Retrospective 2005 – Selected legal and regulatory changes

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1. Relaxation of the CSSF's position as to tolerance thresholds in relation to investment policy/restriction breaches by UCIs[1]

CSSF Circular 02/77 concerning the protection of investors in case of NAV calculation error and correction of the consequences resulting from non-compliance with the investment rules applicable to UCIs provides for tolerance thresholds (0.25 % for cash and money market funds; 0.50 % for bond funds and mixed funds; 1.00 % for equity funds) in relation to **net asset value calculation errors**.

The same Circular provides that, except for the *de minimis* rule[2], no tolerance thresholds can be applied in case of **investment policy/restriction breaches**. As a consequence, the provisions of Circular 02/77 entailed that, upon the correction of the consequences resulting from an

[1] In this document, the term UCITS refers to undertakings for collective investment in transferable securities subject to the amended EU Directive 85/611/EEC and part I of the Luxembourg law of 20 December 2002 regarding undertakings for collective investment whereas the term UCI refers to both UCITS and other undertakings for collective investment organised under part II of the aforesaid law of 20 December 2002.

[2] Under the *de minimis rule*, a UCI may decide not to pay to individual investors indemnification amounts which do not exceed a specific amount, generally fixed at EUR 25, due to the fact that bank charges and other costs are likely to exceed the amount to be paid.

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investment policy/restriction breach, (i) the UCI must be fully indemnified for the loss incurred and (ii) upon such indemnification of the UCI, shareholders who subscribed/redeemed during the breach period must also be indemnified by reference to the recalculated net asset value, regardless of any materiality considerations (except for the *de minimis* rule).

Since early 2005, the CSSF takes the position that the tolerance thresholds applicable in relation to net asset value calculation errors (0.25 %, 0.50 % and 1.00 %, as described above) can also be applied in the context of the indemnification of investors in case of investment policy/restriction breaches.

Consequently, in case of an investment policy/restriction breach and upon the subsequent cure of the breach:

- the UCI will need to be indemnified for any loss incurred without regard to any tolerance thresholds,

<u>but</u>

- investors will only need to be indemnified if the error impacted the NAV per share by more than the applicable threshold of 0.25 %, 0.50 % or 1.00 %, as may be applicable depending on the investment policy of the Fund concerned.

2. CSSF Circular 05/186 reflecting the implications of CESR[3] discussions on UCITS[4] III grandfathering provisions

The purpose of this CSSF Circular is to inform about the CESR recommendations[5] which are expected to be applied by the supervisory authorities in the various EU member countries in which Luxembourg UCITS are registered for public distribution. The CESR recommendations themselves are more detailed than the CSSF Circular which only reflects the main consequences arising from the recommendations:

- the publication by all UCITS (grandfathered or not) of a simplified prospectus as from 30 September 2005 at the latest;
- the implementation of the Product Directive[6], including evidence of employing a risk management process, by 31 December 2005 at the latest; and
- the compliance of management companies which manage UCITS with the Substance Directive[7] by 30 April 2006 at the latest.

An English translation of the CSSF Circular 05/186 is published on our website.

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[3] Committee of European Securities Regulators
[4] See footnote 1
[5] CESR's guidelines for supervisors regarding the transitional provisions of the amending UCITS Directives (2001/107/EC and 2001/108/EC), ref: CESR/04-4346, February 2005
[6] Directive 2001/108/EC
[7] Directive 2001/107/EC

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In the same manner as the CESR recommendations, the CSSF Circular does not specifically deal with the implementation of the Substance Directive in respect of self-managed SICAVs. Applying to self-managed SICAVs the same deadlines as those applicable to management companies would imply that self-managed SICAVs would have to implement the Substance Directive by 30 April 2006, at the latest.

The aforementioned deadlines are applicable to Management Companies which have created new UCITS after 13 February 2002 and to umbrella UCITS within which new sub-funds have been created after 13 February 2002. Similarly Management Companies and umbrella UCITS which have not created new UCITS or sub-funds, respectively, after 13 February 2002, have to implement the Product Directive and the Substance Directive before creating new UCITS or sub-funds, respectively. The question arose whether the aforesaid requirements to implement the Product Directive and the Substance Directive prior to 13 February 2007 are also applicable in relation to Luxembourg UCITS which are not registered for public distribution in any EU member country (other than Luxembourg) to the extent that for these management companies and UCITS, one can take the view that only the provisions of Luxembourg law (which do not comprise the deadlines brought forward by the CESR recommendation) are relevant. In this context, the CSSF has accepted that UCITS which do not market their shares in any EU member country (other than Luxembourg), comprising UCITS which market their shares only in non-EU member countries (such as Switzerland), have the option to wait until 13 February 2007 for implementing both the Product and the Substance Directive and are not prevented from creating new UCITS or sub-funds in the meantime.

