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REPORT

American Bar Association Central and East European Law Initiative (CEELI)*

A Concept Paper on Investment Funds for Bulgaria**

I. Introduction

The purpose of this paper is to discuss the issues that should be considered in the drafting of a law in Bulgaria to regulate investment companies or investment funds, also commonly known as mutual funds, investment trusts, unitary funds, or unit trusts.[1] In brief, the objective of such funds is to sell their securities to the public, and with the monies so received, invest in the securities of other companies. Each investor in a fund thus acquires an interest in the group or "pool" of securities owned by the fund.

*The Central and East European Law Initiative (CEELI) is a public service project of the American Bar Association designed to advance the rule of law and commercial law in the world by supporting the law reforms underway in Central and Eastern Europe and the New Independent States of the former Soviet Union. Through various programs, CEELI makes available U.S. legal expertise and assistance to emerging democracies that are in the process of modifying or restructuring their laws or legal systems.

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1. For ease of reference this paper will generally use the terms "investment fund" or "fund" to encompass all the terms by which such entities are known.

In recent years, the popularity of investment funds as a means for the public to participate in the securities markets has grown enormously in a number of countries. The public has come to understand that the funds enable them to share, for a relatively modest fee, professional management of a diversified pool of securities. Without such funds, investors would have to choose individual securities, a task that is often difficult for the financially inexperienced, and which is made more so in view of the competition from large institutional buyers and professional managers who often have considerably more information at their disposal. By investing in an investment fund, the small investor gains access to a professional manager, and spreads investment risks over the many different securities owned by the fund. By attracting large numbers of investors into the securities markets, investment funds not only strengthen those markets, but they promote the sense in each fund investor of being a part of the financial or economic system rather than a non-participating outsider. As a result, it is fair to say that investment funds are both financially and socially useful and should be encouraged.

While it is clear that investment funds can play an important role in an economy, in order for them to succeed it is essential that they are operated properly and honestly. Although such an objective is no different from that of any business undertaking, experience has shown that the nature of investment funds presents unique problems and opportunities for dishonesty and abuse. For this reason, regulation of investment funds is commonly more detailed and complex than laws regulating other securities or financial enterprises. The material that follows discusses the concerns or problems relating to investment fund operations and the regulatory approaches to those concerns in various countries, including the proposals of the European Community.[2]

II. Types of Investment Funds[3]

Basically, two types of investment fund structures have developed: a contract or "unitary" form, and a corporate form. The unitary form, which is the

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2. As was noted in CEELI, *A Concept Paper on Securities Regulation for Bulgaria*, October 1, 1992 [reprinted in 27 INT'L LAW. 837 (1993)]: "As Bulgaria follows a civil law tradition, and as it aspires to European Community membership, which would require eventual compliance with European Community securities law directives, Bulgaria will wish to focus on these directives as guides. European Community securities law is subject to certain limitations in scope and depth due to the harmonization process by which it is formed, and is evolving. Therefore, while Bulgaria will want to comply with the minimum requirements of current European Community law, Bulgaria should adopt a more comprehensive securities law." Similarly, it is advisable that Bulgaria consider adopting an investment fund law that is more comprehensive than what may be required under the European Community standards.

3. The working group for this concept paper wishes to acknowledge a member of the group, David Silver, formerly president of The Investment Company Institute, for his paper, *Meeting the Demand for Pooled Investments in a World Market*, September 24, 1991, which is the source of much of the material herein relating to operation of investment funds outside the United States. Acknowledgement is also given to David Reed and Andrew Ballheimer for their article *The Legal Framework of the Securities Industry in the European Community Under the 1992 Program*, 29

required structure for German and British funds, as well as for funds in certain other countries, is created by the fund's sponsor-manager and is a contractual arrangement between the sponsor-manager and investors. Under that arrangement the fund does not have an independent existence. Investors in a unitary fund purchase units and have no voting rights concerning the way the fund is operated. The corporate form, required in the United States, has a separate existence from that of its manager, and is owned by its shareholders, like any corporation. Under the law, shareholders are given certain voting powers, including approval of the manager's agreement with the fund, and the election of the board of directors.[4] In France, both the corporate and unitary forms of investment fund are permitted.

