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Luxembourg: Trends & Developments

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Trends and Developments

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Current Perspective

While the market has recovered from the turbulence caused by the pandemic, the geopolitical troubles that struck in the first quarter of 2022, and related concerns on various asset class pricing and interest rate increases, affected the regularity of deals despite the continuous appetite of market players for new investments and acquisitions. The banking and finance industry in Luxembourg has, nevertheless, remained very active in 2022 with increased volumes in all fields.

The cross-border finance market remained dynamic, albeit on a saw tooth pattern in terms of deal completion rhythm and volume. This has been particularly true for the cross-border real estate finance market, but the appetite of new market players, notably on the lender side, and the steady volume of new projects across the United Kingdom, Ireland and continental Europe, has kept the Luxembourg finance practice busy.

Fund finance

Given the circumstances, deal incubation periods were extended and somewhat bumpier; nevertheless, the fund finance practice has continued to show unprecedented levels of activity, continuing the trend observed in previous years. This includes technical amendments to existing facilities (upsizing, accessions of additional borrowers or guarantors, higher advance rates, extension of terms and adjustments to LIBOR-related provisions), sponsors launching new funds to seize the opportunities arising from the unprecedented circumstances and putting in place bridge facility arrangements. The UK and North American institutional lenders remain keen to respond to funds' demand for traditional bridge financing arrangements. The "flavour of the month" is definitely the increasing numbers of net asset value (NAV) or hybrid financing arrangements, a suitable option where higher advance rates may not be borne or as a means to provide long-term financing facilities that shall remain available throughout the entire life cycle of the funds, regardless of whether there remain unfunded capital commitments to be drawn down.

Alternative lenders have continued to step in to largely negate the prospect of higher pricing and fund-sourcing issues (due to regulatory thresholds). Similar to 2021, there has been a surge of ESG-linked subscription credit facilities governed by New York or English law.

Amendments to the Securitisation Law

On 9 February 2022, the Luxembourg parliament voted on Bill No 7825 amending the Law of 22 March 2004 on securitisation (the "Securitisation Law") and the long–awaited law entered into force on 8 March 2022. The Securitisation Law is now a modernised piece of legislation that makes Luxembourg an attractive jurisdiction in the securitisation field as it addresses the market need for further legal certainty and more flexibility in transactions.

The changes introduced by the new regime mainly affect securitisation vehicle (SV) sources of funding, their financial activity as well as corporate governance matters.

SV fundraising

Under the previous regime, an SV could finance its operations primarily by issuing securities reflecting the value or return of its pool of assets (in practice, through the issuance of notes, preferential shares or units, but also derivative instruments). The interpretation of the term "security" had been controversial, especially in cases where the instruments issued were governed by foreign law. In addition, although complementary leverage through loan funding was possible, the former restrictions created constraints. The legal framework is now much broader, as it now refers to the issuance of "financial instruments or contracts, for all or part of it, any type of loan" instead of "security". The SV can hence be funded entirely through borrowings, using a variety of sources including asset-backed or profit participating loans.

Another clarification that arose relates to the concept of financial instruments "offered to the public… on a continuous basis", which, when performed, triggers supervision by and prior authorisation from the *Commission de Surveillance du Secteur Financier* (CSSF). Thus far, the concept was solely based on mere CSSF interpretation (therefore, without binding effect, negatively affecting legal certainty).

This issue is now resolved with the inclusion of a statutory definition in Chapter 2, Section 1 of the Securitisation Law pursuant to which "continuous basis" means "… the issuance of financial instruments more than three times in one financial year". In addition, the issuance will be treated as offered to the public if any of the following conditions are met:

- it is not intended for professional clients as defined by Article 1(5) of the 5 April 1993 law on the financial sector as amended;
- its denominations are less than EUR100,000; and
- it is not distributed as a private placement.

It is worth noticing that although the conditions are generally in line with the former CSSF guidelines, the threshold of the denomination set at EUR125,000 by CSSF is lowered to EUR100,000 in the Securitisation Law. This constitutes an effort of the Luxembourg legislature to align with the EU Prospectus Regulation provisions.