3. CSSF Circular 05/185 on Management Companies managing UCITS and UCITS in the form of self-managed SICAVs (aiming at complementing CSSF Circular 03/108)

On 30 July 2003, the CSSF issued CSSF Circular 03/108 describing the rules applicable to management companies managing UCITS and to UCITS organised in the form of self-managed SICAVs. In the Circular, the CSSF had, in the context of the description of the human resources which need to be available to a management company or a self-managed SICAV, ruled that at least one of the two persons responsible for conducting the business of the management company (or the self-managed SICAV) has to be "on site".

In the new Circular 05/185 published on 24 May 2005, the CSSF specifies that, in light of the experiences made in the setting-up of management companies and self-managed SICAVs, it can accept, on a case by case basis, that none of the two persons conducting the business be on site if the CSSF is comfortable that the proposed set-up of the management company or the self-managed SICAV comprises sufficient other features which permit to conclude that it has in Luxembourg more than only an address or a registered office. The Circular mentions, as an illustration, Luxembourg resident directors, the holding of board meetings in Luxembourg and other

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considerations of corporate governance as features which, in addition to others, may be taken into consideration by the CSSF in this context.

The CSSF Circular does not provide any details as to what would constitute the minimum required substance. However, as an example, we believe that a situation where the management company or the self-managed SICAV has in Luxembourg one or more members of permanent or temporary staff (other than the persons conducting the business) one could conclude that there is sufficient substance in Luxembourg, in which case it would be acceptable for none of the two conducting persons to be themselves on site.

An English translation of the CSSF Circular 05/185 is published on our website.

4. CSSF Circular 05/177 on the approval process of Marketing Material used in the context of UCIs

IML Circular 91/75 required that any marketing documents published by a Luxembourg UCI be approved by the CSSF unless they were subject to an approval process by the supervisory authority of the country where such marketing material was used. CSSF Circular 05/177 published on 6 April 2005 abrogates this requirement, reminding however that marketing documents must be prepared in accordance with the rules of conducts applicable to the institution responsible for preparing them and, obviously, must not be misleading.

An English translation of the CSSF Circular 05/177 is published on our website.

5. Use of derivative financial instruments by UCITS and other investment restriction related issues

5.1 CSSF Circular 05/176

On 5 April 2005 the CSSF has published Circular 05/176 concerning the rules of conduct to be adopted by UCITS in relation to the use of financial derivative instruments. The Circular mirrors to a large extent the text of the European Commission Recommendation on the use of financial derivative instruments for UCITS[8]. In the same manner as the EC Recommendation, the CSSF Circular distinguishes between non-sophisticated UCITS which have to assess market risk by using the commitment approach and sophisticated UCITS which may adopt a method of assessing leverage by means of VaR approaches and stress tests. The CSSF Circular further discusses how collateral can be recognised in order to reduce a UCITS' counterparty risk arising from the use of financial derivative instruments. Also, the CSSF Circular describes how cover rules apply to transactions with listed and OTC financial derivative instruments.

An English translation of the CSSF Circular 05/176 is published on our website.

[8] Commission Recommendation 2004/383/EC of 27 April 2004 on the use of financial derivative instruments for UCITS, OJL 144,30.4.2004, p.33.

5.2 Exposure of UCITS to Commodities Indices and Hedge Funds Indices

The CSSF has taken the view that UCITS may, under certain specified conditions, seek exposure to commodities indices and hedge funds indices through the investment in certificates (qualifying as transferable securities) which grant exposure to such indices or through the investment in derivative financial instruments which grant exposure to such indices. It was understood that, in relation to this type of investments, the position might have to be reviewed depending on the outcome of the CESR consultation on eligible assets and the resulting CESR position paper which was finally published in January 2006[9]. It appears that the CSSF's position regarding exposure to commodities indices remains unchanged whereas the CSSF now takes a more restrictive approach in relation to exposure to hedge funds indices, pending the further work which will be performed by CESR in this area and in relation to which an update is expected later in 2006.

5.3 Investment by UCITS in Credit Default Swaps

In the context of the possibility for a UCITS to invest in derivative financial instruments to achieve its investment goal, the CSSF has permitted UCITS to invest principally in credit default swaps, where previously a 20% limit was imposed[10], subject to an adequate risk management system being employed including, in case of sophisticated UCITS[11], the measurement of global exposure through a VaR methodology.

5.4 Investment by UCITS in Credit Linked Notes

The CSSF has taken the view that UCITS may invest in credit linked notes ("CLN") and that these types of investments may constitute the main investment policy of a UCITS. The main conditions imposed by the CSSF in relation to these investments are that (i) the CLN must be issued by first class financial institutions specialised in this type of transactions, (ii) the CLN must be dealt on a regulated market providing sufficient liquidity and (iii) the investment restrictions (diversification rules; concentration limits) must be complied with both at the level of the issuer of the CLN and at the level of the underlying reference entities. In addition, the specific risks inherent to this type of investments and the advantages of investing therein compared to direct investments in the underlying reference entities have to be adequately disclosed in the prospectus.

