

COMMISSION de SURVEILLANCE
du SECTEUR FINANCIER

Luxembourg, 5 April 2006

To all investment companies in risk capital
(SICARs)

CIRCULAR CSSF 06/241

Re: Concept of risk capital under the Law of 15 June 2004 relating to the investment company in risk capital (SICAR)

Ladies and Gentlemen,

The purpose of this circular is to give a general description of the concept of risk capital under the law of 15 June 2004 relating to the investment company in risk capital (SICAR), (hereinafter “the SICAR law”), and of the criteria applied by the CSSF to assess the acceptability of the investment policies proposed for the SICARs.

I. CONCEPT OF RISK CAPITAL

The **purpose** of the SICAR law is to promote the collection, within a vehicle specialised in risk capital, of funds from well-informed investors accepting, with full knowledge and in expectation of a better return, the increased risks most often associated with risk capital, i.e. lower liquidity, higher price volatility and lower credit quality.

Article 1(2) of the SICAR law specifies the **assessment criteria** applying to the concept of risk capital, which is defined as the direct or indirect contribution of funds to entities in view of their launch, development or listing on a stock exchange.

Generally speaking, risk capital under the SICAR law is characterised by the concurrent gathering of two elements, namely a high risk and an intention to develop the target entities. The intention to develop the target entities is deemed to be inherent *per se* in the contribution of capital to entities in view of their launch or their listing on a stock exchange.

Application files submitted to the CSSF shall include a description of both “risk” and “development” aspects of the SICAR project. The purpose of this section is to further specify

the criteria applied by the CSSF to assess whether an envisaged investment policy is eligible under the SICAR law.

The parliamentary works specify that the concept of “**risk capital**” notably refers to venture capital and private equity financings.

Venture capital usually refers to capital contributed to newly launched undertakings (start up) or entities active in sectors with high development potential.

The concept of private equity is to be construed in the broad sense. Private equity bears an inherent risk which is notably the risk due to lack of liquidity. It may be described, as opposed to listed securities, as an investment in a non-listed private company, often of a relatively limited size and a significant level of risk.

In accordance with the legislator’s intention, the SICAR’s primary objective should be to contribute to the development of the entities in which it invests.

The **concept of development** is construed in the broad sense as value creation at the level of the portfolio companies. This value creation can take different forms.

Investments made by SICAR generally represent a contribution in development capital to portfolio companies. However, a contribution of new capital in portfolio companies is not required each time. The acquisition on the secondary market of securities representing risk capital is also eligible.

In order to maximise profits from investments for the SICAR’s shareholders, the SICAR will often intervene in the management of the portfolio companies *via* an advisory activity or a representation in the managing bodies of the portfolio company, thereby aiming to create value in the latter through restructuring, modernisation, and by promoting any measures likely to improve the allocation of resources.

An active intervention of the SICAR to create value in the portfolio companies is not required in every case, as other elements may establish the risk capital characteristics, such as the financing mode used or the type of participants, or their remuneration. However, where the SICAR invests into a sole portfolio company, the active management element is important.

As far as the different **forms** of investments in risk capital or the objective pursued by these investments are concerned, the parliamentary works specify that the scope of the law covers all types of private equity investments. Private equity risk capital investments may notably

take the form of transactions of the Buy-offs, Leveraged Buy Outs, Management Buy Out and Management Buy In type. Venture capital investments may take the form of Start-up and Early Stage investments. Moreover, the manner in which the SICAR divests from an entity in which it has invested, be it *via* an over-the-counter sale, or via an Initial Public Offering (IPO), is not delimited by the law. The management of the SICAR will have to determine the most appropriate legal and fiscal way for this divestment.

Furthermore, no **type of financing** of the portfolio companies is excluded *a priori*. In principle, all financing modes are eligible, be it by way of an equity contribution, bond issuance, bridge finance or similar financing, mezzanine-type financing, convertible debt, subject to the financing being a “risk capital” type of contribution.

The SICAR law does not lay down **risk diversification** with respect to the chosen investments. It is thus perfectly conceivable that certain SICARs restrict their investments to one or several undertakings active for example in a particularly narrow niche or in extremely specialised sectors.

Finally, it should be noted that as investment company in risk capital, the SICAR’s declared intention shall be in general to acquire financial assets in order to sell them with a profit, as opposed to a holding company which acquires to hold. In this respect, the **holding duration** is an important criterion to determine whether an investment is eligible or not.

One may conclude that in practice, several aspects should be considered (number and type of target entities, their maturity level, development projects, planned holding duration, etc.) to determine whether an investment policy is eligible under the SICAR law.

The case of real-estate investments

Whereas the law does not permit SICARs to hold real estate directly, the indirect investment *via* entities that hold or invest in real estate assets representing risk capital characteristics (private equity real estate), as well as the contribution of capital to real estate companies, is possible.

Application files of SICARs envisaging to invest in the real estate sector shall include a statement aiming to establish that the planned investments are really risk capital within the meaning of the SICAR law.