SV financial activity

Another significant innovation recently introduced in the Securitisation Law is that the active management of debt portfolios is now expressly permitted, unless the relevant securitisation is offered to the public. Formerly, irrespective of whether the management had been delegated by the SV, the management needed to be limited to a passive, prudent person management of the securitised risks and the administration of financial flows linked to the securitisation operation itself, to the exclusion of any economic activity that would requalify the SV as an entrepreneur. The Draft Law on Securitisation authorises the active management of a securitised debt portfolio to the extent that it is not offered to the public. In the absence of such limitation, Luxembourg now offers an efficient legal framework and solid legal basis for actively managed collateralised loan obligations (CLOs) and collateralised debt obligations (CDOs).

Such changes may be reasonably expected to attract some of the transactions that were previously structured either through other European jurisdictions or issued in the USA but structured through offshore jurisdictions.

The Securitisation Law also allows the SV to acquire its pool of assets either directly or indi-

rectly. Namely, the SV can securitise not only the assets it directly owns, but also the assets owned by an SV subsidiary or an acquired holding entity. However, this change should not be seen as a green light for the SV to engage in commercial activities. The securitised assets should be able to be liquidated easily, if need be, in order to meet the securitisation's objectives.

The intention of the Securitisation Law to adopt a friendlier stance towards SV financial activity is further strengthened by the repeal of restrictions relating to security-granting that formerly jeopardised the validity of security granted by the SV to secure third-party obligations. SVs were not allowed to grant security over their assets to third parties to the securitisation transaction, unless such security was granted to the SV's investors or for the purpose of securing the obligations subscribed in connection with the securitisation of those same assets. This sometimes went against the expectations of third-party creditors extending loans to the SV and expecting the grant of security over the SV's assets. SVs are now allowed to give security to a wider scope of beneficiaries, ie, any creditor, for any obligation (including third-party obligations) directly or indirectly related to the securitisation transaction. For instance, SVs are able to guarantee the indebtedness of the subsidiaries through which they own assets or grant security in favour of the lenders of acquired loans. This change is expected to enhance legal certainty and have a positive impact especially on the execution of fund finance transactions.

Corporate governance

The panel of legal forms available to SVs increased with the inclusion of partnerships (general corporate partnerships (*sociétés en nom collectif*), simple limited partnerships (*sociétés en commandite simple* – SCSs), simplified joint stock companies (*sociétés par actions simplifiées*) and special limited partnerships (*sociétés en commandite spéciale* – SCSps)). Such amendment was imperative as many of the corporate forms now included in the Securitisation Law did not exist when the law was first enacted in 2004. This development confers more flexibility on the Luxembourg securitisation framework as a variety of corporate forms with different features are now offered to establish SVs, including the tax-transparent legal forms that are the SCS and the SCSp. The use of such legal forms is expected to be at the expense of the existing securitisation funds (in the form of fiduciary estates or co-ownerships) that have existed since 2004, but which are more sophisticated and less familiar to foreign investors.

Changes have also been made with regard to mandatory filings. For example, securitisation companies must comply with the Law of 19 December 2002 on the trade and companies register and accounting practices, essentially meaning that securitisation funds should register with the Luxembourg Trade and Companies Register (RCS). In addition, the new regime opts for a decentralised approach when it comes to the establishment and operation of compartments financed by way of shares. In particular, the approval of financial accounts takes place at a compartment shareholders' level subject to the articles of incorporation of the relevant entity. Similarly, distribution of profits and reserves (including the legal reserve) may be determined on a compartment-by-compartment basis without the distribution being affected by the global situation of the SV.

The Securitisation Law introduces a new subordination regime for financial instruments issued by the SV. Essentially:

- the shares, units or partnership are subordinated to debt (financial instruments and loans contracted);
- the shares, units or partnership interests are also subordinated to beneficiary shares, while beneficiary shares themselves are subordinated to debt; and
- non-fixed income debt (financial instruments only) is subordinated to debt financial instruments with a fixed rate.

This regime applies by default unless the parties have agreed otherwise.

