International Comparative Legal Guides

Derivatives 2020

A practical cross-border insight into derivatives

First Edition

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1 Documentation and Formalities

1.1 Please provide an overview of the documentation (or framework of documentation) on which derivatives transactions are typically entered into in your jurisdiction. If the 1992 or 2002 ISDA Master Agreements are not typically used, please describe the contracts which are used, as well as any appendices or annexures.

Derivative transactions are typically entered into the form of English law or New York law governed by the 2002 ISDA Master Agreements and the related schedule, credit support documentation and definitions.

1.2 Are there any variances in documentation for certain types of derivatives transactions or between certain types of counterparties in your jurisdiction? For example, what differences do you see between over-the-counter ("OTC") and exchange-traded derivatives ("ETD") or for particular asset classes?

ETDs are standardised derivatives with transparent characteristics and prices. In order to be admitted to trading on a regulated market, a prospectus needs to be drawn up in accordance with Regulation (EU) No. 2017/1129, as amended (the "**Prospectus Regulation**"). OTC derivatives are individually negotiated and typically executed bilaterally with features tailored to the two counterparties.

1.3 Are there any particular documentary or execution requirements in your jurisdiction? For example, requirements as to notaries, number of signatories, or corporate authorisations?

In principle, no. According to article 109 of the Luxembourg Commercial Code, any means of evidence (including invoices) are acceptable in respect of agreements between merchants (*commerçants*) and, depending on the specific circumstances, an agreement between parties may be evidenced by their behaviour. Derivative transactions are typically executed or confirmed in writing.

Further, article 1326 of the Luxembourg Civil Code provides that if the agreement creates an obligation to pay a sum of money or deliver a fungible asset to only one party, the agreement must bear the signature of the obligor (handwritten or electronic) and mention the relevant amount/quantity in full words.

1.4 Which governing law is most often specified in ISDA documentation in your jurisdiction? Will the courts in your jurisdiction give effect to any choice of foreign law in the parties' derivatives documentation? If the parties do not specify a choice of law in their derivatives contracts, what are the main principles in your jurisdiction that will determine the governing law of the contract?

English law or New York law are the most often specified in ISDA documentation.

The provisions of Regulation (EC) No. 593/2008, as amended (the "**Rome I Regulation**") are directly applicable in Luxembourg. According to article 3 of the Rome I Regulation, a contract shall be governed by the law chosen by the parties, unless the application of the provisions of foreign law would be manifestly incompatible with Luxembourg public policy (*ordre public*) provisions as provided by article 3(3) of the Rome I Regulation.

According to article 4 of the Rome I Regulation, where the seller and the obligor do not specify an express choice of law governing the receivables contract, the applicable law will be the law of the country which is (i) most closely connected to the situation, and (ii) typically the law of the country where the party to effect the characteristic performance of the contract has its residence, except when it results from the circumstances of the case that the contract is manifestly more closely connected with another country, in which case the law of that country shall apply.

2 Credit Support

2.1 What forms of credit support are typically provided for derivatives transactions in your jurisdiction?

Guarantees and collateral agreements are typically governed by English, New York or Luxembourg law.

2.2 How is credit support for derivatives transactions typically documented in your jurisdiction? For example, under an ISDA Credit Support Annex or Credit Support Deed.

In addition to the ISDA Credit Support annex, standardised Luxembourg law governed collateral management service agreements with a central counterparty have been developed to overcome collateral fragmentation and optimise the allocation of collateral.

2.3 Where transactions are collateralised, would this typically be by way of title transfer, by way of security, or a mixture of both methods?

