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Venture capital investment in Luxembourg: market and regulatory overview

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MARKET OVERVIEW

1. What are the main characteristics of the venture capital market in your jurisdiction?

Venture capital and private equity

Venture (or risk) capital is defined in the Luxembourg law on venture capital investment companies, dated 15 June 2004, as amended. Venture capital means the direct or indirect contribution of funds to undertakings for the purposes of their launch, development or introduction to the stock exchange (*Law on venture capital investment companies*). The term private equity is not defined by law.

Pursuant to Circular 06/241 (Circular) of the Luxembourg regulator (*Commission de Surveillance du Secteur Financier (CSSF)*), two cumulative elements are required to constitute risk capital, namely:

- A high-risk investment.
- The intention to develop the target entities (for example, in view of their launch or the listing of their shares on a stock exchange).

The Circular further explains the concept of risk capital, also referring to private equity. The approach taken on risk capital as provided in Circular 06/241 was recently confirmed by the Luxembourg government when commenting on the bill of law 6929 regarding reserved alternative investment funds (*fonds d'investissement alternatifs réservés (RAIFs)*). In Europe, venture capital investments form part of private equity investments. It follows that the structures used for venture capital funds are frequently equivalent to the structures used for private equity funds.

The main characteristics of venture capital in Luxembourg are as follows:

- Venture capital is included in the concept of private equity. Private equity is construed in a broad sense, bearing the inherent risk due to lack of liquidity and/or inefficiencies and/or poor financial performance of the target entity. Private equity refers to participation in a target company with a traceable track-record, existing products and cash flows, with a view to improve its margins and build growth. Private equity funds invest, therefore, in portfolio companies with growth and optimisation potential. This contrasts with venture capital investments in companies that are not as mature as companies in which private equity funds invest, that is, cash-hungry start-ups, with little track-record of performance or companies in their early years of development.
- Private equity and venture capital sponsors invest in non-listed private companies (as opposed to listed securities), often of limited size and at a significant level of risk. In Luxembourg, an investment can be considered to be risk capital or private equity even if the shares of the investment target are listed, if the listed companies fulfil the criteria of risk capital (that is, high-risk with a development aspect).
- Buy-offs, leveraged buy-outs, distressed investments, management buy-outs and management buy-in transactions are private equity. Seed funding, start-up and distressed investments are venture capital. All are risk capital transactions.
- Venture capital fund raising remains a small fraction of European fund raising (EUR4.1 billion out of a total of EUR44.4 billion in 2016, with a limited market share on investments (with over 3,000 companies receiving investment with a trend of larger financing rounds), out of a total of EUR53.7 billion of investments in 2016 (the second highest level since 2008) (*Invest Europe, May 2017*).

Sources of funding

Much funding is available in Luxembourg, as Luxembourg is often chosen as the place to establish a business with growth strategy in Europe. Many private and public organisations assist in launching businesses. They bring together seed funds, venture capital funds and entrepreneurs to fund business development and support innovation.

Early stage companies obtain funding from the following sources:

- Equity financing (and quasi-equity financing such as hybrid securities and/or shareholder loans) to young businesses with rapid growth potential occurs through angel investors or venture capital funds.
- Third party lending.
- Government subsidies.

The types of funding are discussed in detail below:

- **Equity finance through angel investors (or business angels).** These are high net worth individuals often investing in businesses they are familiar with. Angel investors often take equity in a young company with a preferred return on their investments. They are, sometimes, happy to take greater risks or accept lower returns if they are attracted to the non-financial characteristics of a

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business. They often take an active role in the management of the business and/or mentor the entrepreneur.

- **Equity finance through venture capital funds.** These also seek a preferred return on their equity investment, based on the risk profile of the business, with an active involvement in the development of the business to complete the exit strategy agreed with the entrepreneur. A venture capital investor will typically structure the equity of the company, take a position on the board of directors of the company, give directions on its governance, strategy, marketing and so on, with a view to delivering a high return at exit. Usually, capital injections are made in various rounds agreed with the entrepreneur when the business plan was designed. Each capital injection, which takes the form of equity and/or debt instruments (convertible or not), is determined by assessing the business needs at each milestone of the agreed business plan, achieving high returns and minimising risks for the venture capital investor.
- **Third party lending.** The most common third party financing for start-ups to finance equipment is leasing. There is appetite for venture debt, with investments alongside venture capital. Venture debt is commonly used to expend cash reserves in the young company and/or to reduce the level of dilution for the entrepreneur. It also helps young companies raise more capital to reach the milestones agreed with the venture capital investor. Borrowers would normally be expected to be backed by venture capital in order to obtain venture debt. Bank financing for working capital purposes is, in practice, usually more difficult to obtain, especially for young companies with no track-record.
- **Government subsidies.** Luxembourg strongly supports innovation and research for development and dwarfs many European countries with funding growing faster than GDP (*Eurostats, Europe 2020 indicators - research and development, December 2014*). State aid schemes available in Luxembourg for start-ups, SMEs less than six years old or established businesses are set-out in the law of 5 June 2009 on the promotion of research, development and innovation. Luxembourg's public research sector, which has developed considerably over the past few years and a number of international industrial groups have chosen to locate research and development operations in Luxembourg.

Schemes and measures in Luxembourg that support research, development and innovation include, in particular:

- Research and development projects or programmes, which support SMEs, with co-financing schemes for expenses associated with the development of innovative SMEs.
- Innovation advisory services and innovation support services.
- *De minimis* measures for established businesses, including financial support to fund technical feasibility studies, industrial property, and so on.