Market reaction to the Securitisation Law

Although, Luxembourg lost its leading position, for the first time, to Ireland in 2021 in terms of number of SVs (29% vs 31%) and series (30% to 45%), by the end of April 2022, there were more than 1,400 active SVs subject to the Securitisation Law, ie, 100 more SVs than last year. There were 188 newly created or transformed SVs in 2021 and to date, 2022 is showing encouraging numbers. By the end of the year, while the SARL has become the leading legal form (ahead of the SA), there will be new SVs established under some of the newly available transparent legal forms (even more so considering the increase in the number of securitisation fund formations). Although it is difficult to conclude whether this increase in SV creation or transformation is solely due to the new legal regime, it is certain that market players have perceived the modernisation of the Securitisation Law very positively and that it increases the attractiveness of Luxembourg tremendously as a European hub for securitisations. According to recent surveys, the legal certainty and flexibility provided by the Securitisation Law is one of the main factors attracting arrangers to Luxembourg for securitisation transactions. In addition, the ability to create distinct and segregated compartments under the Securitisation Law in combination with the tax regime give Luxembourg a competitive advantage and put it in a market-leading position in Europe according to a recent PricewaterhouseCoopers survey.

Amendments to the Luxembourg Law of 5 August 2005 on Financial Collateral Arrangements

On 20 July 2022, significant amendments were added to the Luxembourg law dated 5 August 2005 on financial collateral arrangements, as amended from time to time (the "Collateral Law"). The major amendments relate to the enforcement regime.

The definition of enforcement has been amended to provide enhanced contractual freedom to parties to Luxembourg law-governed security agreements in determining trigger enforcement events and by eliminating the requirement for payment obligations to be due and payable (whether by acceleration or otherwise) as a prerequisite to enforcement. The amended definition now reads as follows: "enforcement event means an event of default or any other event *whatsoever* as agreed between the parties on the occurrence of which, under the terms of a financial collateral arrangement or the relevant financial obligation agreement or by operation of law, the collateral taker is entitled to realise or appropriate financial collateral or a close-out netting provision comes into effect". Such change, which reflects the current market practice is, in the authors' perspective, more of a clarification to confirm that the interpretation of the Collateral Law by existing case law is indeed in line with the intention of the legislature.

The other change consists in adding a new paragraph whereby it will be expressly stated that, when the relevant financial obligations (ie, the

secured obligations) are not payable upon the occurrence of one of the enforcement events agreed between the parties, the proceeds of realisation shall, unless otherwise provided for, be applied towards the discharge of the relevant financial obligations regardless of whether these are already due and payable. This additional paragraph emphasises the foregoing, ie, clarification on the definition of event of default.

In terms of the same approach, the Collateral Law now includes a new means of enforcement by expressly allowing enforcement of its rights under the security agreements by selling the financial instruments on any trading venue where the pledged financial instruments are listed and admitted to trading, this being a regulated market, a multilateral trading facility or an organised trading facility or by appropriating such financial instruments at their market price on such trading venue. Such methods of enforcement are offered as additional means to other existing enforcement methods (private sale in a commercially reasonable manner and public auction).

A specific means of enforcement for units or shares of undertaking for collective investment is now provided for, enabling the pledgee to:

- appropriate the units or shares of undertaking for collective investment:
  (a) at their market price if listed on any trading venue (the innovation being the reference to that concept of trading venue); or
  (b) at the price of the latest published NAV provided that it does not exceed one year, effectively allowing appropriation as at the latest published NAV of undertakings for collective that do not publish NAV on a regular basis; or
- redeem the units or shares at the redemption price in accordance with the instruments of incorporation of such vehicle.

Regarding the pledge over claims from an insurance contract, it is now clarified that the pledgee is entitled to exercise a repurchase or redemption right or demand payment directly from the insurer of the amounts due under such contract.

Another key innovation in respect of enforcement methods consists in giving powers to bailiffs (*huissiers*) or notaries sworn in the Grand Duchy of Luxembourg to lead any public auction actioned by the pledgee. In the past, the public auction was supervised by the Luxembourg Stock Exchange, at the expense of expediency in light of the applicable awkward procedure, and this method was hence rarely used. A very detailed and flexible procedure to be followed in the context of an enforcement by public auction is now expressly provided for in the Collateral Law.

