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The Legal Framework of the Securities Markets in Bulgaria

The Bulgarian parliament passed the Securities, Stock Exchanges, and Investment Companies Act (the SSEIC Act) on June 29, 1995,[1] and the Privatization Funds Act (the PF Act) on December 19, 1995.[2] Both Acts have laid down the legal groundwork of the emerging securities market. Aspiring to membership of the European Union, the Bulgarian legislators have abided by the requirements of the respective European directives.[3] They have benefited also from the experience of other legal systems.[4]

The two Acts have filled a legal gap that has both restrained the development of securities markets and allowed numerous notorious incidences of fraudulent

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1. Zakon za tzennite knizha, fondovite borsi i investitzionnite druzhestva [The Securities, Stock Exchanges and Investment Companies Act], DARZHAVEN VESTNIK, Issue No. 63 (1995) [hereinafter SSEIC Act].

2. Zakon za Privatizatzionnite Fondove [The Privatization Funds Act], DARZHAVEN VESTNIK, Issue No. 1 (1996) [hereinafter PF Act].

3. For an overview of the approach of the European Communities (EC) to securities markets regulation, see David Reid and Andrew Ballheimer, *The Legal Framework of the Securities Industry in the European Community under the 1992 Program*, 29 COLUM. J. TRANSNAT'L L. 103 (1991). For the texts and short comments on the respective EC directives, see Louis Vogel, *Code européen des affaires, in* ANNOTATIONS DE JURISPRUDENCE ET BIBLIOGRAPHIE (1995).

4. The Central and East European Law Initiative (CEELI) has prepared two conceptual papers on Securities Regulation and on Investment Funds, which it presented for consideration to the Bulgarian authorities. The recommendations contained therein have been largely taken into account by the Bulgarian legislators. *See* CEELI, A CONCEPT PAPER ON SECURITIES REGULATION FOR BULGARIA, *reprinted in* 27 INT'L LAW. 837 (1993); and CEELI, A CONCEPT PAPER ON INVESTMENT FUNDS FOR BULGARIA, *reprinted in* 28 INT'L LAW. 237 (1994).

financial activities.[5] With a very thin securities market,[6] the adopted legislation has yet to prove its effectiveness in the specific financial environment of Bulgaria. It may be expected that the Acts, designed as framework laws, will give rise to new legislative and administrative initiatives to provide for a comprehensive and efficient regulatory regime.[7]

I. Scope and Objective of the Legislation

The SSEIC Act consists of five principal parts: (1) general provisions; (2) stock exchanges; (3) securities transactions; (4) investment companies; and (5) enforcement administrative measures and administrative liability. The objective of the SSEIC Act is to ensure a proper legal framework for the offering of and transactions in securities, the establishment and the operation of stock exchanges, investment intermediaries and investment companies, and the introduction of governmental control over all aspects of the legal framework.[8] The PF Act may be characterized as transitory legislation that governs the establishment and the operation of privatization funds, the governmental supervision over such funds, and the protection of investors.[9]

II. Governmental Supervision

The Securities and Exchanges Commission (the SEC)[10] is a governmental body empowered to regulate and control the offering of and transactions in securities, and the creation and activities of stock exchanges, investment intermediaries, and investment companies. The purpose of the regulation and control by the SEC is to protect investors and promote securities market development.[11] The officers

5. Similar to other countries in Eastern Europe, the lack of proper securities regulation and securities markets watchdogs have permitted numerous "pyramid" investment schemes to deceive thousands of small savers. Pyramid investment schemes attract people by paying the initial investors unusually high dividends out of incoming installments. Eventually, the sponsors of such schemes disappear with the accumulated moneys.

6. For example, the daily volume of the six major stock exchanges, as reported on the financial pages of the business daily *Pari* on January 31, 1996, amounted to only BGL 670,905 (US$9,200). It is expected, however, that the mass privatization program, which was launched on January 8, 1996, will boost securities market development.

7. Examples of the pending acts include: rules of organization and activity of the SEC; rules of organization and activity of the Central Depositary; and regulation on the offering, acquisition, and payment of Treasury securities, and the like.

8. SSEIC Act, *supra* note 1, art. 1.

9. PF Act, *supra* note 2, art. 1. The privatization funds are expected to become the main vehicles of the mass privatization program by pooling the distributed vouchers and investing them in shares of 1063 selected companies. The total book value of the selected companies amounts to BGL 201,233 million (US$1 = BGL 73), out of which BGL 80,450 million will be offered for privatization against vouchers. Six months after the last privatization auction the privatization funds may be transformed into investment funds under the SSEIC Act or into holding companies under the Commercial Code. *Id.*, Transitory and Final Provisions, para. 4.