The Luxembourg National Agency for Innovation and Research advises innovative companies or entrepreneurs on aid eligibility and generally assists them at all stages of their project (for example, identification of a technical support partner, technology transfer issues, funding needs, and so on).

The Luxembourg Cluster Initiative actively encourages networking between the private and public sectors. It is the key place for business-to-business activities and for identifying funding. The focus is placed on key technologies that have been identified as important for the future sustainable development of the Luxembourg economy, such as:

- Automotive components.
- Eco-innovation.
- Healthcare and biotechnologies.
- Information and communication technologies.
- Material technologies.
- Space technologies.

Types of company

The largest portion of venture capital investments are in technology and biotechnology companies.

The following types of company attract venture capital investment:

- New energy companies.
- Technology companies.
- Mechanical companies.
- Retail companies.
- Food producing companies.
- Financial companies.
- Fintech.

The seven priority investment sectors of the Luxembourg government are:

- Life sciences.
- Eco technologies.
- Information and communication technologies.
- Materials and production technologies.
- Space technologies.
- Young innovative businesses.
- Skilled crafts.

Market trends

Luxembourg offers a wide range of regulated and unregulated investment vehicles, which are chosen by venture capital funds on the basis of their investment strategy and the investor base. The strongest demand is for unregulated funds set-up as common limited partnerships (with legal personality) or special limited partnerships (without legal personality).

The Luxembourg Law of 12 July 2013 on Alternative Investment Fund Managers (AIFM Law), transposing Directive 2011/61/EU on alternative investment fund managers (AIFM Directive) was the opportunity to roll out a new regime for limited partnerships, matching the expectations of many investors familiar with common law partnerships set up in the UK, Delaware or the British Virgin Islands (BVI).

Since the AIFM Law, existing funds set up outside Europe have migrated to Luxembourg from offshore jurisdictions and the swift adoption by Luxembourg of the AIFMD swelled further assets under management in Luxembourg. With the implementation of the AIFM Directive, many Luxembourg funds were set up with alternative investments funds managers (AIFMs) set up outside of Luxembourg benefitting from a passport to manage (regulated or unregulated) alternative investments funds (AIFs) in Luxembourg. The trend is now to set up Luxembourg-based AIFMs or use the services of third party Luxembourg-based AIFMs.

Article 50 of the Treaty of Lisbon was triggered by the UK government at the end of March 2017 and, pending the

conclusion of the negotiations between the EU and the UK, it is unclear how that will affect Luxembourg VC funds managed by UK-based AIFMs and/or UK VC funds. The VC industry is planning for the worst, hoping for the best, with new fund raisings considering, for example:

- Parallel Luxembourg funds structures and/or terms permitting changes to existing UK-based AIFMs in favour of Luxembourg-based authorised AIFMs.
- Alternative structures with third party Luxembourg-based AIFMs appointed to minimise the impact of the loss by UK-based AIFMs of passporting post-Brexit.

Non-UK major funds also move to Luxembourg, setting up a Luxembourg-based AIFM, or increasing their presence, to prepare for the implementation of the OECD base erosion and profit shifting initiative (BEPS) that requires increased substance in Luxembourg.

Unregulated funds. The vast majority of funds are unregulated funds. The VC industry has a strong appetite for Luxembourg limited partnerships, a fund structure that is universally understood by investors. The AIFM Law reformed the common limited partnership (*société en commandite simple*) (SCS) and introduced the special limited partnership (*société en commandite spéciale*) (SCSp) in the Act dated 10 August 1915 on commercial companies, as amended (Companies Act). The SCS and the SCSp are the structures of choice for the PE and VC industries. The SCS (as a Scottish limited partnership and a Delaware limited partnership) has separate legal personality, unlike the SCSp (as an English limited partnership and a Cayman limited partnership).

Despite the lack of legal personality, the assets contributed to the SCSp are registered in the name of the partnership and can only satisfy the rights of creditors that have been created in relation to the creation, running or liquidation of the SCSp. Therefore, the assets of the SCSp are not available to personal creditors of the general partners or the limited partners, but only to creditors of the SCSp. In practice, 80% of funds are set up as unregulated funds, a vast majority of which are set up as an SCSp.

Regulated funds. As per the CSSF's Newletter No. 194 of March 2017, Luxembourg private equity regulated vehicles included:

- 283 risk capital investment companies (*sociétés d'investissement en capital à risque*) (SICARs).
- Some of the 1,639 specialised investment companies (*fonds d'investissement specialisés*) (SIFs).
- Since the law of 14 July 2016 on the reserved alternative investment fund (RAIF), sponsors who considered a SIF or SICAR as a main fund vehicle or feeder fund of an unregulated fund now very much favour a RAIF. This is because RAIFs avoid the over-layering of supervision (applicable to SIFs and SICARs) that came into existence with the law of 12 July 2013 on alternative investment funds managers. Their establishment is also much more expedient than regulated funds as this is done without the regulatory licensing or oversight of the CSSF, while RAIFs provides favourable tax and legal regimes.
- RAIFs provide additional structuring solutions for AIFs, with supervision through the AIFM. Further, no legal constraints apply to the statutory reserve for funds set up with a corporate form. There is also no restriction on dividend distributions and the redemption of shares. Those funds are not required to consolidate the intermediary holding companies with the funds.

As at the end of April 2017, 82 RAIFs were registered at the Luxembourg trade and companies register.