Further minor amendments were made, including, notably, an extension of the definition of financial sector professional to any payment institution or electronic money institution. This additional player may hold the security on a fiduciary basis in the context of a transfer of title to collateral for security purposes. In the same vein, the transfer of title was previously permitted only to secure the obligations of the transferor or a third party towards the transferee. The requirement that a transfer of title needed to secure obligations of the transferor (or a third party) "towards the transferee" has been removed, enabling the transferor to transfer title to secure financial obligations granted to a person acting on behalf of the beneficiaries. Finally, to strengthen the remoteness of pledges governed by the Collateral Law and the unassailability of

the effects of their enforcement, Article 19 (b) now lists sequestration among the measures to which they are immune.

Blockchain

Market reaction to recently introduced legislation

The Luxembourg Trends & Developments chapter of the 2021 Banking and Finance Global Practice Guide addressed the amendments to the Luxembourg law of 6 April 2013 on dematerialised securities, whereby the use of distributed ledger technologies (DLT) has been expressly recognised as a means to record securities at issuance.

Following this legislative step and as anticipated last year, key market participants have started preparing the path for the use of DLT in the context of their functions. Most prominently, the CSSF issued, in January 2022, its white paper on DLT and blockchain. Apart from reading as a very comprehensible introduction to DLT, the white paper issues recommendations for entities subject to the CSSF's supervision who wish to resort to DLT. Those recommendations range from topics such as choosing the appropriate DLT model (public or private) over nodes management, smart contract deployment, data privacy and security to IT infrastructure resiliency. In general, the CSSF demonstrates openness towards DLT and a readiness to proactively assist and guide market participants in their projects.

The influential Luxembourg Capital Markets Association published a proof of concept, which identifies pathways for market participants to issue tokenised securities within the current Luxembourg legal framework. This proof of concept explores the potential of a private permissioned DLT platform. It concludes that under the current legislative framework, the issuance of tokenised securities, while possible, remains complex given certain discrepancies between the requirements of the current national and EU regulatory frameworks and an efficient use of DLT.

Lastly, the Luxembourg Stock Exchange (LuxSE) allowed the listing of tokenised securities on its Securities of Official List (SOL), which, along with the regulated market and the EuroMTF, is one of the three segments operated by the LuxSE. As of now, this change in policy only concerns securities that are not admitted to trading. A further change regarding the admission to trading of tokenised securities on the regulated market and the EuroMTF would be welcome in light of recent legislative changes at the EU level with the adoption of Regulation 2022/858 on a pilot regime for market infrastructure based on DLT.

New bill on security taking over tokenised securities

In July 2022, the Luxembourg government lodged bill No 8055 with the Luxembourg Parliament. This bill aims at amending the Collateral Law to expressly recognise the possibility to take security over tokenised securities. The wallets, in which the tokenised securities are held, shall be subject to the same perfection requirements as book entry-registered financial instruments. For those, the Collateral Law provides for a variety of perfection options. Most of those options rely on the intervention of a custodian in one way or another. Indeed, to date, Luxembourg legislation recognising DLT does not entirely circumvent the intermediation of a central account keeper between the issuer of tokenised securities and the investors.

Perfection of a pledge over book entry-registered financial instruments is typically and most often achieved by notifying the custodian,

ensuring that the custodian shall comply with the terms of the pledge agreement. Since the custodian will inevitably be a party to the relevant DLT platform, it can be assumed that the simple deployment of a smart contract formalising the terms of the pledge on such DLT platform satisfies the purpose of notification, given that all parties (including the custodian) would have visibility on the code.

Another means of perfecting a pledge over tokenised securities, without the intervention of a custodian, would consist in transferring the tokenised securities to the wallet of the pledgee or a trusted third party, whereby the powers of such pledgee/third party over the tokenised securities can be determined and limited by smart contract.

Crowdfunding

Regulation (EU) 2020/1503 of 7 October 2020 on European crowdfunding service providers (ECSPs) for business (the "Regulation re crowdfunding") was implemented in Luxembourg by the law of 25 February 2022. The CSSF is thereby designated as the competent authority to supervise ECSPs and to grant the necessary licence to exercise the supervisory and investigation powers listed in the Regulation re crowdfunding and to impose administrative sanctions in the case of violation. As a reminder, the provision of crowdfunding services in Luxembourg requires a licence as an ECSP. The legal framework offering the adequate level of protection to investors is now in full force and effect.

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