The purpose of private equity real estate investments shall, in any case, be to bring about a **development** (i.e. creation of added value) at the level of the underlying real estate object. The sole fact that real estate objects can present a particularly high risk or are located in

countries with a certain political risk does not in itself suffice to prove a risk capital characteristic.

This creation of value at the level of the underlying real estate object can be construed in the broad sense as a change in the existing conditions. It can adopt several forms, such as the enhancement of the real estate through renovation, renegotiation of contracts, renewal of tenants, restructuring of the portfolio.

In order to allow the qualification of an investment as private equity real estate as opposed to simple real estate, it shall moreover be evidenced that the underlying real estate objects represent a **particular risk**, above the normal real estate risk on a given market.

Such particular risk may consist, for example, in the fact that the real estate may not be easily rented out or is located in a disaster-stricken or disadvantaged building zone. Although not necessarily sufficient in itself, the political risk may also be one of the elements to consider. Conversely, the price risk resulting from a price explosion on certain real estate markets is not a sufficient criterion as opposed to the transfer risk or the legal risk resulting, as the case may be, from the geographical location of the underlying real estate.

Finally, as already described above, it should also be stressed that in the field of real estate investment in particular, the purpose of the SICAR as investment company shall be to buy with a view to sell at a profit. The creation of a SICAR whose policy would be for example limited to the holding or management, through a SICAR, of family, corporate or group properties, is not eligible.

Consequently, the “risk capital” criterion with respect to real estate investments is assessed on the basis of a string of elements, such as:

- Investments with a high appreciation potential owing to the particular risks associated with the underlying real estate
- Development / value creation projects at the level of the underlying real estate
- High risk level / expected return
- Identity of the managers, nature of their remuneration and selection criteria of the real estate assets
- Financial participation of the managers / initiators in the project
- Active management of the underlying real estate, holding duration/investment horizon limited in time
- Generally, absence of regular rental income
- Financing types: often high leverage, mezzanine, distressed, non-performing or CBO type financing

By reference to the common financial terminology used in real estate matters, this could be simplified by saying that an opportunistic type investment strategy is in principle acceptable. Opportunistic real estate can notably be characterised by the absence of renting out, the transformation of the premises or the building of new premises.

II. PRUDENTIAL APPROACH

The purpose of this section is to inform on the prudential approach adopted in certain specific cases.

Indirect investments

In general, the law allows the indirect investment in assets representing risk capital without imposing any restrictions as to the type or legal form of the intermediary companies.

In particular, the indirect investment *via* a UCI or another private equity investment vehicle is acceptable in so far as the investment policy of these vehicles restricts them into investing in assets that are eligible as risk capital within the meaning of the SICAR law.

The same approach applies to investments in real estate funds.

On the other hand, hedge funds are, generally speaking, not eligible investments for SICARs, as they do not pursue the objective of creating value at the level of target companies.

Political risk

The criterion of geographic location of the target entities in itself does not always suffice to justify the risk capital characteristic. The arguments set forth in the application file, aiming to prove the risk capital characteristic by showing on the one hand a political risk and in addition other specific risk characteristics on the other hand, will be analysed on a case-by-case basis.

Investment in companies located in regions exposed to political risk seems possible in so far as a development which creates value at the level of the target company can be evidenced.

The same applies to real estate matters, where the fact that the underlying real estate objects are located in countries with a certain political risk does not necessarily suffice to prove the risk capital characteristics.

Mezzanine loans (primary & secondary market) and distressed debt

Mezzanine financing is an eligible financing tool in so far as the target entity to which funds have been contributed fulfils the eligibility criteria for risk capital, for example in the case of

a non-listed company. Such is not the case where the mezzanine financing targets a listed company, unless the financing is made for the purpose of a specific development project, a delisting for example.

Investments in existing mezzanine securities and/or distressed debt securities also qualify as private equity investments where the goal pursued is to increase the value of the investments *via* a restructuring of the companies concerned.

Use of derivative instruments

A SICAR may use derivative instruments for hedging purposes or where such transactions are necessary to the realisation of its investment policy. However, investment in derivative instruments cannot constitute the object of its policy.

Investments in listed securities

The SICAR is a specialised company whose sole purpose shall be to invest in assets representing risk capital within the meaning of the SICAR law.

The risk capital criterion is not necessarily challenged in the case of investments in listed securities, for example where securities are listed on a stock exchange that does not meet the requirements applicable to regulated markets or where securities, although listed on a regulated market, have been issued by an entity representing risk capital within the meaning of the SICAR law. Likewise, the investment in certain listed securities can be eligible in specific cases where it is associated to a particular development project of the target company or if aimed at the delisting of the securities. Listed small caps for instance may constitute eligible investments for a SICAR and the listing of these companies does not necessarily put an end to the investment.

Finally, the investment policy of a SICAR may provide that liquidities pending investment may be invested temporarily in liquid listed securities not representing risk capital.

Yours faithfully,

COMMISSION DE SURVEILLANCE DU SECTEUR FINANCIER

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