2. Are there any recent or proposed regulatory changes affecting the venture capital industry?

Two major reforms favoured the VC industry in 2016:

- The law of 13 July 2016 improves the law on commercial companies of 10 August 1915 and modifies the Civil Code confirming practices which were used with a health warning due to the uncertainty of the law on these questions. Since 13 July 2016, the board or the general partner can suspend the voting rights of shareholders failing to comply with their obligations. A company may also issue tracking shares, and clauses providing for restrictions on transferability of shares are now formally recognised. In addition, a new form of company, the simplified public limited company, has been introduced into the Luxembourg legal system and it offers far more flexibility to its shareholders and managers than the public limited company. Among the many innovations adopted by this reform is the introduction of a new corporate entity, the *société par actions simplifieés* (SAS), which enables promoters to design their own set of governance rules and could serve as a holding company for private equity investors.
- The law of 14 July 2016 on the reserved alternative investment fund (RAIF), is an important and much needed reform as it tackles the over-layering of supervision that came into existence with the law of 12 July 2013 on alternative investment funds managers. It also facilitates the processes of establishing regulated funds (SIFs, SICARs and FCPs), as this will be done without the regulatory licensing or oversight of the CSSF and provides favourable tax and legal regimes.

Uncertainty as to what the regulatory environment will look like following the Brexit negotiations affects many Luxembourg AIFs currently managed by authorised UK-based AIFMs. Progress on a third-country passport is certainly out of reach since the vote on Brexit. Further, uncertainty over existing Luxembourg funds managed by UK-based AIFMs, and current fundraisings of Luxembourg funds, raises the question of what will happen to Luxembourg funds with managers who do not have to comply with the AIFMD, either because they are regulated outside the EU, or because they operate in the EU but are too small to be within its scope. Currently, managers actively fundraising must comply with national rules in each of the countries in which they want to market their fund (unless they are managing the fund within the EU and either qualify for the venture capital passport under Regulation (EU) 345/2013 on European venture capital funds (EuVECA,) or "opt-in" to full compliance with the AIFMD. These national private placement rules (NPPRs) are not easy to navigate, and compliance burdens range from relatively light to almost impossible. There is a risk that the EU turns inwards and adopts a more protectionist stance, especially as it contemplates what future access to give the UK.

All portfolio managers should review their policies and procedures to ensure that, following the implementation of MiFID II on 3 January 2018, all marketing materials and other communications to be made to clients and potential clients will be reviewed to ensure compliance with the MiFID II requirements before they are sent. Communications to all client categories will need to comply with the "fair, clear and not misleading" rule. However, the most significant change is that MiFID II extends to professional clients, whereas most of the specific requirements under MiFID I only apply to retail clients. Firms that confine their client base to professionals and have

previously been able to ignore many of the more detailed and prescriptive rules are likely to find that they need to do a great deal of additional work to ensure they can comply from 3 January 2018.

The provisions of Directive 2011/61/EU on alternative investment fund managers (AIFM Directive) on remuneration initially caused concern, with requirements that included the deferral of a proportion of "variable remuneration" and the need to pay a substantial part as fund interests (or equivalent). The AIFM Law permits carving out certain provisions on the remuneration rules in light of proportionality, considering the:

- Size of the alternative investment fund manager (AIFM).
- Scope of the AIFM's activities.
- AIFM's internal organisation.

Given that carried interest, combined with executive co-investment, aligns the interests of the fund manager with its investors and discourages excessive risk taking, many VC houses have been able to disapply the most onerous requirements under the proportionality test. This was confirmed in the European Securities and Markets Authority's (ESMA's) final report (released at the end of March 2016). However, ESMA also wrote to EU lawmakers suggesting that further clarification is needed, possibly through amendments to the AIFM Directive itself. While it is expected that the CSSF will keep its approach to proportionality, there could be amendments to the AIFM Directive which could change the way in which the principle of proportionality must be applied by fund managers. ESMA did provide clarification for managers who are part of a group, where other entities are subject to different remuneration rules (other than the AIFM Directive). An example of this is a fund manager within a banking group where other entities may be subject to Directive 2013/36/EU on capital requirements (Capital Requirements Directive IV). In this case, the AIFM Directive remuneration rules continue to apply to the fund manager. However, some individuals within the AIFM who have group-level responsibilities or impact may be subject to the more stringent Capital Requirements Directive IV remuneration rules.

In July 2013 EuVECA introduced the possibility for some AIFM Directive exempt managers to choose a European venture capital fund (EuVECA) status for their venture capital funds (and benefit from a European marketing passport), provided that they complied with certain requirements. Although its purpose was to attract more capital to Europe and help Europe's companies become more innovative and competitive, EuVECA had little success (there are only 34 funds throughout the EU, one of which is based in Luxembourg). This is for various reasons, including tax and the limited range of eligible assets in comparison to other forms of AIFs. Therefore, VC funds are often set up as unregulated funds or RAIFs.

Regulation (EU) 2015/760 on European long-term investment funds (ELTIFs) came into force on 9 December 2015. ELTIFs are funds that focus on investing in various types of alternative asset classes such as infrastructure, small and medium sized enterprises and real assets. The first Luxembourg ELTIF was established in November 2016 and no other has been registered as at the end of May 2017. Managers who decide to use ELTIFs must issue:

- A full prospectus, whether marketing to retail investors or not.
- A "key information document", as prescribed under the Packaged Retail Investments Products legislative package when marketing to retail investors.

Managers must also:

- Obtain permission from the regulator to provide the additional services permitted under Article 6(4) of the AIFM Directive.
- Carry out an assessment on the "suitability" of the ELTIF for retail investors.
- Provide retail investors with appropriate investment advice (from either the manager or a distributor) before they invest.
- Where a retail investor has an investment portfolio of less than EUR500,000, make sure that the initial minimum investment in ELTIFs is at least EUR10,000 and the maximum aggregate investment is no more than 10% of its investment portfolio.
- Have a depositary in cases of authorised AIFMs and a bank depository in the case of ELTIFs sold to retail investors (as with UCITs funds).