Under the corporate form, the shareholders and/or the directors have the power to dismiss the manager[5] and any other providers of services to the fund. Dismissal of the manager is unusual, however, absent serious breaches of duty. If the independent directors recognize conduct by the manager that is believed contrary to the fund's interest, their "fiduciary" obligations, that is, the duties imposed upon them by their positions of trust, require them to take appropriate action to ensure that the fund is not harmed. In serious cases, the government regulator (the SEC, in the United States) will be heavily involved, and may impose any of a variety of penalties, up to and including banning the manager from the fund industry. Only rarely have shareholders and/or directors removed investment managers because of disappointment with fund investment performance.

In the unitary system, an independent trustee or depositary (custodian) and the government regulator play a role in monitoring the manager's activities. The initial responsibility for discipline of the manager lies with the manager itself. The independent trustee or depositary monitors or oversees the actions taken, and to the extent of its authority, may take corrective action. Under both the unitary and corporate systems, the government regulator can step in at any time and take whatever action it considers appropriate under the law.

COLUMBIA JOURNAL OF TRANSNATIONAL LAW 103 (1991), for material therein pertaining to the European Community Directive concerning "undertakings for collective investments in transferable securities" (the "UCITS Directive").

4. The United States investment company law requires that a fund's board of directors include a percentage of members with no interest in or affiliation with the manager, in order to provide a degree of director independence from the manager. In practice, funds commonly maintain boards with a majority of independent directors. Although independent directors receive payments from the manager for their board service, there has been little if any evidence or experience that their independence has been compromised, or weakened, by those payments. The United States Securities and Exchange Commission ("SEC"), the governmental regulatory body, has the authority to make a finding that the payments to a director are so significant, or "material," that the director should not be considered independent.

5. The term "manager" as used refers to the entity responsible for selecting the fund's investments (the "investment adviser") as well as operating the fund. The terms manager, adviser, investment manager, and investment adviser are generally used interchangeably herein. Where more than one organization is involved, they are ordinarily closely related.

Under the UCITS Directive, a UCITS from one European Community Member State that is properly authorized by that State (its "Home State") may sell its securities in any other Member State, subject to marketing, advertising, and tax laws of the other State (the "Host State"). The UCITS Directive covers only "open-end" UCITS, both the unitary and corporate form.[6]

III. Particular Problems or Concerns of Investment Funds

Any company, including an investment fund, that proposes to sell securities to the public must provide sufficient information about the company and its operations, or "full disclosure," to allow investors to make an informed investment decision. Experience has shown, however, that a disclosure requirement alone is not adequate to protect fund investors. As noted previously, investment funds present unique opportunities for abuse and dishonesty, and, therefore, they warrant more extensive regulation than is customary under securities law. In the United States, the investment fund history and experience of several decades led to the enactment of the Investment Company Act of 1940, a statute that provides comprehensive regulation of funds. It is instructive to note that, while there have been a number of amendments in the intervening fifty years since its enactment, the Investment Company Act remains substantially intact as to its core, or major, provisions. That fact indicates the belief of regulators that the opportunities for investment fund abuse that were uncovered prior to 1940 remain today.

The special problems presented by investment funds arise in large part from the nature of their assets: pools of securities, often highly negotiable or "liquid." Unlike the assets of operating businesses, which may consist of factories, machinery, and merchandise, a fund's only assets are its securities (and currency), which can be easily stolen without proper safeguards. As a result, and as discussed later in this paper, it is essential to ensure that the method of custody of fund assets eliminates to the extent possible the opportunities for such misconduct.

While theft of fund securities is perhaps the most easily understood type of misconduct, without effective regulation persons who control an investment fund—its management or "insiders"—may employ less obvious methods to use the fund more for their benefit than for the welfare of their investors. As examples:

- The prices of fund securities charged to "insiders" (those in a position of power or influence over a fund) might be less than the prices to the public. Similar unfair pricing practices could exist when fund securities holders "redeem," or sell, their fund securities to the fund.
- Insiders might sell to the fund at excessive prices securities they own (other than the securities issued by the fund) for use in the fund's portfolio of investments, or could purchase securities owned by the fund at less than their value.