5.5 Applying the 5/10/40% diversification rule

The CSSF has taken the position that with respect to the 5%/10%/40% diversification rule imposed by article 43 (2) of the law of 20 December 2002 (investments in issuers in which the UCITS has invested more than 5% of its net asset value may, in aggregate, not

[9] CESR's Advice to the European Commission on Clarification of Definitions concerning Eligible Assets for Investments of UCITS, Ref: CESR/06-005, January 2006

[10] CSSF activity report 2003, p.85, CSSF activity report 2004, p.77

[11] see Section 5.1. above

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exceed 40% of the UCITS' net asset value), issuers of the same group do not need to be combined. In other words, holdings of less than 5% of NAV in two or more issuers of the same group do not need to be aggregated and considered as holdings in a single issuer for the purpose of the 40% rule.

5.6 Scope of article 41(2) of the 2002 Law

On a number of occasions, the CSSF had to take a position on the interpretation of article 41 (2) of the law of 20 December 2002 which permits a UCITS to invest up to 10% of its assets in transferable securities and money market instruments other than those referred to in article 41 (1) (sometimes called "*ratio poubelle*"). In this context, the CSSF has taken the position that in order for an investment to be eligible under this 10% rule, it must be an instrument mentioned in article 41 (1), i.e. a transferable security, a money market instrument, a unit of a UCITS or other UCI, a financial derivative instrument, or a deposit (all referred to in sub-paragraphs a) to h) of article 41 (1)), which does however not necessarily meet all the requirements imposed by the detailed provisions of article 41 (1) (such as a transferable security which is not dealt in on a regulated market; a unit of another UCI which does not meet all the requirements set forth in article 41 (1) e); a derivative financial instrument which does not meet the requirements set forth in article 41 (1) g)). On the other hand, instruments which are not mentioned in article 41 (1) (such as non-securitised loan obligations, real estate) are not permissible investments within the 10% limit set forth in article 41 (2).

6. UCITS and wholly owned subsidiaries

There was some uncertainty as to whether, in view of the wording of article 48 (3) e) of the law of 20 December 2002, the CSSF would continue to accept that UCITS may hold wholly owned subsidiaries (generally used for the purpose of enabling the UCITS to benefit of the double tax treaties existing between the country of the subsidiary and the country of investment. The CSSF has taken the position that such subsidiaries can still be operated or created by UCITS in the future, provided the terms of article 48 (3) e) are fully complied with i.e. that "the subsidiary, exclusively on behalf of the UCITS, carries on only the business of management, advice or marketing in the country where the subsidiary is located, in regard to the redemption of units at the request of unitholders". Evidence that such conditions are met must to be brought to the CSSF on a case by case basis.

7. UCIs and CSSF Circular 05/211 on the fight of money laundering and terrorist financing

Following the coming into force of the law of 12 November 2004 implementing in Luxembourg EU Directive 2001/97/CE, the CSSF has published on 13 October 2005 CSSF Circular 05/211 which repeals and replaces previous CSSF circulars on the subject and aims at "consolidating, in a coherent manner in a single circular, all guidelines and instructions concerning the practical application of the professional obligations [regarding the fight against money

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laundering and terrorist financing], in an aim to facilitate the reading of the existing regulations".

In relation to UCIs, the CSSF Circular distinguishes between those UCIs which distribute themselves their shares and therefore have a direct contact with investors and the UCIs which distribute their shares through intermediaries. The latter are not subject to the identification obligations imposed by the law if the intermediaries are subject to identification obligations equivalent to those applicable in Luxembourg [12].

With respect to non-Luxembourg intermediaries, and the discussion whether they are subject to an identification obligation equivalent to the one imposed by Luxembourg law, the CSSF has for quite some time taken the view that this condition is automatically met in relation to financial institutions and professionals of the financial sector established in a member country of the EU, the EEE or the FATF. This is reconfirmed in Circular 05/211[13] but, in addition, the Circular specifically refers to the possibility for the Luxembourg professionals of the financial sector or the UCI to check and make themselves comfortable, under their own responsibility, that in respect of other countries than those referred above, there exist identification obligations equivalent to those imposed by Luxembourg law. On this basis, certain UCI promoters had conducted investigations and due diligence procedures to conclude at the existence of equivalent identification obligations in certain countries, comprising for example Korea and Taiwan.

More recently, the CSSF has accepted that not only the member countries of the FATF can automatically be considered to have equivalent identification obligations but that this can also be assumed in respect of (i) member countries of the Gulf Cooperation Council (the latter being itself an FATF member), and (ii) member countries of " FATF – Style Regional Bodies", such as the Asia/Pacific Group on Money Laundering (APG) and the Financial Action Task Force on Money Laundering in South America (GAFISUD)[14].

