

<p>Q&A CNC 25/036</p>	<p><u>QUESTIONS / ANSWERS:</u></p> <p>INTERPRETATION OF ARTICLE 1711-8 PARA. (3) POINT 3° OF THE LAW OF 10 AUGUST 1915 ON COMMERCIAL COMPANIES IN THE SPECIFIC CASE OF COMPANIES OPERATING IN THE ALTERNATIVE INVESTMENT SECTOR</p>
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Context:

Article 1711-8, para. 3, point 3° of the amended Law of 10 August 1915 on commercial companies (hereinafter "LSC") provides as follows: "*In addition, an undertaking need not be included in consolidated accounts where (...) 3° the shares of that undertaking are held exclusively with a view to their subsequent resale*".

This provision, when it was still numbered Article 317, para. 3, point c) LSC, led to the issuance by the CNC, on 18 December 2009, of CNC Opinion 2-1, subsequently renumbered as CNC Opinion 09/002.

Through this opinion, CNC sought to establish additional guidance for the application of the above-mentioned provision by investment companies in risk capital (*venture capital / private equity*) that did not have the SICAR status within the meaning of the amended Law of 15 June 2004 on investment companies in risk capital.

The scope of this opinion was limited to companies incorporated under Luxembourg law owned by one or more well-informed investors, the sole purpose of which was to invest their funds in one or more securities representing risk capital (hereinafter "investment"), defined as the direct or indirect provision of funds to one or more entities for the purpose of launching, developing or initial public offering of such entity or entities, such investment(s) being held by the company with the intention of reselling it or them at a profit.

The CNC Opinion then set out four conditions to be met cumulatively by these companies in order to make use of the aforementioned provision, the application of which to all subsidiaries could de facto result in an exemption from consolidation, in the absence of a scope of consolidation.

It has since become apparent that the implementation of this CNC Opinion has given rise to difficulties of interpretation and application.

Furthermore, new factors to be taken into consideration have also arisen.

Thus, IFRS 10, "*Consolidated Financial Statements*", was issued in May 2011 by the IASB and came into force in the European Union on 1 January 2014. This standard provides for a consolidation exception (i.e. prohibition) – rather than an exemption – for the investment entities it defines, assists in identifying and describes the typical characteristics of.

Finally, Article 1711-9 point 2° LSC – as introduced into that law by the Law of 18 December 2015 transposing Accounting Directive 2013/34/EU¹ of 26 June 2013 – provides as follows: "*(...) any parent company (...) shall be exempted from the obligation imposed in Article 1711-1 [A/N: requirement to prepare consolidated financial statements and a consolidated management report] if: (...) 2° all its subsidiary undertakings can be excluded from consolidation by virtue of Article 1711-8²*". As a result, a parent company whose subsidiaries may all be excluded from the scope of consolidation is, in practice – and now also legally – exempt from the obligation to prepare consolidated accounts and a consolidated management report.

¹ Directive 2013/34/EU of the European Parliament and of the Council of 26 June 2013 on the annual financial statements, consolidated financial statements and related reports of certain types of undertakings, amending Directive 2006/43/EC of the European Parliament and of the Council and repealing Council Directives 78/660/EEC and 83/349/EEC

² It should be noted that under Article 1711-8 LSC, the exclusion of a subsidiary from the scope of consolidation may result not only from ownership / holding with an exclusive view to subsequent resale, but also from the immateriality of the subsidiary, from severe long-term restrictions on the parent company's ability to exercise control, or from the inability to obtain the necessary information from the subsidiary without disproportionate expense or undue delay.

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In view of the above, CNC considered that it was appropriate to issue recommendations regarding the interpretation to be given to Article 1711-8 para. 3 point 3° LSC in the specific case of companies operating in the alternative investment sector, and to withdraw CNC Opinion 09/002.

Questions / Answers:

1. Interpretation of Article 1711-8 para. 3 point 3° LSC

1.1. Scope of companies covered by this Q&A

The case under consideration relates to a parent company **whose sole activity**³ consists of (i) raising funds from **well-informed investors**⁴ within the meaning of Article 2 of the Law of 15 June 2004 on SICARs, with the aim of providing these investors with investment management services; (ii) and the investment of these funds solely for returns arising from capital appreciation following the resale of these investments, as well as investment income. It should be noted that this activity does not preclude the parent company from holding subsidiaries whose purpose and activity consists in the provision of services related to investment activities, services provided, inter alia, to the parent company⁵.

However, companies that acquire shareholdings in other undertakings with the aim of carrying out a commercial or industrial activity, or for which such shareholdings represent strategic investments held for an indefinite period, are expressly excluded.

In essence, the scope of companies covered by this Q&A corresponds to that of the undertakings covered by CNC Opinion 09/002, namely primarily vehicles active in the *private equity* and *venture capital* industries, as well as, more generally, vehicles active in the **alternative investment** industry in the broad sense.