Depending on the transaction, collateral may be given by title transfer or by security. The law of 5 August 2005 on financial collateral arrangements, as amended (the "**Law on Financial Collateral**") recognises and allows both security transfer and standard security without the transfer of property. On 22 April 2020, a new bill on professional guarantees of payment (*garantie professionelle de paiement*) was submitted to the parliament (the "**Professional Guarantee Bill**"). Under the Professional Guarantee Bill, as it is currently drafted, it is possible to grant a personal guarantee securing all kind of obligations determined by the parties, including under derivatives transactions (the "**Professional Guarantee**"). The Professional Guarantee is in addition to the existing instruments of the personal guarantee (*cautionnement*) and autonomous guarantee (*garantie autonome*).

2.4 What types of assets are acceptable in your jurisdiction as credit support for obligations under derivatives documentation?

Typical collateral includes cash, corporate debt securities, corporate equity securities, asset-backed securities and sovereign debt securities. According to Section 2 of the Delegated Regulation (EU) No. 2016/2251, as amended (the "**EMIR RTS**"), only certain collateral listed therein, and at a certain concentration, may be eligible for initial margin and variation margin in relation to non-centrally cleared OTC derivative transactions.

2.5 Are there specific margining requirements in your jurisdiction to collateralise all or certain classes of derivatives transactions? For example, are there requirements as to the posting of initial margin or variation margin between counterparties?

The margining requirements set out under article 11 of the Regulation (EU) No. 648/2012, as amended ("**EMIR**") and the EMIR RTS apply in Luxembourg. In particular, parties entering into non-centrally cleared OTC derivative transactions shall protect themselves against counterparty credit risk by exchanging collateral in the form of initial margin and variation margin. The margining requirements were phased in starting from 2017 with progressively lower thresholds to increase the number of parties providing margins.

2.6 Does your jurisdiction recognise the role of an agent or trustee to enter into relevant agreements or appropriate collateral/enforce security (as applicable)? Does your jurisdiction recognise trusts?

Security governed by the Law on Financial Collateral and the Professional Guarantee Bill (as currently drafted) may be granted in favour of a person acting for the account of the beneficiaries of the collateral, such as a security agent or a trustee.

Pursuant to the law of 27 July 2003 on trusts and fiduciary agreements, as amended (the "**Fiduciary Law**") foreign trusts are recognised in Luxembourg to the extent that they are authorised by the law of the jurisdiction in which they are created.

2.7 What are the required formalities to create and/or perfect a valid security over an asset? Are there any regulatory or similar consents required with respect to the enforcement of security?

The formalities required to create a valid security under the Law on Financial Collateral depend on the asset being used as collateral. With respect to cash held in an account, the security is created and perfected as against the debtor and the third parties by the mere execution of the pledge agreement. With respect to book entry securities, the security is perfected by (i) the conclusion of a pledge agreement if the custodian is the pledgee, (ii) an agreement between the collateral provider, the pledgee and the custodian, or between the collateral provider and the pledgee notified to the custodian, (iii) the book entry registration of such securities to an account of the pledgee, or (iv) the book entry registration of the securities to an account maintained by a custodian in the name of the collateral provider, with the securities being registered as pledged.

There are no regulatory or similar consents required with respect to the enforcement of security.

3 Regulatory Issues

3.1 Please provide an overview of the key derivatives regulation(s) applicable in your jurisdiction and the regulatory authorities with principal oversight.

The key derivative regulations are EMIR and the EMIR RTS. The key regulatory requirements under EMIR and EMIR RTS are (i) mandatory clearing obligations through central counterparties for specific OTC derivative transactions, (ii) reporting obligations to corresponding trade repositories, and (iii) margining requirements as outlined under question 2.5 above. In addition, small non-financial counterparties and small financial counterparties, which do not want to be subject to clearing obligation (see question 3.3 below), should calculate their aggregate month-end average position for the previous 12 months.

The regulatory authorities with principal oversights are the European Securities and Markets Authority ("**ESMA**") and the Financial Sector Supervisory Commission (*Commission de Surveillance du Secteur Financier* "**CSSF**").