Notwithstanding this more liberal approach, it should be reminded that CSSF Circular 05/211, in general terms, suggests for financial institutions and professionals of the financial sector to apply, in the context of AML procedures, "customer due diligence measures on a risk-sensitive basis" which may require an increased diligence in relation to certain type of intermediaries in certain countries. It is also to be noted that Directive 2005/60/EC of 26 October 2005 on the prevention of the use of the financial system for the purpose of money laundering and terrorist financing[15] provides in its Chapter VI for

[12] Section 15 of CSSF Circular 05/211

[13] Section 92 of CSSF Circular 05/211

[14] Other "FATF-Style Regional Bodies" are the Caribbean Financial Action Task Force (CFATF), the Council of Europe Select Committee of Experts on the Evaluation of Anti-Money Laundering Measures (MONEYVAL), the Eurasian Group (EAG), the Eastern and Southern Africa Anti-Money Laundering Group (ESAAMLG) and the Middle East and North Africa Financial Action Task Force (MENAFATF).

[15] Official Journal of the European Union, L309, 25.11.2005, p.15

the possibility for the EU Commission to take various implementing measures, including the possibility to identify third countries which, *inter alia*, do not meet the requirement to impose on local credit or financial institutions AML requirements equivalent to those laid down in the Directive.

8. Listing of foreign UCIs on the Luxembourg Stock Exchange

The Luxembourg authorities clarified in 2004 and 2005 the conditions under which non-Luxembourg undertakings for collective investment ("foreign UCIs") may be listed on the Luxembourg Stock Exchange[16].

On 29 June 2005, the Minister of Treasury and Budget signed a Ministerial Order restating the rules and regulations of the Luxembourg Stock Exchange and putting in place a specific set of rules for admission to listing of shares and units issued by foreign UCIs and of securities linked to these UCIs. This Ministerial Order took into account the contents of the law of 10 July 2005 implementing into Luxembourg law the Prospectus Directive[17].

The law of 10 July 2005 led to the creation of the Euro MTF-Market which is operated by the Luxembourg Stock Exchange. The criteria laid down by the above rules and regulations facilitate the listing on the Euro MTF-Market of foreign UCIs (including hedge funds) based in jurisdictions that are deemed to offer a lower level of supervision.

The Euro MTF-Market is not set out in the list of regulated markets published by the European Commission. However, the CSSF recognises the Euro MTF-Market as a regulated market, for the purpose of the UCITS rules.

9. Laws of 21 June 2005 implementing the European Savings Directive and approving bilateral agreements with certain dependent and associated territories of Member States of the European Union

9.1. General

On 1 July 2005 the law of 21 June 2005 (the "Savings Law") implementing the European Council Directive 2003/48/EC dated 3 June 2003 on taxation of savings income in the form of interest payments (the "EU Savings Directive") and the law of 21 June 2005 approving bilateral agreements with certain dependent and associated territories of Member States of the European Union (together with the "Savings Law" referred to herein as the "Laws") have come into force.

Legal basis

On June 3, 2003, the European Council approved the EU Savings Directive and under the related Accords with certain dependent or associated territories and certain non-EU Member States (together the "relevant States"), EU Member States are required to provide to the fiscal authorities of another EU Member State and all the relevant States details of payments of interest or similar income

[16] Ministerial Order of the Minister of Treasury and Budjet of 11 June 2004 and CSSF Circular 04/151 of 13 July 2004
[17] See Section 11 below for details on the scope of the Prospectus Directive

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made by a person within its jurisdiction to an individual resident in that other EU Member State or a State, except that Austria, Belgium and Luxembourg may instead operate a withholding system for a transitional period in relation to such payments unless during such period they elect otherwise.

Under the Savings Law, payments of interest or similar income made or ascribed by a paying agent established in Luxembourg to or for the immediate benefit of an individual or certain residual entities as defined by law, who as a result of an identification procedure implemented by the paying agent are identified as *residents* or are deemed to be *residents* of an EU Member State or a relevant State other than Luxembourg, are subject to a withholding tax unless the relevant beneficiary has adequately instructed the relevant paying agent to provide details of the relevant payments of interest or similar income to the fiscal authorities of his/her country of residence or deemed residence or has provided a tax certificate from his/her fiscal authority in the format required by law to the relevant paying agent.

Where withholding tax is applied, payments of interest and similar income is subject to a withholding to be made by the relevant paying agent at the initial rate of 15% during the a three-year period which started on 1 July, 2005, at a rate of 20% for the subsequent three-year period and at a rate of 35% thereafter.
Additional clarifications on the Laws have also been provided for by the Luxembourg direct tax authorities in several circulars (RIUE n° 1 of 29 June, 2005, RIUE n° 2 and 3 of 12 August, 2005, RIUE n° 2 bis of 21 September, 2005, RIUE n° 2 ter of 11 October, 2005, Circular RIUE n°2 quater of 10 November, 2005 and RIUE n°2 quinter of 30 November, 2005).

Scope of the Laws

Luxembourg levies withholding tax on interest paid to beneficial owners who are individuals resident in another Member State than Luxembourg as well as the Netherlands Antilles, Aruba, Jersey, Guernsey, Isle of Man, Montserrat and the BVI.

No withholding tax is levied by Luxembourg paying agents on interest credited to individuals residing in the third countries (comprising Switzerland, Liechtenstein, San Marino, Monaco, Andorra) nor the three dependent or associated territories (Cayman Island, Anguilla as well as Turks and Caïcos Islands) also referred to in the EU Savings Directive.

