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Luxembourg

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Greetings:

Dear Reader,

Our Oktoberfest in Luxembourg was a great opportunity to celebrate the end of the third quarter of the year 2013 which has among other things given rise to several innovations in the Luxembourg legal framework.

To keep up with the newest Luxembourg legal innovations, you will find herewith our Newsletter for the third quarter of the year 2013.

Enjoy your reading,

Eric Sublon
Managing Partner
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Banking, Finance and Capital Markets update

1. The interpretation of the Court of Justice of the European Union of Article 24 of the Council-Regulation (EC) n°1346/2000 of 29 May 2000 on insolvency proceedings

With the constant drive to promote the proper functioning of the European internal market, the Council-Regulation (EC) n°1346/2000 of 29 May 2000 on insolvency proceedings (the "**Regulation**") aims to permit efficient and effective cross-border insolvency proceedings and in doing so provides for, among other things, conflict of laws rules and substantive law's provisions which shall apply in each Member State regardless of the *lex concursus.* Among those substantive law's provisions, you will find Article 24 (1) of the Regulation providing for the following exception:

"*Where an obligation which has been honoured in a Member State for the benefit of a debtor who is subject to insolvency proceedings opened in another Member State, when it should have been honoured for the benefit of the liquidator in those proceedings, the person honouring the obligation shall be deemed to have discharged it if he was unaware of the opening of proceedings.*"

In the case at hand, the Court of Justice of the European Union (the "**CJEU**") has been asked to interpret this Article 24 (1) in the light of the below mentioned facts and the preamble of the Regulation and in particular as to whether this exception shall apply to the execution of a payment by a bank pursuant to a written order of the insolvent debtor, such payment being made for the benefit of one of the creditor of the latter.

Factual background

An application to open insolvency proceedings with respect to Grontimmo, a property development company with registered office in Antwerp (Belgium), has been made before the *Tribunal de commerce* in Brussels.

After the application to open insolvency proceedings with respect to Grontimmo has been made, two cheques of an aggregate amount of EUR 1,400,000 were issued for the benefit of Grontimmo by two of its debtors.

During the annual general meeting, the shareholders of Grontimmo accepted the resignation of the directors and appointed new directors. On the same day of the annual general meeting, Grontimmo acquired a purchase option for an aggregate amount of EUR 1,400,000 issued by Kostner Development Inc. ("**Kostner**").

Following the annual general meeting, Grontimmo opened two accounts with Dexia Banque International à Luxembourg (now known as "**BIL**") on which the two aforementioned cheques have been deposited.

The new directors of Grontimmo gave BIL a written order to issue a cheque for EUR 1,400,000 for the benefit of Kostner. A month only after this written order, Grontimmo was declared insolvent by a judgment of the *Tribunal de commerce*, Brussels, by which Grontimmo was divested automatically and from the first hour of that day of all its assets. That judgment was published in the *Moniteur belge* ten days after the judgment but was not published in the *Journal officiel du Grand-Duché de Luxembourg*.

In compliance with the aforementioned written order received from their client and a day after the judgment declaring Grontimmo insolvent, BIL issued and encashed a cheque for EUR 1,400,000 for the benefit of Kostner in payment for the purchase option granted by Kostner.

The liquidators of Grontimmo asked the BIL to repay the entire amount of EUR 1,400,000 to Grontimmo, claiming that the payment had been made in contravention of the divestment of the insolvent company's assets and that it was accordingly enforceable against the general body of creditors, the payment in question having been made after the opening of the insolvency proceedings. The BIL, on the other hand, refused to repay the amount and claimed that it had been unaware of the insolvency proceedings and that it could rely on Article 24 of the Council-Regulation (EC) No 1346/2000 of 29 May 2000 on insolvency proceedings (the "**Regulation**").