6. Open-end funds must redeem their securities at net asset value. See note 8 below.

- Fund managers could charge unfair fees for various services to the fund.
- Funds might issue securities of different types or classes whose provisions, rights, or privileges could affect each other, the result being a capital structure too complex for investors to understand.
- Investors in a fund may fail to receive adequate and accurate information concerning the investment policies or objectives of the fund, including timely information when those policies or objectives are changed.
- Advertisements for funds may attempt to influence potential investors with insufficient or false or misleading information.
- The prices of fund securities to the public could be incorrect because of erroneous valuations of the fund's assets; in that case, investors would pay too much or too little for their investments in the fund.[7]

While the above concerns relate mainly to the manner in which management operates a fund, the regulatory authorities must also decide what approach to take on a number of other important issues including the following:

- Should fund managers be required to meet certain qualification standards, commonly referred to as "merit regulation"?
- Do all investment funds require regulation, or should certain funds be exempted?
- How frequently should "open-end" funds be required to redeem securities?[8]
- How should investment funds be taxed?

While many concerns and problem areas are listed above (and further discussed below), it is difficult, if not impossible, to include every conceivable regulatory issue. Furthermore, regulation is continuously changing, because experience has shown that over time, particularly as investment funds grow in number and variety, new issues continuously present themselves. Moreover, as a practical matter, it would be difficult for the drafters of a new statute dealing with a fund industry in its infancy to attempt to cover every conceivable aspect of regulation. To do so would be unnecessarily complex and time-consuming. It is more important that a system of regulation be in place as soon as possible to deal with a number of basic, clearly definable problems. Otherwise, an investment fund

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7. Investors redeeming their fund units would similarly receive too little or too much for their investments. Incorrect valuation of assets often results from negligent or unqualified personnel rather than from intentional acts. Whatever the reason, management and regulators must do all that is possible to assure proper valuation, because without it public confidence in investment funds is not possible.

8. Investment funds can be the "open-end" or the "closed-end" type. An open-end fund issues "redeemable" securities; that is, the fund must repurchase its securities from any owner of its securities who offers them to the fund. A closed-end fund has no such obligation, and its securities trade on the market, like the securities of any company. The European Community's UCITS Directive (see note 3 above) states that UCITS securities must be redeemable, and portfolio securities (the securities that comprise the fund assets) must be liquid. (Liquid securities are those that can be readily traded on the market. Securities that have a "thin" market, that is, a small trading volume, are not considered liquid. The prices of such securities tend to display "volatility"; that is, they tend to move up or down quickly, and often significantly.)

industry could emerge without regulatory guidance, other than a general securities law, assuming such has been adopted.[9] As time passes, the regulatory authority can determine from experience what amendments to the statute are needed or desirable.[10] It is suggested that a statute proposing to regulate investment funds in Bulgaria should initially consider at least the following categories of issues:[11]

a. valuation of portfolio securities in connection with sale and redemption of fund securities;
b. requirements as to custody of fund assets;
c. dealings of the fund with insiders or "affiliates";
d. regulation of the fund manager's fees;
e. disclosure and information relating to the fund for potential and existing fund investors;
f. limitations as to capital structure, particularly classes of securities.

What follows is a discussion of these issues and the approach to them in various countries and the European Community or "EC."

IV. Approaches to Investment Fund Regulation

A. Valuation of Portfolio Securities in Connection with Sale and Redemption of Fund Securities

The type of fund known as the open-end fund is required to redeem its securities upon the request of an investor. Open-end funds also normally offer their securities continuously to the public. If they did not do so, their obligation to redeem their securities upon demand would cause fund assets to diminish and eventually be depleted. However, it is the requirement to redeem that establishes the fund's type. The price of a share or unit of such a fund for both sales and redemptions

9. While a general securities law would provide requirements for all companies that offer securities to the public, it would not, as noted, deal with the numerous other investment fund issues. One approach the authorities might consider is the immediate adoption of a policy, by law or regulation, that no investment funds may operate until the enactment of a statute specifically regulating such undertakings. As an alternative, investment funds formed prior to enactment of a specific fund statute could be required to comply with such a law when it takes effect. Of course, the latter approach could result in serious fund problems arising prior to the existence of statutory means to deal with them.