The newly created European Fund for Strategic Investment (EFSI) was established within the European Investment Bank to mobilise at least EUR315 billion of investment over the next few years. It is the perfect way to seed a funds-of-funds programme, if its commitments to each fund-of-funds are matched by private sector institutional investors. Invest Europe has been in contact with private sector fund-of-funds managers to assess interest. As a result, some have approached the European Commission which indicates that there is appetite within the industry for such a proposal. Invest Europe now expects something concrete from the European Commission (perhaps not a formal proposal, but a "concept" on which they can get feedback) before summer 2017.

TAX INCENTIVE SCHEMES

3. What tax incentive or other schemes exist to encourage investment in venture capital companies? At whom are the schemes directed? What conditions must be met?

Venture capital investment company

This was invented as a vehicle promoting investment in companies for the purpose of development. As an incentive, a favourable tax regime applies to venture capital investment companies. A venture capital investment company incorporated as a company is subject to regular corporate income tax, but any gains or proceeds received that derive from investments in risk capital are tax exempt. Venture capital investment companies established as common limited partnerships/special limited partnerships are tax transparent and therefore not subject to tax in Luxembourg, except for the municipal business tax.

Specialised investment fund

The specialised investment fund is not subject to tax, apart from a registration tax (*taxe d'abonnement*) of 0.01% on the net asset value per annum, which is, itself, subject to certain exemptions.

Participation exemption regime

This regime applies to a financial interest holding company and is subject to Directive 2014/86/EU and Directive 2015/121/EU implementing new EU anti-abuse provisions in Parent-Subsidiary Directive (2011/96/EU) as transposed and into force in Luxembourg since 1 January 2016 and provides that if certain holding thresholds (percentage or value) are fulfilled, dividend payments and capital gains are tax exempt. In addition, Luxembourg has a far-reaching network of treaties avoiding double taxation.

Taxation of RAIFs

A RAIF that invests in risk capital and is not a mutual fund (*fonds commun de placement (FCP)*) will be subject to a tax regime similar to the one applicable to SICARs, namely:

- RAIFs are fully subject to corporate income and municipal business tax (unless it is established as a SCS or SCSp, in which case, as a transparent entity, it will be as a rule exempt from corporate income tax and municipal business tax). However, income and gains derived from securities will be exempt from tax.
- RAIFs are exempt from net wealth tax, except for the minimum net wealth tax amounting to, in most cases, EUR4,815 (since 2017). This replaces the minimum corporate income tax as from 1 January 2016 (unless it is established as a SCS or SCSp in which case it will also be exempt from this minimum net wealth tax).
- RAIF distributions will generally not be subject to any withholding tax and should not be subject to Luxembourg taxation in the hands of non-resident investors.
- The management of RAIFs is VAT exempt.

The OECD released the final reports on the 15 Actions of the Base Erosion and Profit Shifting Project (BEPS) which aims to address double non-taxation as well as double taxation issues in the global economy as these may have an impact on VC firm's returns on investments. The BEPS project will be partly implemented into the domestic legislation of all EU member states from 2019 with the entry into force of Directive (EU) 2016/1164 laying down rules against tax avoidance practices that directly affect the functioning of the internal market (Anti-Tax-Avoidance Directive), as amended. This deals with hybrid mismatches, interest deduction limitations, controlled foreign corporations, exit taxation and general anti-abuse rules. One of the remaining issues which is still being addressed by the OECD is "treaty-shopping" which enables an investor to take advantage of a tax treaty by investing into a portfolio company through an intermediate jurisdiction, and thereby get an advantage which would not be available had the same investor invested directly. A further step should be made in this respect with the signing of the multilateral instrument (MLI) in June 2017. More than 100 jurisdictions have concluded negotiations on the MLI that will transpose results from BEPS into more than 2,000 tax treaties worldwide. The MLI will implement minimum standards to counter treaty abuse and to improve dispute resolution mechanisms, while providing flexibility to accommodate specific tax treaty policies and allowing states to strengthen their tax treaties with other tax treaty measures developed in the BEPS Project.

Funds tend to pool investors from a range of countries – for obvious commercial reasons, and to not take advantage of tax treaties. However, the OECD's concern is that a fund may include investors who would not be entitled to benefit from a tax treaty if they invested directly. If funds are not carved out, then many investors may be in a worse position and fund managers would be subject to a significant compliance cost in differentiating between the two types of investor.

FUNDING SOURCES

4. From what sources do venture capital funds typically receive funding?

See *Question 1, Sources of funding.*

FUND STRUCTURING

5. Can the structure of the venture capital fund affect how investments are made?

The structure of the investment vehicle does not usually affect how investments are made. However, financial interest holding companies (including partnerships) and venture capital investment companies are not subject to risk diversification. A specialised investment fund and a RAIF (if set-up as a SIF) must generally respect a risk diversification ratio of at least 30% (certain limited exemptions are permissible). A SIF, SICAR and RAIF can create compartments, meaning that the assets of one compartment are only linked to the liabilities of that same compartment (ring-fencing). Compartments do not have legal personality, but their existence allows a promoter of a regulated fund such as a SIF, SICAR or RAIF to keep investments/investors segregated.

6. Do venture capital funds typically invest with other funds?

Co-investment schemes are common and can be set up using a venture capital fund structure.

7. What legal structure(s) are most commonly used as vehicles for venture capital funds?

Non-regulated vehicles

Special limited partnerships, common limited partnerships (LPs) and *soparfis* are non-regulated vehicles that have the object of holding and financing participations in portfolio companies.

