, and that therefore the law of 20 December 2002 on undertakings for collective investment (the "2002 Law") imposes on UCITS to employ a "Risk Management" structure as well as a detailed financial risk limitation system.

In such introduction, the circular also clarifies that it deals only with the financial risks covered in the 2002 Law, namely the global exposure, the counterparty risk and the concentration risk. It also deals with coverage rules and valuation of OTC derivatives. It does however not deal with other types of risks which UCITS may incur (such as operating risk, payment on delivery risk, legal risk, etc.).

In a section II. headed "**Implementation of a risk management process**" the CSSF distinguishes between (i) sophisticated UCITS (and non-sophisticated UCITS using a VaR approach), whose Risk Management unit must meet certain specific qualitative criteria set forth in the circular in order to satisfy the CSSF's expectations and (ii) non-sophisticated

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UCITS, where the organisational structure of Risk Management does not have to be as developed and substantive as that of sophisticated UCITS.
In both cases, Risk Management must cover the global exposure, the counterparty risk as well as the concentration risk associated with all the portfolio's positions. Risk Management's scope of activities should further comprise the monitoring of coverage rules, valuation of OTC derivatives and the establishment of risk monitoring reports for the persons who conduct the business of the management company or the self-managed investment company (*société d'investissement auto-gérée*, "SIAG") (the "Conducting Persons").

In section III. headed "**Limitation of risks applicable to UCITS' investments**" the circular, after quoting the applicable provisions of the 2002 Law, successively deals with the limitation of market risk, limitation of counterparty risk and limitation of concentration risk.

With respect to limitation of *market risk* (article 42 (3) of the 2002 Law), the circular specifies that each UCITS has to conduct a self-assessment of its risk profile to classify itself either as a non-sophisticated UCITS or a sophisticated UCITS, which classification must be approved by the Conducting Persons and the board of directors of the Management Company or SIAG. The assessment process must be documented and must be kept available for the CSSF.

The rules of conduct to be considered in the classification process are the following:

- a non-sophisticated UCITS is a UCITS with less or less complex positions on derivatives or with derivatives used solely for hedging purposes; and

- a sophisticated UCITS is a UCITS using, for an important part, derivatives and/or making use of more complex strategies or instruments.

The circular then describes how non-sophisticated UCITS and sophisticated UCITS, respectively, must determine their global exposure, which, pursuant to the 2002 Law, must not exceed the UCITS' total net assets:

- non-sophisticated UCITS determine their global exposure on the basis of the commitment approach pursuant to which positions on derivatives instruments must be converted into equivalent positions on the underlying assets, subject to the possibility to use certain netting processes. An Appendix 1. to the circular details the calculation method for the derivatives most commonly used by UCITS. Non-sophisticated UCITS are however not precluded from using, in the same manner as sophisticated UCITS as described below, a VaR approach;

- sophisticated UCITS must in principle calculate their global exposure by using an approach based on the internal model, taking into consideration all the sources of global exposure (general and

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specific market risks) which might lead to a significant change in the portfolios' value. Such internal model is to be of the value-at-risk ("VaR") type, using certain parameters, as more fully discussed below.

For sophisticated UCITS (and non-sophisticated UCITS which use the VaR approach), the circular distinguishes between the use of a "relative VaR limitation" which may not exceed two times the VaR of a reference portfolio of the same market value as the UCITS. The circular describes how the relevant reference portfolio must be determined by the UCITS.

With respect to sophisticated UCITS which are unable or for which it is not appropriate to determine a reference portfolio (such as "absolute return" type UCITS), an absolute VaR on all of the portfolios' positions must be determined and such maximum VaR may not exceed a threshold of 20%.

The required VaR parameters are set forth in an Appendix 2. to the circular, which also describes to what extent *equivalent* VaRs with different parameters can be used.

With respect to limitation of *counterparty risk* (article 43 (1) of the 2002 Law), the circular clarifies that the calculations can be limited to OTC derivatives (and need not take account of derivatives executed on a market involving a clearing house meeting certain conditions). The circular then describes the detailed rules for calculating counterparty risk, followed by acceptable methods for mitigating the counterparty risk, including netting techniques and the effect of the UCITS receiving financial collateral.