10. *See* SSEIC Act, *supra* note 1, ch. II.

11. *Id.* art. 5.

of the SEC are appointed by the Council of Ministers, but the SEC itself is legally and financially independent.[12] In order to fulfil its mission, the SEC has the power to: (1) supervise securities trading and institutions; (2) license securities market participants; (3) confirm prospectuses; (4) investigate alleged violations of the law and the regulations it administers; (5) secure compliance with disclosure requirements; (6) propose regulatory measures to the government; (7) inform the public; and (8) impose administrative sanctions.[13]

In cases of suspected violations of the securities market regulatory regime, the SEC is authorized to require the production of documents and written explanations and to investigate all persons suspected of violations. In carrying out its investigations, the SEC has the right of free access to office premises, the right to be represented on managing or supervisory bodies of entities it supervises, the right to require lifting of bank secrecy,[14] and the right to require assistance from other governmental bodies or officials. Article 141 (Coercive Administrative Measures and Administrative Liability) entitles the SEC to use its powers in cases of confirmed breaches of the law and regulations or when investors' interests are in jeopardy. The SEC may require concrete measures for rectification, suspend transactions in certain securities either temporarily or permanently, reject the confirmation of a prospectus for a new offering, inform the public of unlawful activity, propose personnel changes, or withdraw granted licenses. The SEC may fine wrongdoers if their acts do not constitute a criminal offense. Revenues generated as a result of unlawful activities on the securities market are confiscated by the state.[15]

III. Stock Exchanges

Stock exchanges in Bulgaria came into being without any relevant authorization or supervision. However, the newly adopted legislation sets forth a legal framework for the creation, operation, and regulation of stock exchanges. A stock exchange is an organized self-regulated securities market that ensures equal access to market information and equal trading conditions to its members and clients. Such a stock exchange must now be authorized by the SEC.[16] Stock exchanges are organized as joint-stock companies under the Commercial Code with a minimum paid-in capital of BGL 100 million.[17] A person or entity may be a member of

12. *Id.* art. 6.

13. *Id.* arts. 10, 11, 141.

14. *See* Zakon za bankite i kreditnoto delo [Banking Act] art. 47(6), DARZHAVEN VESTNIK, Issue No. 25 (1992), amend. Nos. 59, 109 (1993), No. 63 (1994). The district court may order the lifting of bank secrecy upon a request by the SEC. Due to the lack of precedent, it is not clear if the SEC may file such a request in the course of its ordinary supervisory activities or only when there are suspected violations of the law.

15. SSEIC Act, *supra* note 1, art. 142.

16. *Id.* art. 16.

17. *Id.* arts. 18-19; *see also* Targovski zakon [Commercial Code], DARZHAVEN VESTNIK, Issue No. 48 (1991).

only one stock exchange.[18] Stock exchanges appoint arbitration panels to settle trade disputes between members.[19] The Ministry of Finance and the Bulgarian National Bank (the BNB) are entrusted with the task of organizing the establishment of and participation in the operation of a Central Depositary.[20]

The SEC sets forth the general guidelines for securities listings on a stock exchange. The stock exchange is obliged to disclose information concerning listings and the trading of securities.[21]

IV. Securities Trading

A. Investment intermediaries

The SSEIC Act introduces the notion of investment intermediaries as the only professional market participants that may engage in securities deals including underwriting and trading. In order for a financial institution to qualify as an investment intermediary, it must be licensed under either the SSEIC Act or the Banking Act.[22] Investment intermediaries can be constituted only as banks, joint-stock companies, or limited liability partnerships that have minimum own capital equal to the capital requirements for a joint-stock company.[23] The SEC sets requirements pertaining to the amount and structure of the capital that investment intermediaries are required to maintain at any time; the level of minimal liquidity; and the permanent and risk-based provisions.[24] Managers are required to meet high standards of professional expertise and personal integrity.[25]

In executing securities deals, the investment intermediary is obligated to perform due diligence inquiries of issuers and to inform investors of associated risks.[26] If the intermediary infringes this duty, it may be heavily fined by the

18. *Id.* art. 32.

19. *Id.* arts. 33-37.