By far the most commonly used forms of non-regulated vehicles are the special limited partnership (*société en commandite spéciale*) (SCSp) and the common limited partnership (*société en commandite simple*) (SCS).There is a strong appetite for Luxembourg limited partnerships, due to their key features:

- **Confidentiality is guaranteed.** Registration of the SCS/SCSp at the Luxembourg trade and companies register (RCS) is minimal and includes their name, the name of their general partners (GPs), their object, their address and their duration. There is no publication of the performance of the SCSp and the SCSp's accounts are not filed at the RCS.
- **Safe harbour for actions by LPs.** In Delaware and the Cayman Islands, the scope of decisions made by limited partners without compromising their limited liability is uncertain. In Luxembourg, the Luxembourg act dated 10 August 1915 on commercial companies, as amended (Companies Act) introduced a non- exhaustive list of actions that may be taken by LPs, which do not, as such, put their limited liability at risk.
- **Wide choices for contributions.** Contributions to an SCS and SCSp can be made in kind, cash or industry, and can include loans granted to the partnership, with no debt-to-equity ratio to be complied with. A mere statement in the limited partnership agreement (LPA) by the partners suffices for non-cash contributions. Contributions, withdrawals, loans, allocations to profits, losses and expenses can be booked for each limited partner in a capital (and loan) account.

- **The GP and the LP's creditors cannot seize the SCSp's assets.** The assets contributed to the SCSp are registered in the name of the partnership and can only satisfy the rights of creditors that have been created in relation to the SCSp's business. The SCSp's assets are not available to the GPs or the LP's creditors.
- **High flexibility on power and economic distributions.** Limited or multiple as well as non-voting partnership interests (which may be represented by securities issued by the SCS/SCSp) are permitted, enabling investors to distribute powers as they deem fit in the LPA. In addition, there is no claw back on distributions in the case of insolvency, except for in the case of fraud.
- **Freedom to organise transfers of partnership interests.** The LPA organises all conditions relating to the redemption, transfer, splitting or pledge of their interests by the LPs. The Companies Act provides conditions for transfers if those transfers are not dealt with in the LPA. The Companies Act also provides that partnership interests can be listed on a stock exchange or a regulated market.

Other unregulated fund structures include:

- Private limited company (*société à responsabilité limitée*) (SARL). This is commonly used for investing in private equity, since it offers significant flexibility. The minimum share capital is EUR 12,000 and the number of shareholders is limited to 100.
- Partnership limited by shares (*société en commandite par actions*) (SCA). The SCA requires at least:
  - one general partner with unlimited liability being in charge of the management (*commandités*);
  - one limited partner with limited liability (*commanditaires*), who cannot be involved in the management of the SCA.
- Its minimum share capital is EUR30,000. The rules applicable to public limited companies (*société anonyme*) (SA) generally also apply to SCAs. The SCA regime has been modernised by the Alternative Investment Fund Managers (AIFM) Law. When the SCS or SCSp are structures available to sponsors, these are now much preferred in comparison to the SCA.
- Publiclimited companies (*société anonyme*) (SA). Its minimum share capital is EUR30,000. There is no restriction on the number of shareholders and its shares are freely transferable. The board of directors requires in principle at least three directors. It can also be listed.

Regulated vehicles

Conversion to RAIF. Since the law of 14 July 2016 on the reserved alternative investment fund (RAIF), many sponsors consider a RAIF instead of a regulated vehicle. This new law was a clear shift from a product approach to indirect regulation through the external authorised alternative investment fund manager (AIFM), while having the benefit of the EU passport in relation to the marketing of its interests, units or shares throughout the EU. It tackled the over-layering of supervision that came to existence with the implementation of Directive 2011/61/EU on Alternative Investment Fund Managers (AIFMD) in Luxembourg while streamlining the process to establish regulated funds in Luxembourg.

RAIFs combine the legal and tax features of regulated AIFs like specialised investment funds (*fonds d'investissement spécialisés*) (SIFs) or investment companies in risk capital (*société d'investissement en capital à risqué*) (SICAR) without the regulatory licensing or oversight of the Financial Sector Supervisory Commission (*Commission de Surveillance du Secteur Financier*) (CSSF), together with favourable tax and legal regimes.

Whether or not existing funds should become a RAIF requires a case-by-case analysis from tax, legal and regulatory perspectives. For example:

- Unregulated sub-threshold funds that cannot market in some jurisdictions and must appoint an authorised AIFM in any event, should consider closely the tax regime applicable to RAIFs for their conversion.
- Unregulated SCSs and SCSps may wish to benefit from an umbrella structure and benefit from a marketing passport, and SICARs, SIFs and FCPs may wish to benefit from the lighter requirements on redemptions.

In addition, the absence of a regulatory approval requirement allows managers to reduce the time to market their fund and reduces costs compared to other types of regulated fund vehicles. A RAIF is the structure of choice in comparison to Luxembourg regulated funds.

The assessment of whether a RAIF should be preferred to an unregulated fund structure very much depends on the initiator's key motivations.

- RAIFs can be set up as one of the following corporate forms:
- SCS.
- SCSp.
- SCA.
- Co-operative (*société cooperative organisée sous forme de société anonyme*).
- SARL.
- SA.

These various possibilities offer significant contractual freedom.

Regulated funds. The following vehicles are supervised and authorised by the regulatory authority, the Commission for the Supervision of the Financial Sector's (*Commission de Surveillance du Secteur Financier*) (CSSF) (*www.cssf.lu*).

Risk capital investment companies (*sociétés d'investissement en capital à risque*) (SICARs) were implemented to offer a new lightly regulated vehicle for investment in private equity to well-informed investors. It combines a flexible corporate structure for investing in risk capital, with the benefits of light supervision by the CSSF and a neutral tax regime.