3.2 Are there any regulatory changes anticipated, or incoming, in your jurisdiction that are likely to have an impact on entry into derivatives transactions and/or counterparties to derivatives transactions? If so, what are these key changes and their timeline for implementation?

On 4 May 2020, the European Supervisory Authorities published joint draft regulatory technical standards to amend the EMIR RTS in order to postpone the 2020 phase of margin requirements (see question 2.5 above) to 2021 in response to the COVID-19 outbreak. The draft regulatory technical standards are expected to be approved by 1 September 2020.

3.3 Are there any further practical or regulatory requirements for counterparties wishing to enter into derivatives transactions in your jurisdiction? For example, obtaining and/or maintaining certain licences, consents or authorisations (governmental, regulatory, shareholder or otherwise) or the delegating of certain regulatory responsibilities to an entity with broader regulatory permissions.

Regulation (EU) No. 2019/834 amending EMIR ("**EMIR

Refit") slightly reduced the compliance burden for small financial and non-financial counterparties. Small financial counterparties may choose not to clear their OTC derivative transactions. Small non-financial counterparties are exempted from reporting obligations in case of derivative transactions with financial counterparties, where only the financial counterparties shall carry out the reporting for both counterparties.

3.4 Does your jurisdiction provide any exemptions from regulatory requirements and/or for special treatment for certain types of counterparties (such as pension funds or public bodies)?

The EMIR framework does not apply to a number of public bodies listed under articles 1.4 and 1.5 of EMIR such as EU central banks, certain non-EU central banks (e.g., United States, Japan and Switzerland), certain multilateral development banks (including EBRD, EIB and EIF), EFSF and ESM.

The clearing obligations under EMIR will not apply to pension funds until 18 June 2021.

4 Insolvency/Bankruptcy

4.1 In what circumstances of distress would a default and/or termination right (each as applicable) arise in your jurisdiction?

Termination rights would typically arise upon the occurrence of insolvency proceedings (as defined in the relevant derivative documentation). A company would be deemed insolvent under Luxembourg law if it meets the two cumulative tests of bankruptcy, namely the cessation of payments (*cessation de paiement*) and the loss of creditworthiness (*ébranlenment de crédit*).

4.2 Are there any automatic stay of creditor action or regulatory intervention regimes in your jurisdiction that may protect the insolvent/bankrupt counterparty or impact the recovery of the close-out amount from an insolvent/bankrupt counterparty? If so, what is the length of such stay of action?

Upon the declaration of bankruptcy and insolvency, a receiver is appointed to realise the assets of the bankruptcy estate and pay creditors. Alternative measures are available for the debtor, such as controlled management (*gestion contrôlée*), suspension of payment (*sursis de paiement*) and composition proceedings (*concordat préventif de la faillite*). Financial institutions and insurance undertakings may become subject only to suspension of payment measures, liquidation procedures and, with respect to banks, the single resolution mechanism set out under Regulation (EU) No. 806/2014. After a bankruptcy declaration, individual actions and enforcement of court decisions are in principle suspended, save for certain creditors (e.g., creditors holding a security governed by the Law on Financial Collateral or, if approved, a professional guarantee governed by the Professional Guarantee Bill). The length of the insolvency proceedings depend on the situation of the debtor and the timeframe set by the court.

4.3 In what circumstances (if any) could an insolvency/ bankruptcy official render derivatives transactions void or voidable in your jurisdiction?

While declaring bankruptcy, the court may specify a period not exceeding six months before the day of such decision. Certain payments and transactions entered into during such pre-bankruptcy hardening period (e.g., payment of matured debt received by a creditor who knew about the insolvency situation), or 10 days before the beginning of such period (e.g., creation of certain security interests for debt incurred previously, or payment of debts which have not fallen due), may be declared void by the court upon proceedings initiated by the insolvency received. Security interests created under the Law on Financial Collateral are not subject to a hardening period.

4.4 Are there clawback provisions specified in the legislation of your jurisdiction which could apply to derivatives transactions? If so, in what circumstances could such clawback provisions apply?