The legal interpretation by the Court of Justice

In connection with the above, the following question was asked to the Court of Justice for a preliminary ruling:
"*How should the words "obligation for the benefit of a debtor" in Article 24 of the Regulation be interpreted? Must those words be interpreted as including a payment made to a creditor of the insolvent debtor at the latter's request, in the case where the party which honoured that payment obligation on behalf and for the benefit of the insolvent debtor did so while unaware of the existence of insolvency proceedings which had been opened against the debtor in another Member State?*"

The CJEU first observed that, according to the ordinary meaning of the expression "for the benefit of", honouring an obligation for the benefit of a person subject to insolvency proceedings does not, prima facie, cover the situation in which an obligation is honoured on the order of that person for the benefit of one of its creditors. In its current usage, that expression means only that an obligation is honoured in favour of that person. Furthermore recital 30 of the preamble of the Regulation states that the situation specifically referred to by Article 24(1) of the Regulation thereof is that of a "payment" to the insolvent debtor.

Article 24(1) of the Regulation provides that the obligation honoured for the benefit of the insolvent debtor should have been for the benefit of the liquidator. That makes it very clear that Article 24 (1) of the Regulation refers to the debts of the insolvent debtor which have become debts of the general body of creditors after the opening of the insolvency proceedings.

Considering the above, the CJEU came to the first conclusion that according to the wording of Article 24 (1) of the Regulation the persons protected by this provision are the debtors of the insolvent debtor who, whether it be directly or indirectly, honour an obligation for the benefit of the latter in good faith. Irrelevant is the fact that in the present case a bank made a payment pursuant to the insolvent debtor's order as such payment has not been made "for the benefit of" the insolvent debtor within the meaning of Article 24 (1) of the Regulation but "for the benefit of" a creditor of the insolvent debtor.

For the CJEU, it results from Article 24 (1) of the Regulation and the recital 30 of the preamble of the same regulation that Article 24 (1) of the Regulation permits the assets belonging to the general body of creditors to be reduced by debts of the insolvent debtor paid to the latter by its debtors in good faith. However the provision must not be interpreted in a sense which also enables those assets to be reduced by the debts that the insolvent debtor owes to its creditors.

This interpretation does not allow the insolvent debtor to transfer its assets to one or more of its creditors via third parties who are unaware of the opening of the insolvency proceedings and therefore to undermine one of the principal objectives of the Regulation, set out in recital 4 of its preamble, which consists in avoiding incentives for the parties to transfer assets from one Member State to another, seeking to obtain a more favourable legal position.
Finally the CJEU stated that Article 24 (1) of the Regulation must be interpreted as meaning that a payment made at the behest of a debtor subject to insolvency proceedings to one of the latter's creditors does not fall within the scope of that provision. That being said, this does not give rise to the obligation for the bank concerned to reimburse the disputed sum to the general body of creditors.

2. European Commission adopted a communication on shadow banking

In 2008 the world experienced another financial crisis. The international response was notably coordinated at the level of the G20 and the Financial Stability Board ("**FSB**") and aimed mainly to establish sustainable health and stability to have responsible financial markets. Due to the (i) size of the area of non-bank credit intermediation (so called "**Shadow Banking**"); (ii) its close links to the regulated financial sector; and (iii) the systemic risks that it represents, the European Commission (the "**Commission**") considers it a priority to examine in detail the issues posed by Shadow Banking. A "**Green Paper**"[1] was drafted with the purpose to take stock of current development and present on-going reflections on the subject to allow for a wide-ranging consultation of stakeholders. The Green Paper is based on a FSB report of October 2011. On 4 September 2013, the Commission adopted a communication (the "**Communication**") which sets out possible further actions and is a follow-up to the Green Paper. By way of this Communication, the Commission intends to set out its roadmap for the upcoming months targeted to limit the emergence of risks in the unregulated system, particularly the risks of systemic nature. Thus, this Communication outlines a number of priorities where the Commission envisages kicking off initiatives.

Definition of Shadow Banking and benefits and risks

Definition:

Regulators define Shadow Banking as a "*system of credit intermediation that involves entities and activities outside the regular banking system*." Therefore, the Shadow Banking is based on two intertwined pillars:

a) Entities outside the regular banking system engaged in

- accepting funding with deposit-like characteristics;
- performing maturity and/or liquidity transformation;
- undergoing credit risk transfer; and
- using direct or indirect financial leverage.