³ CNC is of the view that this activity should correspond to the company's corporate purpose or should not be incompatible with or even in contradiction to it.

⁴ Within the meaning of Article 2, sub-paragraph 1 of the Law of 15 June 2004 on investment company in risk capital (SICAR): "*Within the meaning of this law, a well-informed investor shall be an institutional investor, a professional investor "within the meaning of Annex II to Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU, hereafter "Directive 2014/65/UE" 4 or any other investor who meets the following conditions:*

- 1) *he has confirmed in writing that he adheres to the status of well-informed investor and*
- 2) *he invests a minimum of EUR 100,000 in the company, or*
- 3) *he has been the subject of an assessment made by a credit institution within the meaning of Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and amending Regulation (EU) No 648/2012, by an investment firm within the meaning of Directive 2014/65/EU, by a management company within the meaning of Directive 2009/65/EC of the European Parliament and of the Council of 13 July 2009 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) or by an authorised AIFM within the meaning of Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011 on Alternative Investment Fund Managers and amending Directives 2003/41/EC and 2009/65/EC and Regulations (EC) No 1060/2009 and (EU) No 1095/2010, hereafter Directive 2011/61/EU, certifying his expertise, his experience and his knowledge to adequately appraise an investment in the SICAR.*

The conditions set forth in this article do not apply to directors and other persons taking part in the management of the SICAR. The SICAR shall have the necessary means in order to ensure compliance with the conditions set out in the first subparagraph."

⁵ It should be noted that, in the absence of grounds for exclusion (e.g. immateriality), these service subsidiaries should be consolidated by the parent company, unlike subsidiaries held exclusively with a view to their subsequent disposal.

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In this regard, it is specified that “**alternative investment**” refers to investment in non-conventional assets or investment strategies, which are often less liquid, more complex and have a risk / return profile that differs from that of traditional financial markets. The main forms of alternative investment include:

- private equity;
- venture capital;
- real estate⁶;
- infrastructure;
- private debt;
- other speculative strategies⁷.

It is also worth noting that this type of companies generally share common characteristics with “investment entities”⁸ as defined by IFRS 10 “Consolidated Financial Statements”.

1.2. Application of the exclusion / exemption for the companies concerned

CNC is of the opinion that, in order to validly claim the exclusion from the scope of consolidation referred to in Article 1711-8 para. 3 point 3° LSC, and thereby be exempt from the obligation to prepare and publish consolidated accounts referred to in Article 1711-9 point 2° LSC, all of the following conditions must be met:

1. Existence of a divestment strategy from the outset (1.2.1);
2. Exclusion of all subsidiaries held for resale (1.2.2.);
3. Disclosure in the notes to the accounts of the fair value of companies held for resale (1.2.3.);
4. Disclosure in the notes to the accounts of significant events, guarantees and/or uncertainties (1.2.4.).

These conditions are explained below.

1.2.1. Existence of a divestment strategy from the outset

The **genuine and serious** intention to dispose of the subsidiary at a profit exists **from the date of acquisition**. This implies the existence **from the beginning of a documented (formally / in writing) exit strategy** at the end of a **specified holding period**.

This holding period may be defined on the basis of the achievement of a specific objective (e.g. an initial public offering), the achievement of specific financial targets, or on the basis of an investment cycle defined by the parent company.

⁶ Real estate investments made on a long-term basis primarily to generate recurring rental income are not considered to fall within the scope of alternative investment.

⁷ Other speculative strategies include digital assets (“*Crypto assets/Digital funds*”), *commodities*, works of art and wine.

⁸ Under IFRS 10, an investment entity is an entity that:

- a) obtains funds from one or more investors for the purpose of providing those investor(s) with investment management services;
- b) commits to its investor(s) that its business purpose is to invest funds solely for returns from capital appreciation, investment income, or both; and
- c) measures and evaluates the performance of substantially all of its investments on a fair value basis.

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It should be noted that neither the LSC nor the accounting directive 2013/34/EU sets a maximum holding period beyond which the application of the provision should be considered abusive. CNC nevertheless considers that, in practice, it is reasonable to assume that parent companies applying this or these exclusions from the scope of consolidation will **only exceptionally** expect to retain their holdings **for more than 10 years⁹** and **never for more than 15 years**; a holding period exceeding 10 years may, however, be justified by **exceptional market conditions**.

The parent company's administrative or management body **periodically reviews** – and whenever a major event calls the previous analysis into question – the exit strategies for all its investments.

1.2.2. Exclusion of all subsidiary undertakings held with a view to their subsequent resale

The exclusion of subsidiaries referred to in Article 1711-8 para. 3 point 3° LSC must be validly applicable and, in practice, applied **to all shareholdings / participations** held by the parent company (except – where applicable – to subsidiaries providing investment services, *inter alia*, to the parent company¹⁰).

As this is a provision whose application may result in the parent company being exempted from the obligation to prepare consolidated accounts and a consolidated management report pursuant to Article 1711-9 point 2° LSC, CNC emphasises the importance of not misusing it.