20. It is envisaged that the Central Depositary be organized as a private entity with equity shares from the Ministry of Finance, the BNB, and the market participants. By the end of June 1996 the Ministry of Finance, the BNB, the Centre for Mass Privatization, the Bulgarian Stock Exchange, and 34 financial institutions had subscribed for the BGL 30 million authorized capital of the Bulgarian Central Depositary. Besides the Ministry of Finance (10%), the BNB (10%), and the Centre for Mass Privatization (6%), no participant in the Central Depositary may own more than 5% of its shares.

21. SSEIC Act, *supra* note 1, art. 86.

22. Initially, the Banking Act permitted banks to engage in practically all financial activities, including investment services. The new bank licensing procedure incorporates the requirements of the SSEIC Act wherever banks ask for authorization to engage in and provide investment services. Banking Act, *supra* note 14, art. 12(2). Before granting such an authorization, the BNB considers any written opinion of the SEC. *Id.* art. 12(3). The SEC may investigate investment activities of banks in cooperation with the BNB. SSEIC Act, *supra* note 1, art. 10(1)-(4).

23. SSEIC Act, *supra* note 1, art. 39.

24. *Id.* arts. 40-43. There are exceptions to the capital requirements rules provided the investment intermediaries are not engaged in underwriting or in dealing for their own accounts. In such circumstances, the intermediary is less capable of having a substantial impact on market prices.

25. *Id.* art. 45.

26. *Id.* art. 56(1).

SEC or its license may be withdrawn. However, lacking explicit provisions, and in the absence of established practice, it is not clear whether investors have a legal remedy against an investment intermediary. The investment intermediaries must keep records and follow strict procedures in order to keep client assets and orders separate from their own.[27]

B. Public Offers

As defined in the SSEIC Act, securities are negotiable instruments and rights that can be offered to the public, such as shares, bonds, and other instruments and rights related to shares and bonds.[28] The investment contracts that are offered publicly also qualify as securities.[29] As to the form of securities, the Commercial Code was amended to allow book-entry securities.[30] According to the Code, public offer occurs whenever an offer is made to fifty or more persons or to an unlimited number of persons by means of the mass media, for example. An offer is also considered to be public when a person participates in the offer without being an investment intermediary or holder of the offered securities.[31]

C. Prospectus

A public offer is made conditional upon written confirmation of a prospectus by the SEC and upon its subsequent publication.[32] The issuer and the investment intermediary authorized by it are liable for damages due to false or incomplete information in the prospectus.[33] The prospectus contains details pertaining to the issuer; the securities; the authorized investment intermediary; the attached rights, privileges, and guarantees; and other information specified by the SEC.[34]

The prospectus must be updated until completion of the subscription period. Otherwise, the issuer and the authorized investment intermediary are liable for any ensuing damages. Substantial corrections of the prospectus in the period between the SEC confirmation and the end of the subscription period permit the subscriber to rescind the transaction, without explanation, within a one-month

27. *Id.* arts. 57, 58, 61.

28. *Id.* art. 2.

29. *Id.* art. 3. Investment contracts are written contracts under which an investor provides funds to another person to invest with the promise of income. It seems that the legislature was referring to contractual investment funds.

30. The Commercial Code provided for securities in bearer or registered physical form. The Ministry of Finance and the BNB have developed the practice of issuing book-entry Treasury securities.

31. SSEIC Act, *supra* note 1, art. 4.

32. *Id.* art. 63. In cases where securities are sold without a published prospectus or where substantially misleading or intentionally incomplete information is given, the investor may claim the contract void within a three-month period.

33. *Id.* art. 65(3).

34. *Id.* art. 66.

period after the corrections are made.[35] The SEC is entitled to authorize the omission of some otherwise required information, which if released might harm legitimate interests of the issuer if the omissions do not mislead the investors as to the value of the securities.[36]

D. Disclosure of Information

Within ninety days after the end of the financial year, the issuer must file an annual report that contains information about the issuer and its activities, the members of the managing and supervising bodies, the shareholders who own or control more than 10 percent of the voting shares in the issuer, audited financial statements, and other information required by the SEC.[37] The issuer is also required to file half-yearly unaudited financial statements.[38] The issuer is under a standing duty to inform the SEC and the public of any substantial changes or circumstances that may have an impact on the market.[39]