Here the Commission is focussing on (not exhaustive list):

- Special purpose entities, including special investment vehicles, which perform liquidity and/or maturity transformation like securitization vehicles such as asset backed commercial paper conduits (the "**SPVs**");
- Money Market Funds (the "**MMFs**") and other types of investment funds or products with deposit-like characteristics, which make them vulnerable to massive redemptions ("**Runs**");
- investment funds, including Exchange Traded Funds (the "**ETFs**"), that provide credit or are leveraged;
- finance companies and securities entities providing credit or credit guarantees, or performing liquidity and/or maturity transformation without being regulated like a bank; and
- insurance and reinsurance undertakings which issue or guarantee credit products.

b) Activities outside the regular banking system which include securitisation, securities lending and repurchase transactions (the "**Repo**").

The FSB has estimated the (i) size of the Shadow Banking at about € 51 trillion in 2011 and (ii) concentration of the geographical distribution in the Eurozone with EUR 16,800 billion and the United States with EUR 17,500 billion.

[1] European Commission, Green Paper Shadow Banking, COM(2012) 102 final on 19.3.2012, text with EEA relevance.

Benefits:

Shadow Banking is deemed to be a useful part of the financial system. Such is the case where (i) it provides alternatives to bank deposits; (ii) it channels resources towards specific needs more efficiently due to increased specialisation; (iii) it constitutes alternative funding for the real economy; and (iv) it is a possible source of risk diversification away from the banking system.

Risks:

They relate to the complexity of Shadow Banking entities and activities, their cross-jurisdictional reach, the inherent mobility of securities and fund markets and the interconnectedness with the regular banking system. They can be summarised as follows (not exhaustive list):

a) Deposit-like funding structures may lead to Runs

Shadow Banking activities are exposed to similar financial risks as banks, but without being regulated and supervised in a comparable manner.

b) Build-up of high, hidden leverage

Because of the lacking regulation and supervision, Shadow Banking activities can be highly leveraged with collateral funding being churned several times. This can increase the fragility of the financial sector.

c) Circumvention of rules and regulatory arbitrage

The regular banking system could try to circumvent its applied regulation and supervision by imitating Shadow Banking entities or outsourcing certain operations into Shadow Banking entities.

d) Disorderly failures affecting the banking system

Due to the close connection between the regular banking system and the Shadow Banking, any failures can lead to important contagion and spill-over effects.

The most salient features of the Communication and next steps

The Communication sets out measures (i) addressing potential and existing systemic risks and (ii) already taken to deal with some elements of those, e.g. rules governing hedge fund activity and reinforcing the relationship between banks and unregulated actors. The most salient features may be summarised as follows (not exhaustive):

Framework for MMFs

Covered shall be MMFs domiciled or sold in Europe. The provisions aim to (i) stability by setting-up a predefined capital buffer which shall be activated to assist stable redemptions if the value of the MMFs investment assets decrease in value; and (ii) liquidity management, i.e. an MMF would have to have at least 10% of their portfolio invested in assets that mature within a day and another portfolio at least 20% that mature within a week. This shall enable the MMF to be able to repay investors who withdraw funds at short notice. The exposure to a single issuer would be capped at 5% of the MMF's portfolio and for standard MMF's a single issuer may account for 10% of the portfolio.

Transparency regarding the Shadow Banking sector

Collection of detailed, reliable and comprehensive data on the Shadow Banking sector. Currently, four initiatives are set out: (i) support of projects regarding the collection and exchange of data; (ii) development of central repositories for derivatives in the context of the European Market Infrastructure Regulation (the "**EMIR**") and the Markets in Financial Instruments Directive (the "**MiFID**"); (iii) implementation of the "legal entity identifier", i.e. a global governance body established by the FSB, in order to create a new standard which ensures to identify each legal entity that is party to a financial transaction; and (iv) need for increase of transparency of securities financing transactions.

Securities law and the risks associated with securities financing transactions

Notably repurchase agreements or securities lending transaction were involved in the excessive level of indebtness in the financial sector. Financial intermediaries were frequently forced to use security (collateral) to obtain financing. The reuse or rehypothecation of securities generates dynamic collateral chains thus the same security is lent several times which may contribute to an increase in leverage and strengthen the pro-cyclical nature of the financial system. In order to solve those issues, the Commission considers issuing a legislative proposal with regard to the securities law in the coming months.