This is indeed a difficult decision that must be based on a thorough and well-documented analysis based on factual and detailed evidence and must therefore **be carefully justified**. It can only be envisaged if there is a clear, ongoing and duly documented intention to dispose of these subsidiaries as part of an exit strategy with a defined timeframe.

1.2.3. Disclosure in the notes to the financial statements of the fair value of companies held for resale

The CNC is led to believe that it is because fair value is regarded by these parent companies as a more relevant *reporting* tool vis-à-vis their investors and other stakeholders than consolidated accounts that these parent companies wish to dispense with the preparation of the latter, as fair value is used by these parent companies both at the time of investment and for the purposes of managing their participation portfolio.

This is why CNC is of the opinion that Article 26 para. 4¹¹ of the amended Law of 19 December 2002 on the trade and companies register as well as on the bookkeeping and annual accounts of undertakings (hereinafter "LRCS") requires these companies, where they are unable to measure their investments at fair value in their balance sheet¹², they must disclose this fair value in the notes to their annual accounts, in order to achieve the objective of a true and fair view and to provide relevant information to users of the accounts.

⁹ Holding periods must be duly documented and justified in the exit strategies described above.

¹⁰ See: details under point 1.1. and in footnote 5

¹¹ Article 26(4) LRCS provides that:
 "(4) Where the application of the provisions set out hereafter would not be sufficient to give a true and fair view within the meaning of paragraph (3), additional information must be given".

¹² Article 64bis para. 4, point c) LRCS provides that:
 "(4) The following may not be measured at fair value: (...)
 d) interests in subsidiaries, associates undertakings and joint ventures (...)"

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For the sake of reliability, it is recommended that fair value be determined by reference to generally accepted approaches, models and techniques (e.g. the IPEV valuation guidelines¹³).

From a relevance perspective, this information on fair value could be provided on an aggregate basis for each category of investment¹⁴.

1.2.4. Disclosure in the notes to the accounts of significant events, guarantees and/or uncertainties

CNC also recommends that companies covered by this Q&A provide information in the notes to the annual accounts on all significant events, guarantees and/or uncertainties at the level of a subsidiary that could have an impact on the parent company's going concern, cash position, liquidity or solvency.

2. Cascade structures and deferral of the exclusion/exemption

CNC is also of the opinion that any company incorporated under Luxembourg law controlled exclusively by a company operating in the alternative investment sector as referred to above may also rely on Articles 1711-8 para. 3 point 3° LSC and 1711-9 point 2° LSC, provided that the conditions set out in the paragraphs of section 1.2.1. to 1.2.4. above in respect of its parent company are complied with and provided that the shareholders or members of that company, holding shares or units in the subscribed capital of that company amounting to at least 10%, if the exempted company is a "société anonyme" (public limited company) or a "société en commandite par actions" (corporate partnership limited by shares), and at least 20 per cent if it is a "société à responsabilité limitée" (private limited company) or another legal form of company, have not requested the preparation of consolidated accounts no later than six months before the end of the financial year. Furthermore, it is specified that in such cases, the company may not claim any of the consolidation exemptions applicable to sub-groups (Articles 1711-5, 1711-6 and 1711-7 LSC) by virtue of its inclusion/presentation at fair value in the annual accounts of its parent company¹⁵.

3. Effective date

This Q&A applies to any open financial year for which the statutory deadline for filing the annual accounts with the Trade and companies register (RCS) has not yet expired.

4. Withdrawal of CNC Opinion 09/002

CNC Opinion 09/002 is withdrawn.

¹³ *International Private Equity and Venture Capital (IPEV)*

¹⁴ The presentation of information relating to fair value in the notes to the annual accounts does not exempt the undertaking from also disclosing the information required by Article 65 para. 1 point 2° LRCS, as interpreted by CNC Q&A 17/015 entitled "Disclosures in the notes to the annual accounts of participations held (Art. 65 (1) 2° LRCS) and exception to the principle of exemption of small undertakings (Art. 66 LRCS)".

¹⁵ See: Q&A CNC 15/006 "Subsidiaries of investment entities (IFRS 10 § 27) and continuation of consolidation exemptions of sub-groups (Art. 314, 315 and 316 LSC)"

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Disclaimer

This document – provided as a courtesy – is an unofficial translation of the French original document entitled “Interprétation de l’article 1711-8, para. 3, point 3° de la loi du 10 août 1915 concernant les sociétés commerciales dans le cas particulier des sociétés opérant dans le secteur de l’investissement alternatif”. In case of discrepancy in interpretation, the French version shall prevail.

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- are intended to contribute to the development of accounting doctrine in accordance with Article 73(b) of the amended Law of 19 December 2002 on the trade and companies register, as well as on the bookkeeping and annual accounts of undertakings;
- only represent the opinion of the GIE CNC on a number of doctrinal and interpretative issues;
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