10. The drafters of a statute regulating investment funds may wish to consider a provision that allows the regulatory authority to issue rules that are necessary or appropriate in the exercise of its powers under the statute. Including this rule-making authority in the statute would allow the regulator to benefit from experience and adapt to changing circumstances without continuously seeking formal statutory change. At the same time, care must be taken that rule-making authority is not given or used so broadly as to defeat the intent of statutory provisions. Any such fundamental changes should be accomplished only by statutory amendment. If the statute does provide for rule-making authority, one possible safeguard could be to require that any rule proposal must be made public, so that affected parties, such as fund managers or fund security holders, could offer comments to the regulatory authority. After consideration of such comments, the regulatory authority would determine whether the rule proposal should be adopted as proposed, or modified, or even withdrawn.

11. A decision as to the form that funds should take, that is, corporate or unitary (or both), is also needed. Those forms have been described at some length above.

depends directly on "net asset value." In essence, net asset value refers to the value of the fund's assets (essentially its portfolio securities and currency) minus any liabilities. Net asset value per share or per unit refers to the figure resulting or derived by dividing the fund's aggregate, or total, net asset value by the number of shares or units outstanding. As noted previously, accurate pricing of open-end funds' portfolio securities in connection with sales and redemptions of fund securities is essential for public confidence, without which a fund industry will not long survive.[12]

In theory, pricing should not present too difficult a problem. Securities have market prices; and fund liabilities, which should normally be minimal, can be handled under generally accepted accounting principles. However, a fund located in a country that does not yet have developed securities exchanges and/or markets faces asset valuation problems that can be considerably more difficult than in places where there are thousands of different securities being traded, and where price quotations are generally easily obtainable. In a country with relatively few securities being traded, and/or with securities being "thinly" traded, relatively minor trading may cause prices to fluctuate significantly. Under those circumstances, it may be difficult to determine at any given time an accurate value of a fund's portfolio of assets. In view of this situation, the government may initially wish to consider whether it should delay authorizing the operation of investment funds until the securities market has reached a certain level of strength and diversification.

Another possible approach to the problem of thin securities markets and limited liquidity is to lengthen the intervals between required redemptions. Presently in the United States, a fund is required to price its shares (by valuing its assets) on any day it receives a request for redemption, or a purchase order.[13] The Investment Company Act also provides that when a holder of fund shares offers his shares

12. Accurate valuation of the assets of a closed-end fund is also important, particularly during any period when the fund is selling its securities to the public. However, previously issued and outstanding securities of this type of fund are not redeemed by the fund, but are traded on securities markets. Therefore, those prices are set by market forces. United States experience demonstrates that the securities of closed-end funds rarely trade at their net asset value. They more frequently have traded at prices below that value, although securities of some funds at times have traded at a premium.

13. Under United States requirements, the price the investor receives or pays is a "forward" price, that is, the price next calculated after the fund receives the redemption or sale request. The requirement for forward pricing as opposed to a "backward" price, that is, a price based on the previous valuation of the fund's assets, assures that an investor will not receive or pay a price that currently does not reflect true asset value because of intervening market changes. Prior to the forward pricing requirement it was not uncommon for insiders, with their access to information relating to fund assets, to take advantage of changes in portfolio values. Upon learning that the value of the fund's assets had risen, they would place an order for fund securities at the previous price. Dilution of the fund's assets resulted because the price paid for the securities issued by the fund was less than the asset value at the time of sale. As a result, the existing fund security holders experienced a decline in the value of their securities. A similar result occurred under backward pricing whenever a fund redeemed its securities at a price greater than the current asset value. In that case, the redeeming security holders would benefit at the expense of all other security holders.

to the fund for redemption, he must receive payment within seven business days. Recently it has been proposed in the United States to allow a fund as much as one month to pay the proceeds of a redemption request. That proposal would permit an open-end fund to invest in securities of lower liquidity than is allowed under the present redemption requirement, because it could sell investments more gradually to meet redemption requests. As a result, the market impact of such sales would be lessened.[14] If investment funds should begin operating in Bulgaria before broad markets exist, it might be sensible to consider a similar policy.

In France, fund shares must be repurchased when a holder makes a request although, under certain extraordinary circumstances, that right may be suspended.[15] The fund also must cease repurchase of its shares if the value of its assets falls below a minimum figure set by statute.