Framework for interactions with banks

The Commission outlines two ways to address the risks posed by Shadow Banking: (i) the prudential rules applied to banks in their transactions with unregulated financial entities will be tightened to reduce contagion risks. This may be covered by the revised and amended capital requirement regulation and directive which will apply from 1 January 2014. Further, new liquidity rules aimed to result in an increase in the maturity of the banks' financial liabilities and to reduce to short-term financing. Starting from 2014, banks will be required to report to their supervisors their main exposures to unregulated entities as well as exposures arising from repurchase agreements and securities lending transactions. By the end of 2014 the European Banking Authority (the "**EBA**") is requested to prepare guidelines to limit banks' exposure to unregulated financial counterparties, while the European Commission is required to determine, by the end of 2015, whether it is appropriate to establish such limits in the EU legislation after considering the work carried out at the both European and international levels. (ii) Possible extension of the scope of application of prudential rules to reduce arbitrage risks. The Commission considers an assessment of the application of the definition of credit institution and the identification of credit institution in the 28 Member States as crucial. In case, this assessment would have as outcome specific problems, the Commission could clarify, for example by means of a delegated act, the definition of credit institution regarding prudential banking regulation.

Supervision arrangement of Shadow Banking entities and activities

Improved supervision at national and European level should assist to monitor the dynamic Shadow Banking sector and help to mitigate the accumulation of systemic risks.

Considering the above envisaged measures, the Communication lists the following main measures for the year 2014 and beyond by the Commission (all dates are of indicative nature):

- indirect approach through banking regulation: Capital requirements directive IV implementation as of 01/01/2014;
- implementation of amendments to IFRS 10,11,12 (consolidation requirements/disclosure);
- EBA report on limits to unregulated counterparties exposures;
- delegated Acts for Solvency II (including capital requirements and risk management requirements);
- UCITS review including investment techniques and strategies of the funds;
- technical standards on contracts subject to mandatory clearing obligation to be adopted (Q2) and to enter into force (Q3);
- Securities law proposal including elements on property rights and transparency;
- entry into force of the reporting requirements for derivatives transactions to trade repo (EMIR – Q1);
- monitoring framework to be developed by authorities (eg ESRB working group);
- Securities law proposals/ Specific actions for securities financing transactions (eg ECB initiative on a trade repo);
- Legal Entity Identifier implementation phase; and
- COM initiative (legislative proposal on recovery and resolution of CCPs and Communication on the policy orientation in relation to other non-financial institutions).

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3. Keeping up with the main newest legal topics and updates

According to a press release dated 4 October 2013, the Luxembourg Government has adopted a bill implementing Article 8 of the Council Directive 2011/16/EU of 15 February 2011 on administrative cooperation in the field of taxation, such bill shall amend the law dated 29 March 2013 relating to the administrative cooperation in the field of taxation and the law dated 4 December 1967 as amended concerning the income tax, along with the related draft of Grand-ducal regulation amending among others the Grand-ducal regulations dated 27 December 1974, 9 January 1974 and 4 December 1967 as amended. As a whole the bill and related draft Grand-ducal regulations permit the automatic and mandatory transfer of information to the tax authorities of other Member States within the five categories described in Article 8 of the Directive and provided that such automatic transfer is possible in practice and that the categories aforementioned are not covered by any professional secrecy (i.e. bank secrecy). More information under the following link (unfortunately only available in French):
Résumé des travaux du 4 octobre 2013

For your update, you will find below the newly issued Circulars CSSF:

- Circular CSSF 13/570 dated 29 July 2013 on supervisory reporting requirements applicable to credit institutions as from 2014, more information under the following link: Circular CSSF 13/570
- Circular CSSF 13/571 dated 19 August 2013 which gives details regarding the scope of the annual long form audit report pursuant to Circular CSSF 03/113 following the entry into force on 1 July 2013 of Circular CSSF 12/552 on central administration, internal governance and risk management, more information under the following link: Circular CSSF 13/571
- Circular CSSF 13/572 dated 4 September 2013 on determination of stressed value at risk ("sVaR") and of incremental default and migration risk charge ("IRC") more information under the following link: Circular CSSF 13/572
- Circular CSSF 13/573 dated 28 October 2013 on FATF statements, more information under the following link: Circular CSSF 13/573
- Circular CSSF 13/574 dated 30 October on con-centration risk (only available in French) more information under the following link: Circular CSSF 13/574