Luxembourg paying agents have to levy withholding tax on interest payments to individual beneficial owners regardless whether they are paid in a context of private wealth management or professional activities.

The beneficial owner as referred to in the Savings Law means any individual resident in another Member State (or certain dependent or associated territories) than Luxembourg who receives an interest payment, unless he provides evidence that it was not received for his own benefit.

Paying Agent

A Luxembourg paying agent means any economic operator established in

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Luxembourg who pays interest to or secures the payment of interest for the immediate benefit of an individual who is the beneficial owner when the beneficial owner of the income is an individual resident in another EU Member State (or certain dependent or associated territories)

In addition, according to the provisions of the Savings Law, any entity established in a Member State to which interest is paid or for which interest is secured for the benefit of the beneficial owner is also considered as paying agent upon such payment or securing such payment ("residual entities"), except if it is a legal person or if its profits are taxed under general arrangements for business taxation or if it is a UCITS recognised in accordance with Directive 85/611/EEC.

The European Banking Federation distributed a temporary list of entities that qualify as residual entities and that, without being exhaustive and legally binding, represent a basis for classification of the status of the entities.

Interest payments

The definition of interest payment given by the Savings Law is very broad and encompasses:

- interest paid or credited to an account relating to debt claims of every nature;
- interest accrued or capitalised resulting from the sale, refund or redemption of such debt claims;
- some income received from UCITS including capital gains from the sale or redemption of shares in UCITS may fall within the definition of interest payment, depending on the percentage of the assets of the UCITS invested in debt claims[18].

Income originating from insurance or pension benefits, real estates assets, commissions and derivative and innovative and structured products are excluded from the application of the Savings Law, within the limits of Article 11 of the OECD Model Convention.

Withholding and exceptions

In principle, every Luxembourg paying agent making an interest payment to a beneficial owner as defined above has to withhold the tax as indicated above (currently 15% until 13 June 2008).

As an exception thereto, the Savings Law authorises the beneficial owner to request that the tax shall not be withheld under certain conditions.

For that purpose the beneficial owner has to:

- expressly authorise the paying agent to report the information concerning interest payments to the competent authority of his Members State of residence; or
- present to his paying agent a certificate drawn up in his name by the competent authority of his Member State of residence for tax purposes.

9.2. UCIs under the Savings Directive

Dividends distributed by a UCITS (and certain UCIs which are not UCITS[19]) are subject to reporting or withholding if

[18] See section 9.2. below
[19] See footnote 1. above

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more than 15% of its assets (on a sub-fund basis for umbrella funds) are invested in debt claims (as defined in the Savings Law). Proceeds realised by shareholders on the disposal of shares are subject to such reporting or withholding if more than 40% of the assets are invested in debt claims.

For the purpose of the aforesaid 15% and 40% tests, either the investment policy as expressed in the UCI's Prospectus or the actual portfolio composition is to be considered.

The text of the EU Savings Directive and the Savings Law imply that dividend payments by and redemption payments from investment companies which do not qualify as UCITS (such as Part II SICAVs) do not fall within the scope of the EU Savings Directive and the Savings Law.

Luxembourg UCITS and UCIs generally publish the "in scope" or "out of scope" of their dividend distributions (if any) and redemption proceeds through CCLux

In respect of non-Luxembourg UCITS and UCIs, the Luxembourg authorities generally accept that Luxembourg paying agents apply the "home country rule", i.e. recognise the "in scope" or "out of scope" qualification determined by the home country rules of the relevant UCITS or UCIs[20].

The Luxembourg Investment Fund Association (ALFI)[21] has published on its website in February 2005 a handbook which reflects the Association's view on the interpretation of the Savings Directive.

[20] This position is in line with the FBE/EFAMA Recommendation of 6 June 2005 on "Home Country Rule for Funds in the context of the Savings Taxation Directive" (www.efama.org)
[21] www.alfi.lu

10. Law of 21 June 2005 amending Article 1 of the amended law of 31 July 1929 on the taxation regime for holding companies

On 1 July 2005 the law of 21 June 2005 amending the Luxembourg 1929 holding taxation regime (the "Law") has come into force.

According to the provisions of the Law, 1929 holding companies that receive during an accounting year at least 5% of the total amount of dividends from foreign companies that are not fully subject to a tax corresponding to the Luxembourg corporate income tax will be excluded from the benefits of the 1929 holding regime for that accounting year.

A company resident in an EU State and covered by the Parent-Subsidiary Directive 90/435/EEC fulfils the above mentioned condition of comparable taxation.

The compliance by the 1929 holding company with the above mentioned condition is to be certified by a registered auditor or an authorised accountant by way of an annual declaration to the *Administration de l'Enregistrement*.

The new rules set out above entered into force on 1 July 2005. However, 1929 holding companies existing before that date benefit from a grandfathering clause until 1 January 2011.