With respect to the limitation of the *concentration risk* (articles 42 (3) and 43 of the 2002 Law), the circular reiterates the general principle that derivatives (with the exception of derivatives on certain indices) must be looked through for the purpose of the investment limits imposed by the 2002 Law.

In section IV. headed "**Other provisions regulating the use of financial derivative instruments**" the circular lays down the coverage rules distinguishing between the situation where (i) the derivative contract provides for physical delivery of the underlying financial instrument (in which case the UCITS must hold, in principle, in its portfolio the underlying financial instrument as cover) and where (ii) the derivative contract provides for cash payment (where the UCITS must not hold the underlying financial instrument but where it is sufficient that it holds sufficient and adequate liquid assets to make the contractually required payment, thus allowing UCITS to hold synthetic short positions).

The same section of the circular provides for the valuation rules applicable to OTC derivatives and the method by which such valuation must be verified by either an appropriate third party or a unit of the UCITS itself which is independent from the department overseeing asset management.

The final section V. headed "**Information to be provided to the Commission**"

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describes the information which must be submitted to the CSSF entailing mainly the following obligations:

- the drawing up and providing of clear and precise documentation with respect to the risk management process at the time of set-up of the management company or the SIAG, in line with the requirements of the circular;

- the drawing up and providing of updated documentation and information each time where a change to the UCITS or the launch of a new compartment would entail changes to the risk management process previously used;

- management companies and SIAGs already approved by the CSSF must proceed with an internal self-evaluation to determine whether the provisions of the circular are met and, if that it not the case, update their risk management process and submit an updated version (in track change mode) to the CSSF. This also entails for the board of directors and the Conducting Persons to conduct, as indicated above, the self-assessment of the risk profile to conclude on the classification of the UCITS (and each sub-fund) as a non-sophisticated or sophisticated UCITS (or sub-fund).

This section then describes, in six sub-sections, the information which the description of the Risk Management procedure must comprise.

The circular concludes with providing in section VI. headed "**Repealing provisions**" that it enters into force immediately and repeals CSSF Circular 05/176.

An English translation of CSSF Circular 07/308 will be published on our website shortly.

4. MIFID and UCITS/UCIs

The Luxembourg law of 13 July 2007 on markets in financial instruments (the "MiFID law") implements Directive 2004/39/EC of 21 April 2004 concerning the markets in financial instruments ("MiFID").

The legal framework has been completed by:

- The grand-ducal decree of 13 July 2007 relating to the organisational requirements and the rules of conduct (implementing Directive 2006/73/EC which executes the MiFID);

- The grand-ducal decree of 13 July 2007 relating to the official stock exchange listing (implementing Directive 2001/34/EC on the admission of securities to official stock exchange listing and on information to be published on those securities, and executing article 37 of the MiFID law).

Further guidances are provided by different CSSF circulars:

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- CSSF Circular 07/302 providing details on the requirement to report transactions in financial instruments in accordance with article 28 of the law of 13 July 2007 on markets in financial instruments;

- CSSF Circular 07/305 relating to the law of 13 July 2007 on markets in financial instruments (presenting the main modifications introduced by the MiFID law);

- CSSF Circular 07/306 on technical arrangements relating to the obligation to report transactions in financial instruments in accordance with article 28 of the law of 13 July 2007 on markets in financial instruments;

- CSSF Circular 07/307: MIFID - Rules of conduct in the financial sector.

The CSSF has announced further circulars to be published during the second half-year of 2007.

The MiFID law will enter into force on 1 November 2007.

UCITS are not themselves subject to the MiFID rules but their operation and distribution will be impacted. The main area of application of MiFID to UCITS is certainly the distribution of shares/units to investors and the application of the local MiFID rules by the professionals which are in direct contact with the investors. The UCITS and/or their management companies have to be satisfied that such professional providers directly or indirectly appointed by them comply (where applicable) with the MiFID rules.

5. CSSF Circular 07/309 of 3 August 2007 relating to risk spreading in the context of Specialised Investment Funds

The law of 13 February 2007 on specialised investment funds ("SIFs") states that SIFs are subject to the principle of risk-spreading but does not provide for specific investment rules or restrictions. The CSSF, via circular 07/309, has issued the following guidelines in this regard.

(1) A SIF may not invest more than 30% of its assets or commitments to subscribe in securities of the same nature issued by the same issuer.