Please be aware that the CSSF has published updated Q&A on securitisation on 23 October 2013 (only available in French), more information under the following link: http://www.cssf.lu/fileadmin/files/Titrisation/FAQ_titrisation_231013.pdf

On a separate note, you will find below the newly issued or updated ESMA's Q&A:

- on the Prospectus Directive
- on the EMIR requirements

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Luxembourg private foundations

An orphan structure comes to complete the Luxembourg family of private wealth management tools

On 22 July 2013, the Finance Minister introduced the long awaited bill for the creation of private foundations in Luxembourg[2] (the "**Bill**"). This Bill comes to complete the Luxembourg toolkit for managing private wealth with an orphan structure offering a high level of confidentiality in full compliance with the international FATF standards[3] on combating money laundering and the financing of terrorism and proliferation.

An orphan structure...

The private foundations are specifically designed to:

- ensure cohesion and safeguard family estate in the long run;
- allow the continuity in the management of family companies by dissociating economic ownership from the management;
- allow the allocation of estate and assets to the benefit of family members; and
- protect families' privacy and security by limiting visibility.

While private foundations are inspired by the rules applicable to public limited liability companies (*sociétés anonymes*), they are fundamentally different from any form of companies since they have no shareholders.

Indeed, with the contribution to the capital of a foundation (either in cash or in kind) assets will exit the estate of the founder and enter the property of the foundation. In turn, the foundation will manage those assets to the benefit of one or several beneficiaries or one or several specific purposes. However, those purposes must not be essentially commercial or non-profit.

The founder will have a wide freedom to determine the rules under which the foundation will be governed but in the meantime the Bill offers sufficient safeguards to protect the rights of such beneficiaries by:

- providing for liability of administrators and liquidators towards the beneficiaries;
- requiring certain information to be made available at the registered address of the foundation; and
- limiting the possibilities to amend the founding act.

... promoted by a favourable taxation regime

As another novelty, the Bill proposes to introduce a "step up" principle that would apply to significant participations held by a non-resident individual becoming a resident in Luxembourg when the transfer of such participations occurs after the transfer of the individual's tax residency. This would aim at avoiding a double taxation of a portion of the capital gain to be realized upon alienation of the participations, notably when the individual is subject to exit tax upon transfer of his/her tax residency in the country of his/her original residence.

Even though the "step up" principle is not specifically linked to private foundations and would be introduced horizontally into the Luxembourg taxation legislation, it is expected to incentivise high wealth individuals not only to use the new private foundations in order to manage their estate out of one jurisdiction but also to relocate their tax residency to Luxembourg.

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[2] Bill N°6595 concerning the private fundation, introduced on 22 July 2013
[3] Financial Action Task Force's (« **FATF** »), 2012 International Standards on Combatting Money Laundering and the Financing of Terrorism & Proliferation and the related recommendations of 16 February 2012

Luxembourg adopts international filing standards for trademarks

The Singapore Treaty on the Law of Trademarks (the "**Treaty**") will finally enter into force in the Benelux countries on 8 January 2014. As of that date, Luxembourg and foreign companies will be able to file their trademarks with the Benelux Office for Intellectual Property (the "**BOIP**") using the international standards and forms provided for under that Treaty.

By notifying the ratification of the Treaty to the World Intellectual Property Organisation (the "**WIPO**") in early September, Luxembourg has been the last of the Benelux countries to adhere to the Treaty and thereby opened the door for BOIP to become a contracting party. The impact on current procedures before the BOIP is limited since its current procedures already comply with the maximum requirements provided for by the Treaty. It needs however to be mentioned that as of 8 January 2014, companies or individuals that currently use the standard forms provided for under the Treaty in any of the other 32 contracting States, will be able to use the same for their Trademark related filings in the Benelux.

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