11. Law of 10 July 2005 on Prospectuses for Securities

The law on prospectuses for securities of 10 July 2005 (the "Prospectus Law") implementing Directive 2003/71/EC of the European Parliament and of the Council dated 4 November 2003 relating to the prospectuses to be published when securities are offered to the public or admitted to trading and amending Directive 2001/34/EC (the "Prospectus Directive") sets up a new framework for the drawing-up, approval and distribution of prospectuses to be published when securities are offered to the public or admitted to trading on a regulated market.

Background and purpose of the new framework

The purpose of the Prospectus Directive and Commission Regulation (EC) N° 809/2004 of 29 April 2004 implementing Directive 2003/71/EC of the European Parliament and of the Council as regards information contained in prospectuses, as well as the format of the prospectuses, incorporation by reference and publication of such prospectuses and dissemination of advertisements (the " Prospectus Regulation") is to harmonise, within the European Union, the requirements relating to the drawing-up, approval and distribution of the prospectus to be published when securities are offered to the public and/or admitted to trading on a regulated market situated or operating within the territory of a Member State. No prospectus shall be published until it will have been granted "approval" by the home Member State's competent authority. This approval is however subject to the compliance with common European standards relating to the content of the information to be published and the terms of publication.

The prospectuses drawn up in accordance with the Prospectus Regulation will be able to benefit from the single European passport, which means that a prospectus, once approved for the offer to the public or the admission to trading on a regulated market by the competent authority in Luxembourg, the *Commission de Surveillance du Secteur Financier*, (the "CSSF"), will be accepted anywhere across the European Union. Conversely, prospectuses benefiting from the European passport owing to their approval by the competent authority of another EU Member State are allowed to proceed to an offer to the public or admission to trading on a regulated market in Luxembourg by way of a simple notification by the competent authority.

The new prospectus regimes

The Prospectus Law provides for three different prospectus regimes:

- a first regime (Part II of the Prospectus Law) with respect to offers of securities to the public and admissions of securities to trading on a regulated market, which are subject to Community harmonisation, and transposing the rules of the Prospectus Directive;
- a second regime (Part III of the Prospectus Law) defining the Luxembourg rules that apply to offers to the public and to admission to trading on a regulated market of securities and other comparable instruments, which are outside the scope of the Prospectus

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Directive, and providing for a simplified prospectus regime; and
- a third regime (Part IV of the Prospectus Law) setting up a Luxembourg specific regime applying to admissions of securities to trading on a market that is no included in the list of regulated markets published by the European Commission.

In brief, the Prospectus Law innovates in several fields and in particular:

- it introduces three different regimes for the approval of prospectuses;
- it designs new powers and duties to the CSSF;
- it amends the terms regarding the publication of the prospectuses and eventually sets out a legal definition of "offer to the public";
- it establishes an alternative investment market in Luxembourg (the "Euro MTF").

Clarifications to the Prospectus Law are provided in CSSF circulars and in particular in circulars 05/210, 05/225, 05/226 (repealing as of 1 January 2006 in particular the CSSF circulars 05/195 and 05/196).

Competent authorities for approving the prospectuses

As of 1 January 2006 the CSSF will be the sole intervening party for approving the prospectuses relating to offers to the public and the admissions to regulated market of securities falling into the scope of the Prospectus Directive and for approving the simplified prospectuses relating to the offers to the public of securities that are outside the scope of Part II of the Prospectus Law.
The simplified prospectuses subject to Part III do not benefit from the European passport and rules as regards their content are less stringent than a provision of the Prospectus Regulation.

The Luxembourg Stock Exchange remains the competent authority for the approval of prospectus subject to the provision of Chapter 2 of Part III (i.e. the admission of securities is not covered by Part II to trading on the Luxembourg regulated market) and for the approval of the prospectus subject to the provisions of Part IV of the Prospectus Law (i.e. the admission of securities on a market not included in the list of the regulated market published by the European Commission).

Publication of the prospectuses

The Prospectus Law does not take the option provided by the Prospectus Directive to require publication of a notice stating how the prospectus has been made available to and where it can be obtained by the public. All possibilities for publication provided for by the Prospectus Directive (newspapers, printed brochures, website) have been integrated into the Prospectus Law. Furthermore, the prospectuses are published by the CSSF on the website of the Luxembourg Stock Exchange for a period of at least twelve months.

Pursuant to Article 16 (4) and Article 38 (4) of the Prospectus Law, the CSSF has delegated the publication of prospectuses to the Luxembourg Stock Exchange, which will publish them on its website at http://www.bourse.lu The publication requirement that lies with the issuers in accordance with Articles 16 and 38, paragraphs 1-3 of the Prospectus Law, is thereby fulfilled in Luxembourg. Investors will thereby be

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able to have effective and in principle free of charge and real time access to information.

This does not prevent the issuer however from using additional means of publication. Every investor can receive, upon his request, a free of charge paper copy of the prospectus. This request should be made to the issuer, offeror, person who asked for the admission of securities to trading on a regulated market or to the financial intermediaries placing or selling the securities concerned.

"Offer to the public"

The Prospectus Law provides clarification on the subject of public offer by setting out a legal definition of an "offer to the public".

