20 years of SICAR: From precursor to obsolescence in Private Equity and Venture Capital

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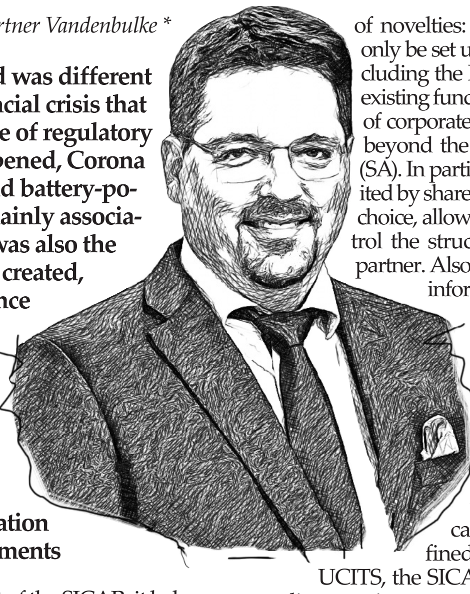

In June 2004, the world was different from today. The financial crisis that triggered an avalanche of regulatory changes had not yet happened, Corona was just a type of beer and battery-powered locomotion was mainly associated with wheelchairs. It was also the time when Luxembourg created, for the first time really since 1988, an entirely new type of investment vehicle: The investment company in risk capital or SICAR when using its French acronym.

The idea: Innovation for illiquid investments

To properly gauge the impact of the SICAR, it helps to remember that 20 years ago Luxembourg was almost exclusively focused on investment vehicles for liquid assets. The UCITS brand was already tremendously successful, and the so-called part II funds were also mostly used for liquid alternative strategies such as hedge funds. While there was also the law dated 19 July 1991 aimed at institutional investors, it was only two pages long and consisted mainly in references to the existing retail funds law. It was also used mainly for liquid strategies and fund-of-funds, and although a CSSF circular 91/75 featured some guidelines for private equity and venture capital funds, illiquid asset classes remained a small niche. In 2003, the assets under management of investment funds under the 1991 law only amounted to around 44 billion EUR, and less than 1% thereof was allocated to illiquid assets.

Worldwide, however, the private equity and venture capital sector was booming, in particular in the U.S. but also in Europe, and fund initiators requested a more flexible, dedicated vehicle for this purpose. Added to this was the strategic ambition to extend the reach of the Luxembourg fund industry to what is now commonly referred to as private assets, and to replicate the UCITS success story in more illiquid asset classes. In hindsight, this was a successful wager but at the time this was far from obvious.

Introduction of new concepts

When the law relating to the SICAR ("SICAR Law") was passed on 15 June 2004, it introduced a number of novelties: While the SICAR could only be set up in a corporate form, excluding the FCP structure used in the existing funds, there was a wider array of corporate types that could be used beyond the public limited company (SA). In particular the partnership limited by shares (SCA) became a popular choice, allowing fund initiators to control the structure through its general partner. Also, the concept of the "well-informed investor" was introduced, such condition for acquiring shares in a SICAR reflecting the sophistication required from investors to assess the risks of illiquid assets.

Radically different from the detailed risk diversification rules and well-defined investment universe of UCITS, the SICAR did not have any risk spreading requirement at all; in return, its investments were limited to the category of "risk capital", without the law however defining such term any further. This happened through a CSSF circular (06/241) a good two years later and based on two elements: The assets had to reflect a specific risk beyond a simple market risk, and the SICAR had to contribute to their development over time, resulting for example in an initial public offer or the launching of a specific product. The SICAR was also attributed a favorable tax status: No subscription tax was due as for all other investment vehicles, and all income derived from risk capital was tax exempt. As a corporate entity, it could also benefit from Luxembourg's extensive network of double tax treaties.

The SICAR was favourably received, and in particular anglo-saxon fund initiators started using it for accessing the investor base in continental Europe. By the end of 2005, 47 SICARs had been entered onto the regulator's official list, and their numbers rose quickly until peaking in 2014 at 288. While at first there were challenges such as how the depositary could perform its supervisory role on the ownership of complex holding structures, or how to value participations in unlisted companies, the legislative framework and regulatory oversight was generally appreciated by both initiators and investors. A criticism that accompanied the SICAR was however the frequently excessive length of its approval process with the CSSF, which could at least partially be explained by the combination of a prudent approach and lack of experience, in addition to stakeholders on the other side that were not used to any regulatory constraints at all.