SICAR is an optional regime, and must be formalised in the object clause of the company's articles of association. SICARs can be incorporated as one of the following companies:

- SCS.
- SCSp.
- SCA.
- Co-operative (*société cooperative organisée sous forme de société anonyme*).
- SARL.
- SA.

These various possibilities offer significant contractual freedom. While general corporate law provisions apply to SICARs, they have substantial flexibility in determining their articles of association:

The share capital of the SICAR must be at least EUR1 million. This minimum must be subscribed to within one year of incorporation and paid up in principle at least up to 5% of the capital, including share premium. It is also possible to opt for variable capital, whatever the corporate form, since the introduction of the (*SICAR Amendment Law*). This new development should attract more foreign investors familiar with the tax incentive vehicles of common law limited partnerships.

Although SICARs are supervised by the CSSF, their reporting obligations are lighter than those of Undertakings for Collective Investments (UCIs), although they must prepare and publish annual accounts, and update the prospectus on the issue of additional shares. An independent auditor (approved by the CSSF) must audit the annual accounts. However, a SICAR is not required to publish a bi-annual report.

Since the SICAR Amendment Law, there is no mandatory legal requirement to calculate the net asset value on a compulsory bi-annual basis. The net asset value must be based on the principle of fair value (similar to the SIF regime).

SICARs must invest in risk capital and have no obligation of investment diversification (unlike UCIs). Therefore, SICARs can invest all of their funds in a single company or project. A SICAR can also be structured as an umbrella vehicle with separate compartments enabling it to run different investment policies in each compartment.

The duty of the custodian is the same as for specialised investment companies (*fonds d'investissement specialisés*) (SIFs) (that is, its monitoring duty is restricted to the general safekeeping of the assets).

SIFs. SIFs are subject to lighter statutory rules than other UCIs. The following can create or invest in a SIF:

- Institutional investors.
- Professional investors.
- Other well-informed investors (whether legal or physical persons).

The SIF aims to be an attractive vehicle through its flexible functioning rules, and the extensive scope of assets open to investment. A SIF can be used to invest in any kind of assets without limitation, to the extent it complies with the general risk spreading rules. It is authorised and supervised by the CSSF and has a neutral tax regime. A SIF can be created as:

- A common fund (*fonds commun de placement*) (FCP). This is a contractually drawn up set of jointly owned assets with no legal personality, managed by a Luxembourg management company.
- An investment company with a variable share capital (*société d'investissement à capital variable*) (SICAV), incorporated as any of the following:
  - SCA;
  - SCS;
  - SCSp;
  - co-operative;
  - SARL;
  - SA.
- A company with a fixed share capital (*société d'investissement à capital fixe*) (SICAF), which is incorporated as any of the following:
  - SCS;
  - SCSp;
  - SCA;
  - co-operative;
  - SARL;
  - SA;
  - unlimited company (*société en nom collectif*) (SNC);
  - civil company (*société civile*).

The legal provisions and types of companies under which a SIF can be incorporated allow investors to set up their own corporate governance rules in a flexible manner:

The subscribed share capital (including share premium) must be at least EUR1.25 million, within 12 months of the date of CSSF approval. The shares need only be paid up to a minimum of 5%.

SIF supervision and its reporting obligations are the same as for a SICAR as are the issuing document requirements (that is, information necessary for the investors to form their view on the investments proposed and its related risks). The SIF's issuing document must provide for the quantifiable limits to be complied with (*CSSF's circular 07/309 relating to the risk-spreading principle for the SIF*).

A SIF can be organised with several segregated sub-funds.

INVESTMENT OBJECTIVES

8. What are the most common investment objectives of venture capital funds?

Funds can be open-ended or closed-ended. Regulated private equity/risk capital funds are usually closed-ended. The average life of a closed-ended fund is seven years with a possibility of a two-year extension. However, depending on the type of investment, a fund can exist for a longer period (for example, 20 years). The return varies, depending on market and political developments in target countries. The time frame for an exit is on average five to six years.

FUND REGULATION AND LICENSING

9. Do a venture capital fund's promoter, manager and principals require licences?

Whether the management bodies require Commission for the Supervision of the Financial Sector's (*Commission de Surveillance du Secteur Financier*) (CSSF) approval depends on the type of investment vehicle used.

The Luxembourg Law of 12 July 2013 on Alternative Investment Fund Managers (AIFM Law) imposes new requirements on Luxembourg based alternative investment fund managers (AIFMs), which must now be authorised by the CSSF when managing assets acquired with leverage in the fund of EUR100 million or more, or assets under management with no leverage in the fund of EUR500 million or more. These requirements include, among other things:

- The obligation to retain eligible conducting officers.
- The enhancement of the central administration and substance of the structure.
- The necessity to introduce rules or policies on risk management, compliance, internal audit, transparency, remuneration and conflict of interest situation.

The CSSF is also the competent authority for approving risk capital investment companies (*sociétés d'investissement en capital à risque*) (SICARs) and specialised investment companies (*fonds d'investissement specialisés*) (SIFs), and specifically requires the following:

- SICAR or SIF directors and managers must prove their ability to perform their duties. The AIFM Law implies changes in this respect (*Question 4*).
- Constitutive documents to be produced (prospectus, issuing documentation, management regulations or articles of incorporation), which must comply with the applicable laws.
- The appointment of a custodian with whom the SICAR's or SIF's assets are deposited.
- The appointment of an independent auditor (for monitoring obligations, see *Question 6*).

There is no requirement for a promoter.