Under the Prospectus Law, an "offer of securities to the public" means a "communication to persons in any form and by any means, presenting sufficient information on the terms of the offer ands the securities to be offered, so as to enable an investor to decide to purchase or subscribe to such securities". Thus the definition of "offer of securities to the public" is extremely wide under the Prospectus Law.

The alternative market

On 18 July 2005 the Luxembourg Stock Exchange launched a new market, the "Euro MTF", the alternative investment market in Luxembourg.

The alternative market is operated independently of the regulated market and offers an alternative market to which the requirements of the EU prospectus and transparency will not apply. By listing their securities on the official list of the "Euro MTF", the issuers are not required to meet financial information requirements provided for by the transparency and prospectus directives.

The operating rules of the "Euro MTF" are defined by the rules and regulations of the Luxembourg Stock Exchange as set out in the decree of 29 June 2005.

12. Laws of 13 July 2005 amending the Luxembourg Pension Fund legislation

The law of 13 July 2005 relating to institutions for occupational retirement provision under the form of pension savings companies with variable share capital (SEPCAV) and pension savings associations (ASSEP) (the "Law") has, together with another law of the same date[22], implemented Directive 2003/41/EC[23] and, at the same time, replaced the previously existing legislation on SEPCAVs and ASSEPs[24].

The main changes brought about by the Law for SEPCAVs and ASSEPs can be summarised as follows:

- The Law permits SEPCAVs and ASSEPs, as aimed at by the Directive, to operate cross border

[22] Law of 13 July 2005 relating to the activities and supervision of institutions for occupational retirement provision

[23] Directive 2003/41/EC of the European Parliament and Council regarding the activities and the supervision of institutions for occupational retirement provision (IORP)

[24] Amended law of 8 June 1999 creating pension funds in the form of SEPCAVs and ASSEPs

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and specifies the regulatory notification procedures which must be undertaken to that effect.

- The Law grants increased flexibility in the structuring of the constitutive documents of the SEPCAVs or ASSEPs in that the pension rules must no longer be part of the articles and there may be separate pension rules for each sub-fund, thus facilitating the structuring of multi-employer schemes.

- The Law, as required by the Directive, permits the appointment of a non-Luxembourg based (but EU based) credit institution as custodian. The possibility for different custodians to be appointed for different sub-funds of an umbrella pension fund is also likely to facilitate the structuring of multi-employer schemes within a single legal entity.

- The role of the liability manager, who is now the principal contact of the CSSF, has been reinforced.

The main changes brought about by the Law have been summarised by the CSSF in a Circular 05/2001 of 29 July 2005.

13. Law of 13 July 2005 modifying the amended law of 6 December 1991 on the insurance sector to regulate the activity of insurance mediation

Directive 2002/92/EC of the European Parliament and of the Council of 9 December 2002 on insurance mediation has been implemented in Luxembourg by the law of 13 July 2005 modifying the law of 6 December 1991 on insurance sector ("the Law").

The purpose of the Directive was to coordinate national provisions on professional requirements and registration of persons taking up and pursuing the activity of insurance mediation in order to contribute both to the completion of the single market for financial services and to the enhancement of customer protection in this field.

It aimed, on the one hand, to allow the insurance and reinsurance intermediaries to avail themselves of the freedom of establishment and the freedom to provide services in other Members States of the Community, and, on the other hand, to enhance the customer protection by imposing professional requirements in relation with professional indemnity cover and financial capacity of the intermediaries and by strengthening the obligations they should have in providing information to customers.
The Law, prior to its amendment by the law of 13 July 2005, already required for agents and brokers to be authorised on a national level, by the relevant Minister, after a verification of their professional competence and these intermediaries had already to be covered by a professional indemnity.

Fundamentally, the Law introduces three elements:

- a new category of intermediaries is created: the subbroker, who works in contact with the customers, on behalf of an independent broker; a register, to which the public can have access at distance and which comprises all the

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approved intermediaries, is created; the customer protection is reinforced by introduction of requirements relating to information to be provided to customers; and

- the competences of the *Commissariat aux Assurances* are extended to handle customer's complaints against insurance intermediaries; and

- it permits brokers to operate cross-border and specifies the regulatory notification procedures which must be undertaken to that effect.

It also strengthens the obligations of insurance intermediaries to provide information to customers.

14. Law of 5 August 2005 on financial collateral arrangements

The law of 5 August 2005 (the "Law") constitutes a major piece of legislation regarding financial collateral arrangements, i.e. collateral arrangements the subject matter of which are financial instruments and claims. The Law transposes into Luxembourg law, with considerable delay, the EC Directive 2002/47/EC of the European Parliament and the Council of 6 June 2002 concerning financial collateral arrangements.

The most important change triggered by the Law is no doubt the validation of close out and netting clauses notwithstanding the opening of bankruptcy or liquidation procedures (Part V, Articles 18-22). While previously such clauses were valid only in limited cases, when agreed upon among parties both of which were so called "financial sector parties", they will now be valid irrespective of the legal qualification of the parties and irrespective of the point of time at which they are entered into.