E. Major Shareholdings Disclosure and Tender Offers

In order to enhance market transparency, any person (either alone or through affiliates)[40] whose stock holdings rise above or fall below 10 percent of the total voting stock of an issuer must immediately inform the company, the SEC, and the stock exchange.[41] Proxies are allowed provided they are made public.[42] A person who wishes to acquire more than 25 percent of the voting shares of a publicly traded company, either alone or through affiliates, must release a tender offer. The contents of and the procedures for releasing tender offers are controlled by the SEC.[43]

F. Insiders and Insider Trading

The ban on insider trading is a new concept introduced by the SSEIC Act. Insiders are forbidden from trading on insider information[44] for their own or a third party's benefit, and also from tipping insider information to noninsiders. Noninsiders in possession of insider information are also prohibited from trading

35. *Id.* art. 70(3).
36. *Id.* art. 71.
37. *Id.* art. 78.
38. *Id.* art. 79. Bond issuers provide quarterly financial reports. *Id.* art. 81.
39. *Id.* art. 82.
40. Affiliates include not only relatives or persons under one's control, but also persons who might be in some position to exercise joint voting rights.
41. SSEIC Act, *supra* note 1, art. 92.
42. *Id.* art. 96.
43. *Id.* arts. 97-105.
44. Insider information is broadly defined as price-sensitive information related to an issuer or its securities that is normally not available to the public. Article 106 incorporates the definition of insider information formulated in the SSEIC Act.

on the insider information.[45] Insiders comprise members of managing or supervisory bodies of the issuer or of companies affiliated with it. Insiders also include any other persons who have access to insider information by virtue of their profession, activity, ownership, control, responsibilities, or contacts with the issuer.[46]

V. Investment Funds and Investment Companies

Though the concept of investment funds was not new in Bulgaria, the recent legislation has introduced clearer and stricter rules. Article 109(1) of the SSEIC Act defines an investment company as a joint-stock company, duly authorized under the same Act, that invests in securities other than those of its own sponsors.[47] Authorization is granted by the SEC when it confirms that the applicant company has fulfilled all legal requirements specified in the SSEIC Act. The law recognizes open-ended and closed-ended investment companies.[48]

In addition to the general requirements under the Commercial Code, an investment company's charter must include the following: (1) the investment objectives and limitations; (2) the amount of capital that may be invested in a single type of security; (3) the procedure for obtaining loans; (4) a ban on dividend distribution prior to the approval of the annual report; (5) the dividend policy; (6) the duration of the closed period, if any, during which an open-ended investment company is under no obligation to buy back its shares; (7) the method of calculating the net asset value; and (8) the redemption procedure and the circumstances under which redemption may be suspended.[49] Public offerings are accompanied by prospectuses. The prospectuses incorporate all relevant information, which will enable the investors to make informed investment decisions and handle their investments without difficulty.[50]

Advertising materials must indicate where prospectuses and charters are available to the public and warn that securities prices may decrease and that profits are not guaranteed.[51] Investments are restricted to listed securities, Treasury securities, shares in other investment companies, money instruments, and other property necessary for the normal performance of an investment company's activities.[52]

45. SSEIC Act, *supra* note 1, art. 108.
46. *Id.* art. 107.
47. The Bulgarian legislators have clearly given their preferences to company-organized investment funds. Though article 3(1) refers to investment contracts, the SSEIC Act does not expand on this issue. *See supra* note 29 and accompanying text.
48. SSEIC Act, *supra* note 1, art. 109(3); *see also id.* arts. 110-111.
49. *Id.* art. 114(1).
50. *Id.* art. 124.
51. *Id.* art. 126(2).
52. *Id.* arts. 134(1) and 140(1).

A. Open-Ended Investment Companies

Open-ended investment companies are managed either by their own governing bodies or by an investment intermediary in accordance with a management contract. The investment manager's fee is limited to 5 percent of the average yearly book value of the investment company's assets.[53] The SSEIC Act stipulates stringent rules to protect investors' interests. The assets of an open-ended investment company must be recorded with the Central Depositary or with a custodian bank. The custodian and the investment manager may be neither the same person nor affiliates. Deposited assets have to be kept and accounted for separately from the custodian's own assets.[54]

Certain investment limitations also serve the purpose of investor protection. The investment company's portfolio may consist of no more than 10 percent in unlisted securities, 10 percent (cumulatively) in other investment companies' shares and property other than securities, and 5 percent in securities of a single issuer with the exception of Treasury securities.[55] Additionally, the open-ended investment company must maintain at least 10 percent of its assets in liquid instruments.[56] It may not acquire stakes permitting them to exercise corporate control.[57] On the other hand, open-ended investment companies are given some means to protect themselves against adverse market developments. They may specify a closed period of up to three years or provide for a redemption suspension procedure.[58]