10. Are venture capital funds regulated as investment companies or otherwise and, if so, what are the consequences? Are there any exemptions?

Specialised investment companies (*fonds d'investissement specialisés*) (SIFs) and risk capital investment companies (*sociétés d'investissement en capital à risque*) (SICARs) are regulated entities and are, therefore, subject to prior approval by the Commission for the Supervision of the Financial Sector's (*Commission de Surveillance du Secteur Financier*) (CSSF) before they are launched. These vehicles must issue a prospectus or issuing document, which is examined or approved by the CSSF (*see Question 14*). The central administration of the fund (bookkeeping, share registrar and transfer agent services) must be located in Luxembourg. RAIFs are supervised through the AIFM managing them.

Soparfis are non-regulated vehicles and therefore do not require regulatory approval. This includes limited partnerships. However, for those *Soparfis* whose equity can be offered to the public, a prospectus complying with the rules of the Law dated 10 July 2005 implementing Directive 2003/71/EC on the prospectus to be published when securities are offered to the public or admitted to trading (Prospectus Directive) must be approved by the CSSF.

Exemptions from publishing a prospectus apply in some circumstances.

11. How is the relationship between investor and fund governed? What protections do investors in the fund typically seek?

The relationship between the investor and the fund is governed by:

- The investment company's articles of association (for a partnership limited by shares, public limited company, private limited liability company or common limited partnership).
- The limited partnership agreement (for a common limited partnership or a special limited partnership).
- The mutual fund's management regulations.

In addition, venture capital investment companies and specialised investment funds must issue a prospectus (not always required for holding companies). Regulated structures do not usually have a shareholders' agreement, but it is possible to develop one for venture capital investment companies, specialised investment funds and holding companies.

Investors usually seek protection or assurance relating to the:

- Accuracy of the prospectus content.
- Clarity of the taxation situation.
- Leaver situations and transfers (drag or tag-along rights).
- Risk indications.
- Competency of the key persons/management of the fund.
- Provisions for the removal of the fund manager for cause and, increasingly, without cause.
- Commitments and capital contributions.

INTERESTS IN INVESTEE COMPANIES AND SECURITIES REGULATION

12. What form of interest do venture capital funds take in an investee company? Are there any restrictions on direct investment in a company's equity securities by foreign venture capital funds? What regulations govern the offer and sale of securities in venture capital transactions?

Forms of interest

VC funds usually take a preferred equity interest in an investee company. However, debt investments or a mix of preferred equity and debt are also common.

Restrictions on direct investment

Luxembourg shows the highest rate of foreign investment in Europe

Securities regulation

The offer and sale of securities in a venture capital transaction do not standardly constitute a public offer or solicitation in Luxembourg and accordingly, no filings are required other than in the registers of the investee company. As a result, the Luxembourg regulatory authorities neither review nor approve documents relating to the sale of the securities of the investee company.

VALUING AND INVESTIGATING INVESTEE COMPANIES

13. How do venture capital funds value an investee company?

The prospectus and articles of specialised investment funds and venture capital investment companies must mention their valuation methods. The valuation methods differ depending on the type of investment and appear in the accounts of the VC fund in the VC fund’s currency, with the effects of changes in foreign exchange rates in accordance with GAAP/IFRS. Expert opinions on the valuation of the investee company or the use of recognised valuation methods (for example, European Private Equity and Venture Capital Association guidelines) are common.

14. What investigations do venture capital funds carry out on potential investee companies?

Venture capital funds carry out a full due diligence exercise in relation to potential investee companies. This involves obtaining necessary documents and information (for example, contracts, accounting information, management team information, client base information) to fully assess the investee company's situation. Third parties can be mandated to carry out additional investigations or research to cover all aspects of the investee company's business position and strategy.

LEGAL DOCUMENTATION

15. What are the principal legal documents used in a venture capital transaction?

The principal legal documents used in a venture capital transaction are the:

- Articles of association (for a company-type fund, which are, in this list, the only publicly available documents), management regulations (for a mutual fund) or limited partnership agreement (for a common limited partnership or special limited partnership, in each case, not available to the public).
- Prospectus.
- Subscription agreement/form.
- Shareholders' agreement.

PROTECTION OF THE FUND AS INVESTOR

Contractual protections

16. What form of contractual protection does an investor receive on its investment in a company?

Contractual protections an investor can receive on its investment in a company include:

- Access to subscription information.
- Access to documents.
- Admission to shareholder meetings with enhanced decision-making tools such as shareholders' reserved matters and special consents.
- Drag or tag-along rights.
- Pre-emption rights.
- Rights to add items to the agenda of shareholders' general meetings.
- Rights to receive information on certain business developments of the company.

Forms of equity interest

17. What form of equity interest does a fund commonly take (for example, preferred or ordinary shares)?

General shares with voting rights are preferred. However, funds can also take the following forms of equity interest:

- Ordinary shares.
- Preferred non-voting shares.
- Beneficiary parts. Holders of these are entitled to participate in the profits of the company, but do not have voting rights (these are not considered as share capital).

While in the private limited liability company the issue of non-voting shares is prohibited, the issue of such shares is possible for a public limited company and the partnership limited by shares, and limited partnerships.

Preferred shares

18. What rights does a fund have in its capacity as a holder of preferred shares?

As a holder of preferred shares, a fund has a right to a preferred dividend in the case of distribution or liquidation.

Management control

19. What rights are commonly used to give a fund a level of management control over the activities of an investee company?

The rights commonly used to give a fund a level of management control over the activities of an investee company depend on the jurisdiction of the investee company. However, there is usually a right to participate in general meetings of the investee company and, depending on the level of participation, the fund can have decision-making power at the general meeting.