But the Law also introduces major changes with regard to pledge agreements over financial instruments and claims (Part II, Articles 3 - 12) and, generally speaking, renders such pledges both more flexible and more reliable. However, while the Law now explicitly addresses the issue of multiple and successive pledges over the same assets, one may doubt that a good choice was made by providing that a second ranking pledge will be valid only if it has been agreed to by the beneficiary of the first ranking pledge (Article 6). This will in particular give rise to difficulties where a bank account is pledged while, as is normally the case, it is subject to a first ranking pledge in favour of the bank pursuant to the bank's general terms and conditions.

On a more positive note in the perspective of banking and finance transactions, the Law provides that the parties to a pledge agreement may agree that the pledgee is entitled to use – and thus also to lend or pledge in turn – the pledged assets (Article 10). The Law now also explicitly addresses the issue of the realization of a pledge over units in a limited company (*société à responsabilité limitée*) by providing for the possibility of an ex-ante approval (*agrément*) of the acquirer of such units pursuant to the realization of the pledge and, possibly, the forced sale of the units (Article 12).

The Law also governs collateral granted by way of transfer of property of financial instruments and claims (Part

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III, Articles 13-14) as well as repo arrangements (Part IV, Articles 15-17). Consequently, the Law abrogates the pieces of legislation which previously governed these types of collateral arrangements (Law of 1 August 2001 on transfer of property for guarantee purposes and Law of 21 December 1994 concerning repo transactions).

An important feature in regard to banking and finance transactions is that the Law introduces provisions allowing specifically for financial collateral to be granted in favour of an agent or a trustee acting on behalf of the lenders or creditors. (Part I, Article 2 (4)). Such agent or trustee can exercise all rights attached to the collateral without any requirement of specific provisions from the lenders or creditors or parallel debt language in credit agreements.

Finally, the Law introduces explicit conflict of law provisions with regard to financial collateral arrangements over financial instruments (Part VI, Articles 23-24). In accordance with the lex rei sitae rule, the Law provides that the law applicable to most issues will be the law of the place where the account into which the financial instruments are placed is held.

15. Grand Ducal Decree of 24 November 2005 relating to the municipal business tax

With effect on 1 January 2006, as a result of the reduction of the multiplier to be applied to the basic rate, the municipal business tax applicable for Luxembourg City has been reduced from 7.50% to 6.75% for companies subject to corporate income tax.

Hence, in 2006 the effective rate of tax on profits for Luxembourg City is reduced from 30.38% to 29.63% (including the contribution to the unemployment fund).

16. Law of 23 December 2005 introducing a domestic withholding tax on interest income for Luxembourg residents

On 1 January 2006 the law of 23 December 2005 (the "Law") implementing a domestic withholding tax on certain savings income received by Luxembourg resident individuals has come into force.

Scope of the Law

The Law introduces a withholding tax amounting to 10% on certain savings income received, through Luxembourg paying agents, by private individuals as beneficial owners residing in Luxembourg without having a tax residency in another State.

The terms "beneficial owner" and "paying agent" have basically the same meaning as given thereto in the Luxembourg law of 21 June 2005 implementing the European Savings Directive.

The withholding tax applies to savings income accruing since 1 July 2005 but paid after 1 January 2006.

Interest payments

The interest payments subject to the withholding tax are limited to those defined under Articles 6.1 a) and 6.1 b) of the Luxembourg law of 21 June 2005

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implementing the European Savings Directive, meaning interests paid or credited to an account relating to debt claims of every kind as well as interests accrued or capitalised resulting from the sale, refund or redemption of such debt claims.

The withholding tax is not applicable to:

- income as defined under Articles 6.1 c) and 6.1 d) and Article 10 of the Luxembourg law of 21 June 2005 implementing the European Savings Directive. As a result, the domestic withholding tax is not applicable in relation to dividend distributions and payment of redemption proceeds by UCITS and UCIs.

- interest, premium and other income received on current and term accounts if the remuneration of these accounts does not exceed the rate of 0.75%.

Exemption

Interests credited only once a year on savings deposits that do not exceed the amount of 250 € per person and per paying agent are exempt from the withholding tax.

Final tax

The withholding tax constitutes a final tax if the income is deriving from assets held in the private wealth of the individual and thus these interests are not to be declared in the annual tax return of the individuals. In case the assets are held in the course of a commercial, agricultural or independent activity the withholding tax is not a final tax.

The withholding of the tax and the payment thereof to the Luxembourg tax authorities will be made by the paying agent without indication of the beneficiaries of the interest payment and thus the banking secrecy is not affected by the Law.

17. Abolishment of Wealth Tax

The Law of 22 December 2005 has abolished the net wealth tax for resident and non resident private individuals starting 1 January 2006.

Additional clarifications on the Law have been provided for by the Luxembourg direct tax authorities in a circular Relibi n°1 of 24 January 2006.

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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2, Place Winston Churchill – B.P. 425 – L 2014 Luxembourg – T (352) 44 66 440 – F (352) 44 22 55 – www.ehp.lu