Irrespective of the measures outlined under question 4.3 above, an insolvency receiver may challenge the fraudulent payments and transactions made prior to the bankruptcy, without limitation of time (*action pauliana*).

4.5 In your jurisdiction, could an insolvency/ bankruptcy related close-out of derivatives transactions be deemed to take effect prior to an insolvency/ bankruptcy taking effect?

According to article 19 of the Law on Financial Collateral, termination clauses entered into with a view to set-off assets are valid and binding against third parties, including insolvency receivers, and are effective notwithstanding the opening of insolvency proceedings. The termination of an agreement made by reasons of conservatory measures or insolvency proceedings is deemed to have occurred before such measures or proceedings apply.

4.6 Would a court in your jurisdiction give effect to contractual provisions in a contract (even if such contract is governed by the laws of another country) which have the effect of distributing payments to parties in the order specified in the contract?

There are no general Luxembourg law provisions or regulations on contractual subordination. Based on the principle of contractual freedom set out under article 1108 of the Luxembourg Civil Code, there is consensus in Luxembourg case law and legal literature on the validity and enforceability of clauses providing for contractual subordination and the waterfall of payments against the subordinated party who freely agreed to such clauses, even in the event of insolvency proceedings affecting the Luxembourg party concerned. For these reasons, Luxembourg courts would typically uphold market standard provisions on contractual subordination and waterfall of payments, whether the contract is governed by Luxembourg law of by the laws of another country.

In addition, the law of 22 March 2004 on securitisation, as amended (the "**Securitisation Law**") explicitly recognises subordination clauses (even if the relevant agreement or the terms and conditions of the notes are not governed by Luxembourg law).

5 Close-out Netting

5.1 Has an industry standard legal opinion been produced in your jurisdiction in respect of the enforceability of close-out netting and/or set-off provisions in derivatives documentation? What are the

key legal considerations for parties wishing to net their exposures when closing out derivatives transactions in your jurisdiction?

An industry standard legal opinion has been produced for Luxembourg with respect to enforceability of close-out netting and set-off provisions. Key legal considerations are: enforceability of the provisions in case of insolvency (see question 4.5 above); calculation and payment of a termination amount; and a single agreement concept.

5.2 Are there any restrictions in your jurisdiction on netting in respect of all derivatives transactions under a single master agreement, including in the event of an early close-out?

There are no specific restrictions under Luxembourg law.

5.3 Is Automatic Early Termination ("AET") typically applied/disapplied in your jurisdiction and/or in respect of entities established in your jurisdiction?

The Law on Financial Collateral does not distinguish between automatic early termination and voluntary termination. There are in principle no reasons for the AET not to be enforceable or to be required under Luxembourg law.

5.4 Is it possible for the termination currency to be denominated in a currency other than your domestic currency? Can judgment debts be applied in a currency other than your domestic currency?

Luxembourg does not have currency or exchange controls or central bank approval requirements restricting payments in currencies other than domestic currencies. Monetary judgments may be expressed in a foreign currency or its Euro equivalent at the time of judgment or payment. However, in the case of forced execution in Luxembourg, the amount must be converted in Euro.

6 Taxation

6.1 Are derivatives transactions taxed as income or capital in your jurisdiction? Does your answer depend on the asset class?

In Luxembourg, there are no clear tax rules applying to derivative transactions. In principle and based on the so-called principle of "*accrochement du bilan fiscal au bilan commercial*" contained in article 40 Luxembourg Income Tax Law ("**LITL**"), for valuation purposes, Luxembourg commercial accounts drawn under Lux GAAP should serve as the basis for calculating the taxable profits. As a result, although not binding to the Luxembourg tax administration which might deviate from it on the substance over form principle, the tax treatment of derivative transactions depends on their accounting treatment under Luxembourg GAAP. A case-by-case analysis of the derivative, its asset class, payment and profit repatriation mechanism will need to be performed in order to determine in which category of income it should be classified.