Decline, marginalisation and legacy

The last ten years have seen a steady decline in numbers of SICARs, resulting in 182 existing today with assets under management of around 86 billion EUR. In comparison to 2745 reserved alternative investment funds (RAIF) and the size of the alternative investment funds sector in Luxembourg estimated at over 1.600 billion EUR, it is a clear indication that the SICAR is no longer considered a competitive product. Based on a superficial look at such figures, the conclusion could be that it was a failure - but that is to ignore its more complex role in paving the way for other innovations. It was an indispensable blueprint for several successive and successful sectoral laws:

The specialised investment fund (SIF) that was created only three years after the SICAR in 2007, and the RAIF introduced in 2016 both share the vast majority of their provisions with the SICAR Law. Combined with the introduction of the limited partnership structures (SCS/SCSp) and the transposition of the AIFM Directive in 2013, they laid the groundwork for Luxembourg being regarded today as Europe's most attractive jurisdiction for alternative investment funds with a cross-border element to them.

The SICAR started the learning curve for the financial industry in relation to the illiquid assets universe, including the regulator and the local service providers, and was therefore of enormous benefit for the entire financial sector. It is likely that, without the SICAR, Luxembourg would not now be the domicile of hundreds of AIFMs and thousands of alternative investment funds. Private Equity and Venture Capital are well-established in Luxembourg today, and since 2010 represented by their own organisation, the LPEA.

Private Equity and Venture Capital structuring today

The reason for the SICAR's decline was the introduction of more attractive products for the same asset classes. Today that is mainly the RAIF and the limited partnership structures, with the SIF continuing to play a role in legacy structures or those where a directly supervised product is required. Since the advent of the AIFM Directive as a manager-oriented rulebook, the necessity of an approval process with the CSSF has been considered an unnecessary disadvantage for SICARs and SIFs, and an obstacle for a short time to market. Also, the limitation to risk capital, with the obligation to have this classification confirmed by an auditor every year, prevented a larger market share for the SICAR. Even specialised private equity initiators favored the SIF once it was available, the constraint of risk diversification being rather modest and attenuated by the possibility of ramp-up periods where this principle did not have to be applied.

Both investment vehicles that are favoured by today's promoters for the establishment of an alternative investment fund investing into private equity or venture capital assets, the RAIF and the partnership structures, have advantages and drawbacks. As for the RAIF, it has the option to be structured similar to a SICAR, without a risk spreading requirement and the same tax features as a SICAR, but also restricted to an investment into risk capital. For a wider asset universe it can also be structured similar to a SIF, but in such case a risk diversification is required (although its extent is not defined and subject to debate), and a subscription tax is due.

In addition to this structuring flexibility, the main advantage of a RAIF over partnership structures is that it can be set up as an umbrella structure with compartments, allowing for economies of scale and synergies in terms of operational complexity. Another factor in favor of the RAIF is a wider choice in terms of corporate types that can be used, including those that are usually considered tax blockers, such as the public limited company (SA) or the partnership limited by shares (SCA). This also implies the possibility to use double tax treaties, which partnership structures such as the SCS or SCSp usually cannot.

On the other hand, the two partnership structures (SCS and SCSp) are more flexible in terms of how they can operate and which prerogatives to make available to its investors (or not). They are only subject to the Luxembourg corporate law provisions and, in case they qualify as an alternative investment fund, indirectly to the provisions of the Luxembourg AIFM law, but not to any further requirements under a specific product law. Also, no subscription tax is due, as opposed to a RAIF. Another attractive possibility, in particular for smaller venture capital initiators, is the possibility for such partnership to be structured with its general partner as its so-called "sub-threshold" AIFM, if the assets under management are below the amount in excess of which the provisions of the AIFM Directive are fully applicable. In such case, while the AIFM distribution passport is not available, only a registration with the CSSF is required, an option that is not available for a RAIF which always has to appoint a fully licensed AIFM.

Lastly, no formalities for the establishment of a partnership are required, as opposed to a RAIF that requires its establishment to be confirmed by a notary and subsequently has to be entered onto the official RAIF list held by the Luxembourg commercial register.

* https://www.vdblaw.com/