B. Closed-Ended Investment Companies

Aside from the general restrictions, the closed-ended investment companies are subject to considerably fewer constraints. They are required to list their shares on a stock exchange within six months after establishment. If their listing is not accepted, they must regularly—not less than twice monthly—publish information on their offerings' prices.[59] Their capital may not be invested in more than 30 percent of unlisted securities and 30 percent of securities of a single issuer.[60]

VI. Privatization Funds

Privatization funds governed by the PF Act are investment companies whose raison d'être is to serve the mass privatization scheme.[61] Only this type of invest-

53. *Id.* art. 130.
54. *Id.* art. 132.
55. *Id.* arts. 134(2)-(3) and 135.
56. Liquid instruments are cash, savings accounts, term deposits, or bills with maturity of up to three months, and other money instruments authorized by the SEC. *Id.* art. 134(5).
57. *Id.* art. 136.
58. *Id.* art. 110(2)-(3).
59. *Id.* art. 139.
60. *Id.* art. 140(2)-(3).
61. The mass privatization program is governed by chapter 8 of the Law on Transformation and Privatization of State and Community Enterprises [Zakon za Preobrazuvane i Privatizatzija na Darzhavni i Obshtinski Predprijatija], Darzhaven Vestnik, Issue 38 (1992), amend. Issue 51 (1994)].

ment fund may accumulate investment vouchers and invest them in shares of designated companies.[62] Presumably, in order to ensure high standards of investor protection, the PF Act provides that privatization funds may issue only registered voting shares. Sponsors are not allowed to reserve privileges for themselves. On the other hand, the funds are protected by restricted free trade of vouchers, a closed period of up to six months after the last auction for trading in their shares, and a limited right to redeem shares for up to five years after inception.[63] There is, of course, a certain payoff in view of decreased liquidity.

The legislators have obviously strived to promote private property and diversification of ownership. To these ends, state-controlled legal persons—where the state's holding exceeds 50 percent—are not allowed to be sponsors or shareholders in privatization funds, and no person alone or through affiliates may hold more than 10 percent of the fund's shares.[64] It seems that the legislators' efforts in this respect might be compromised by setting very high capital requirements.[65] Foreign participation is limited to the established financial institutions that may present bank references from a first-class foreign bank.[66] It is noteworthy that the SEC has the right to a silent refusal of license, whereas the SSEIC Act does not provide for such a possibility.[67]

The privatization funds are subject to certain investment limitations. The accumulated vouchers are exchanged against shares in privatizing companies at special auctions. The cash portion of the capital may be invested in listed securities (no more than 10 percent of the total capital) or in treasury securities (no more than 25 percent of the total capital). The fund may not dedicate more than 10 percent of its capital to investments in a single issuer.[68] However, privatization funds are allowed to acquire up to 34 percent of the voting shares of a company, which might give them a fairly good opportunity to exercise efficient corporate governance.[69]

VII. Conclusions

After considerable delay, the Bulgarian securities markets can now begin operating within an up-to-date regulatory framework. However, the work is far

62. PF Act, *supra* note 2, art. 2.

63. *Id.* art. 4; *see also id.* art. 46.

64. *Id.* arts. 6-7.

65. *Id.* art. 5. This article stipulates that privatization funds' initial capital has to be at least BGL 70 million (around US$1 million). A minimum of BGL 10 million of its capital has to be paid in cash or in Treasury securities, the remainder in investment vouchers. With a voucher's face value of BGL 25,000, some 2,000 voucher holders would need to participate in the creation of a privatization fund.

66. *Id.* art. 8. Foreign financial institutions have to be duly authorized under their national law and they must have performed financial activities for at least five years.

67. *Id.* art. 14(2).

68. *Id.* art. 29.

69. *Id.* art. 30. For comparison, Russian voucher funds may not be used to acquire more than 10% of voting shares in a single company.

from complete. More detailed regulations and established practices are needed to fill in remaining gaps. In a country that has traditionally relied on banking intermediation for financing economic activity, it may be expected that the securities markets will experience some difficulty in getting established. Some inconsistencies in the PF Act demonstrate how political considerations may sometimes prevail over economic logic. Even more difficult will be the task of adopting the legal and administrative machinery to implement the new laws efficiently. Nevertheless, the process has been set in motion and the new framework can only serve to strengthen reforms.