(2) Restriction described under (1) does not apply (meaning a SIF may invest up to 100% of its assets or commitments to subscribe in) to investments in:

(i) sovereign securities; and

(ii) target UCIs which are subject to risk-spreading requirements at least comparable to those applicable to a SIF, it being understood that a sub-fund of a target umbrella UCI is deemed a distinct issuer if the segregation of liabilities amongst the sub-funds of such umbrella UCI is ensured.

(3) To ensure that a similar diversification is ensured for SIFs engaging in short sales, the Circular provides that short

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sales may not result in the SIF holding open positions on securities of the same nature issued by the same issuer representing more than 30% of its assets.

(4) When using derivative financial instruments, a SIF must ensure risk-spreading comparable to the above via an appropriate diversification of such derivatives' underlying assets. With the same objective, counterparty risk in OTC transactions must, as the case may be, be limited in consideration of the relevant counterparty's quality and status.

(5) For the purpose of the aforesaid restrictions, a reference to SIF has to be understood as a reference to any of the sub-funds of an umbrella SIF.

(6) The above are all "principles based" investment restrictions, meaning that CSSF may grant exemptions on a case by case basis.

(7) It is expected that compliance with expressly disclosed limits may, subject to an appropriate wording in the SIF offering document, benefit from a flexible reading so that limited and temporary non-compliance therewith may be permitted without resulting in a breach of the principle of risk-spreading.

(8) Although the Circular specifies that the offering document must contain quantifiable limits evidencing the principle of risk spreading, it is possible (to be discussed on a case by case basis with the CSSF) for some of these limits not to be specifically included in the offering document, but to be only communicated to the CSSF.

An English translation of CSSF Circular 07/309 will be published on our website shortly.

6. CSSF Circular 07/310 of 3 August 2007 on financial information to be prepared by Specialised Investment Funds

For statistical reasons and to enable the CSSF to exercise its supervisory functions, all SIFs need to provide monthly and annual information similar to that transmitted by UCIs under CSSF Circular 97/136.

An English translation of CSSF Circular 07/310 will be published on our website shortly.

7. Law of 11 May 2007 concerning the creation of a family estate management company ("société de gestion de patrimoine familial", "SPF")

The law of 11 May 2007 has come into force on 14 May 2007. It aims at allowing natural persons to use a legal entity for the acquisition, holding, management and realisation of financial assets in view of the organisation of their private wealth management to the exclusion of commercial activities. This law is the answer on the private investment side to

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the abolition of the tax status of holding 29 companies requested by the European Commission according to a decision of July 2006 claiming that the holding 29 tax regime is a state aid incompatible with the European market.

8. Draft bill of law n° 5730 relating to the modernisation of the amended law of 10 August 1915 on commercial companies

On 8th June, 2007 a draft bill of law was submitted to the Luxembourg parliament aiming at completing a wider effort of modernising the Luxembourg corporate law as already partially initiated by recent amendments made to the law of 10th August, 1915 on commercial companies, in particular by the laws of 25th August, 2006 and 27th March, 2007.

The scope of the changes contemplated by the draft bill of law is very broad and relates as well to the different forms of companies as to the various aspects of corporate life such as incorporation, organisation, restructuring, dissolution and liquidation of the companies.

In addition to some amendments that will impact on the general rules applicable to companies such as *inter alia* the introduction of a general regime of dissolution without liquidation for companies whose shares are held by a single shareholder, a specific regime relating to the *usufruct* of shares, a specific regime of invalidity of shareholders' meetings, the possibility for all forms of companies to proceed with public or private bond issues, most of the contemplated amendments consist more specifically changes to the regime of the public companies limited by shares (*sociétés anonymes)* and the private limited companies (*sociétés à responsabilité limitée*).

Given the early stage of the draft bill of law in the legislative process, we will only mention some of the main provisions that are likely to be amended or introduced by the new law once adopted:

1. **For the *sociétés anonymes*:**

- possibility to issue of shares below par value of shares of the same class already in issue
- possibility to grant multiple voting rights for certain shares
- validity of contractual restrictions to the free transferability of shares
- establishment of management committees (comités de direction)
- amendments to the regime of conflict of interests at the level of the management bodies of the company
- introduction of a specific claim for minority shareholders
- confirmation of the possibility for the board to resolve by way of circular resolutions
- amendments to the rules regulating the holding of and voting at shareholders' meetings
- introduction of squeeze out and sell out rules for shareholders
- amendments to the liability regime of board members in case of important losses of the company

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- amendments to the share redemption and financial assistance rules.