Share transfer restrictions

20. What restrictions on the transfer of shares by shareholders are commonly contained in the investment documentation?

The following restrictions on the transfer of shares by shareholders are commonly contained in the investment documentation:

- Lock-up periods from six months to three years.
- In closed-ended funds, transfer is usually subject to approval by general partner.
- Pre-emption rights, drag-along or tag-along rights.

21. What protections do the investors, as minority shareholders, have in relation to an exit by way of sale of the company?

See *Question 20*.

Pre-emption rights

22. Do investors typically require pre-emption rights in relation to any further issues of shares by an investee company?

Investors typically require pre-emption rights in relation to further issues of shares by an investee company. Existing shareholders in a venture capital investment company, open-ended collective investment scheme/specialised investment fund have pre-emption rights if provided in the articles of association. Existing shareholders of a public limited company/partnership limited by

shares have a pre-emptive right of subscription in the case of a capital increase (except if waived by the general meeting of shareholders), and a new shareholder in a limited liability company must be approved by shareholders representing at least three-quarters of the corporate share capital. If an authorised share capital is provided for in the articles of association, the board can proceed, within certain limits, to the issue of shares.

Consents

23. What consents are required to approve the investment documentation?

The investment documentation (prospectus) is usually prepared and amended by the general partner or promoter of the fund. Investors' approval is not required for the general partner or promoter to amend the prospectus, unless approval is expressly required in the investment documentation. However, this depends on the type of investment document (for example, shareholders' agreements require approval by all parties for amendment). The change of nationality of the fund always requires a unanimous consent of the investors. Funds set-up as a SA, SCA or SARL are subject to majority requirements as set out in the Companies Act, with consent from two-thirds (SA, SCA) to three-quarters (SARL) for change of the articles of association. Contractual freedom applies for other forms.

COSTS

24. Who covers the costs of the venture capital funds?

Some costs are pushed down to the investee company, subject to applicable financial assistance rules.

FOUNDER AND EMPLOYEE INCENTIVISATION

25. In what ways are founders and employees incentivised? What are the resulting tax considerations?

Incentives

Founders and employees are typically incentivised through the following:

- Management participation programmes.
- Board participation programmes.
- Option shares.
- Phantom shares.
- Carried interest.

Tax

Taxation depends on the competent jurisdiction for each manager or board member.

Specific tax consequences must be considered for each investor (depending on his jurisdiction of residence) before purchasing shares or divesting shares. Transactions should respect the arm's length principle.

A new carried interest regime has been implemented in Luxembourg. Taxation of the carried interest paid to Luxembourg tax residents who are employees of the alternative investment fund managers AIFMs are, provided that certain conditions are met, taxed at a rate equal to a quarter of the global standard income tax rate.

26. What protections do the investors typically seek to ensure the long-term commitment of the founders to the venture?

Investors typically seek the following protections to ensure the long-term commitment of the founders:

- Long-term structuring of the performance fee (that is, the performance fee would not apply in the first year but later on in the investment phase).
- Good leaver and bad leaver provisions (the detailed rules for these situations must be clearly and prudently drafted in the applicable documentation).
- Transfer restrictions (no withdrawal by the founders from the fund unless the transfer of the founders' shares is approved by a number of investors).
- Restrictive covenants including non-compete provisions are standardly included in the shareholders / investment agreement. Such provisions must be limited in time, limited geographically and limited to similar activities.

See also *Question 25*.

EXIT STRATEGIES

27. What forms of exit are typically used to realise a venture capital fund's investment in an unsuccessful company? What are the relative advantages and disadvantages of each?

The following forms of exit are typically used to realise a venture capital fund's investment in an unsuccessful company:

- Sale (by a bidding process).
- Restructuring (this is costly and time-consuming).
- Liquidation.
- Rollover (that is, the creation of new fund to take over old investments, under amended conditions).

Advantages and disadvantages of each relate to different cost levels for each exit (for example, liquidation may be cheaper than a rollover or restructuring). In addition, a rollover allows current investors to stay on board. A sale by a bidding process may not be successful.

28. What forms of exit are typically used to realise a venture capital fund's investment in a successful company? What are the relative advantages and disadvantages of each?

The following forms of exit are typically used to realise a venture capital fund's investment in a successful company:

- Initial public offering (IPO) (depending on the market situation and regulatory environment).
- Sale (by a bidding process).
- Rollover (that is, the creation of a new fund to take over old investments, keeping the investor base).

Whether an IPO is successful strongly depends on market conditions. These currently fluctuate frequently. See also *Question 27*.

29. How can this exit strategy be built into the investment?

Exit strategies can be built into the fund documentation or management participation programme/board participation programme documentation.

ONLINE RESOURCES

Luxembourg Financial Supervisory Committee (CSSF)

W *www.cssf.lu*

Description. This is the website of the Luxembourg financial supervisory authority. Laws and regulations are generally accessible in French and English. English translations are not binding.

Luxembourg Private Equity and Venture Capital Association

W *www.lpea.lu*

Description. This is the website of the Luxembourg Private Equity and Venture Capital Association. The association represents, promotes and protects the interests of the Luxembourg private equity and venture capital industry.

Association of the Luxembourg Fund Industry

W *www.alfi.lu*

Description. This is the website of the Association of the Luxembourg Fund Industry, which is the official representative body for the Luxembourg investment fund industry.

European Private Equity and Venture Capital Association

W *www.evca.eu*

Description. This is the website of the European Private Equity and Venture Capital Association, the representative body for the European private equity industry.

Luxinnovation

W *http://en.luxinnovation.lu*

Description. This is the website of the National Agency for Innovation and Research.

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