6.2 Would part of any payment in respect of derivatives transactions be subject to withholding taxes in your jurisdiction? Does your answer depend on the asset class? If so, what are the typical methods for reducing or limiting exposure to withholding taxes?

Luxembourg applies a 15% withholding tax on dividend payments or profit participating bonds. Reduced withholding tax rates may be available under the relevant double tax treaties, or a withholding tax relief, under the Luxembourg participation exemption.

As to interest payments, in general, no withholding tax applies on arm's length interest payments. Interest paid under certain hybrid instruments or not at arm's length may be subject to the 15% withholding tax if reclassified as (hidden) dividend payments by the Luxembourg tax authorities.

6.3 Are there any relevant taxation exclusions or exceptions for certain classes of derivatives?

There are no relevant taxation exclusions or exceptions.

It should, however, be noted that derivative transactions have been recently discussed in the framework of the implementation of the Anti-Tax Avoidance Directives into Luxembourg law and especially under the newly introduced interest deduction limitation rule.

7 Bespoke Jurisdictional Matters

7.1 Are there any cross-border issues that apply when posting or receiving collateral with foreign counterparties? For example, are there any restrictions in your jurisdiction on the delivery or acceptance of foreign currencies?

The main cross-border issues relate to potential insolvency of foreign counterparties. For example, pursuant to article 7 of the Regulation (EU) No. 2015/848 (the "**EU Insolvency Regulation (Recast)**"), which is applicable in all Member States of the European Union, other than Denmark, set-off would be permitted in Luxembourg to the extent it would be permitted also in the jurisdiction where the insolvency was opened. It should be noted that security interests created under the Law on Financial Collateral and the Professional Guarantee would not be in principle affected by insolvency of the foreign chargor/principal debtor.

There are no specific restrictions on delivery or acceptance of foreign currencies.

7.2 Are there any restrictions on transferability, for example, assignment and novation (including notice mechanics, timings, etc.)?

The perfection of the transfer of receivables by way of assignment requires the notification of the obligor pursuant to article 1690 of the Luxembourg Civil Code. Prior to the notification, and provided the obligor is not aware of the assignment, the obligor will be discharged while making payments to the seller and the sale will not be enforceable against any subsequent purchasers provided that they are acting in good faith.

In case of novation of a collateralised derivative transaction, article 1278 of the Luxembourg Civil Code requires that the creditor explicitly reserves its security interests under the novated obligation to subsist, or else such security interests would lapse by virtue of the novation.

7.3 Are there any other material considerations which should be taken into account by market participants wishing to enter into derivatives transactions in your jurisdiction?

Even though the risks are remote, due to established market practice, market participants should take measures to ensure that the derivative transactions do not re-qualify as gambling, wagering or gaming or as insurance contracts.

8 Market Trends

8.1 What has been the most significant change(s), if any, to the way in which derivatives are transacted and/or documented in recent years?

We see a general trend towards the standardisation of documents, in particular those that are English and New York law governed. In certain cases, clients have asked for more bespoke documentation, and they did not mind also using Luxembourg law governed documents.

8.2 What, if any, ongoing legal, commercial or technological development do you see as having the greatest impact, positive or negative, on the market for derivatives transactions in your jurisdiction?

The uncertainties related to Brexit may have a negative impact on the market for derivative transactions in the short run, in particular if settlement is moved outside of London.

8.3 In your view, what are the key market trends likely to affect derivatives transactions in your jurisdiction in the upcoming years? For example, the key negotiated commercial terms, the volume of trades and/or the main types of products traded, smart contracts or other technological solutions.

Digital ledger technology, such as blockchain, and smart contracts may provide significant efficiencies in post-trade processing. Given the limitations of the EMIR legal framework, it will take time before such technology can be used for OTC derivatives.

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