2. For the *sociétés à responsabilité limitée:*

- possibility to issue founder shares and shares without voting rights
- introduction of a regime for the redemption of the company's own shares
- introduction of financial assistance rules
- introduction of rules relating to board of managers and clarifications as to the provisions regulating the holding of and resolving at managers' and shareholders' meetings
- introduction of squeeze out and sell out rules for shareholders

The draft bill of law further contemplates the introduction of a new form of commercial company, the *société par actions simplifiée*, inspired by the regime of the French *société par actions simplifiée*.

Finally the draft bill of law intends to provide for the possibility, for consistency purposes, of a future codification of the Luxembourg corporate law.

According to the draft bill of law a transitional period of 24 months following the entry into force of the new law shall allow existing companies to adapt their current articles of association to the amended and modernised law on commercial companies.

9. First decision of the Council for Competition Matters

On 23 April 2007, the Council for Competition Matters (*Conseil de la Concurrence* the "Council") set up by the law of 17 May 2004 on competition (the "2004 Law") rendered its first decision (the "Decision").

An independent Luxembourg distributor of fuel, Rock Fernand Distribution Sàrl (Rock), requested Tanklux SA, the company owing the petroleum tanks in the port of Mertert, which is located on the Mosella River next to the German border, to stock 1,000 m3 fuel (for heating) in its tanks.

Tanklux refused to let part of its tanks capacity to Rock, arguing that all its tank capacities were let out. Rock considered that the refusal of Tanklux was exclusively based on the intention of Tanklux to protect the interests of a number of leading petroleum companies who rent capacities of the tanks in the port of Mertert and filed a complaint in August 2002 with the Ministry for Economic Affairs, under the law of 17 June 1970 on restrictive commercial practices (the "1970 Law"), complaining that Tanklux had abused its dominant position. The 1970 Law has in the meantime been abrogated and replaced by the 2004 Law.

The Investigations were initially made by the commission for restrictive commercial practices, a body set up by the 1970 Law. Since the coming into force of the 2004 Law, the Investigation Division of Competition Affairs (*Inspection de la*

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Concurrence, the "Investigation Division") took over the investigations.

During the investigations on the potential abuse of Tanklux's dominant position, if any, an additional question arose. The Investigation Division revealed that the tanks could be supplied either by waterway (fluvial transport), by rail or by road. The tanks were almost exclusively supplied by waterway. This mean of supplying was expressly laid down in the lease agreements entered into between Tanklux and the lessees. In some of these lease contracts, the company in charge of the fluvial transport had even been appointed by Tanklux. Hence, a second issue arose in relation of the compatibility of such practices with the competition rules.

The Council, having conducted an exhaustive analysis of the Luxembourg petroleum market by analyzing the various types of petroleum as chemical substances and the use thereof as well as the specific legislation governing the petroleum sector in Luxembourg, defined the relevant market being the national market of storage of fuel in Tanklux's tanks located in the port of Mertert.

Since Tanklux owns 100 % of the petroleum storage capacity in the port of Mertert, it occupies a monopolistic position on such market, i.e. a dominant position.

However, the Council concludes that there was no abuse of the dominant position by Tanklux.

Finally, the Council requested the Investigation Division to investigate further the aspect of a potential abuse of dominant position in the market for the transport of petroleum products by waterway as it was not clear on the basis of the relevant information and elements in the file how Tanklux used its dominant position in the market for the storage of petroleum products in order to oblige its contractors to enter into a transport agreement with the fluvial transport undertakings appointed by Tanklux, nor whether Tanklux owns an interest in such fluvial transport companies.

We have commented the Council's Decision in the 2007 edition of the European Competition Journal which will be edited in the near future.

For any further information please contact us or visit our website at www.ehp.lu.

The information contained herein is not intended to be a comprehensive study or to provide legal advice and should not be treated as a substitute for specific legal advice concerning particular situations. We undertake no responsibility to notify any change in law or practice after the date of this document.

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