In Germany, the bank custodian of a fund's assets, with the assistance of the fund management company, calculates prices for sale and redemption. The prices are based on asset value and are calculated each day that the stock exchange does business. The value of a fund portfolio security is either the official daily exchange fixed price for a security traded on the exchange, or is based on market price. The monies paid by an investor for fund securities must be transferred immediately to the fund, although the time of payment for redemptions is normally provided by the contract between the manager and investors.[16]

In the United Kingdom, a unit trust manager must issue or redeem units at least twice monthly.[17] Prices may be either forward or "historic," that is, backward. But the manager must choose one method and disclose it in the fund documents given to investors. However, if valuations are made more than one business day apart, or if the manager believes that net asset value has moved more than two per cent since the last valuation, historic price may not be used.

The European Community's UCITS Directive requires UCITS to repurchase or redeem units upon a unitholder's request. That right can be suspended only in exceptional cases. The method of valuation of UCITS assets for sale and redemption must be provided by law or fund rules or, if applicable, instruments of incorporation. There is no express provision for either forward or historic pricing. UCITS must make prices public at time of sale or repurchase, and prices must be published at least twice a month. However, there is no express provision prohibiting redemptions at intervals longer than twice a month.

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14. Under that proposal (which the SEC may decide to modify) a fund would still have to price its securities on any day it received a purchase order. Of course, a fund could decide not to offer its shares continuously, in order to avoid the daily pricing requirement. Bulgarian funds could determine to sell their shares at stated intervals and price only on the dates of sale. Such a policy would appear sensible where markets are thin.

15. A provision in United States law similarly allows suspension of redemptions under limited, extraordinary situations.

16. As noted earlier, in the unitary type of investment fund, required in Germany and a number of other countries, a contract exists between manager and investor.

17. The unit trust is the form of fund marketed publicly in the United Kingdom.

B. Requirements as to Custody of Fund Assets

In the United States, virtually every fund employs a bank as custodian of its assets. Although the Investment Company Act also permits self-custody or custody with a broker/dealer, the SEC has imposed requirements that make it difficult or impractical to use other than a bank custodian.[18] The SEC has also stated that the custodian bank may not be an affiliate of the fund's investment adviser/ manager.[19] The custodianship agreement requires the fund to send the custodian bank the names (and signatures) of those persons authorized to direct the bank to settle portfolio securities transactions and to pay out the fund's money. The custodian should not pay out money until it has received securities, or deliver securities until it has received money. The fund must keep its money, as well as its portfolio securities, with its custodian. A fund may have more than one custodian and there may be sub-custodians so long as all custodial safeguards are fulfilled.

An investment fund in France must keep its assets with a custodian or "depositary" that is "unique and distinct" from the fund. The Minister of the Economy maintains an approved list from which the fund must select its depositary. The depositary must take "appropriate measures to assure the safety of . . . transactions." Although the depositary may allow third parties to hold fund assets, the depositary's duty with respect to those assets is unchanged.

In Germany, the Federal Banking Supervisory Authority must approve any custodian bank holding fund assets. An approved bank can be a German bank or a branch in Germany of a bank from another EC member state. The directors and officers of the custodian may not be employees of the fund management company; nor may directors and officers of the management company be employees of the bank. The custodian bank must act in the interest of investors. If the management company instructs the bank to perform actions contrary to the fund's contract with the bank, the bank must refuse to carry out those instructions.

In the United Kingdom, a fund must keep its assets under custody and control of a trustee, incorporated in an EC member state, authorized under the Financial Services Act, and independent from the manager. The trustee may appoint sub-custodians, subject to certain regulatory conditions.

The UCITS Directive requires that UCITS assets must be entrusted to a depositary for safe-keeping. No single company may act as depositary and fund management company. A depositary for a unitary or contract form of UCITS also must

18. Many American Investment Company Act experts consider the self-custody provisions to be a deficiency in the Act, and believe that custody should always be in the hands of a third party.

19. In such a situation, the custody would be considered as self-custody. Under United States law, the term "affiliate" refers generally to someone in a position of power or control, whether through official position or stock ownership. An affiliate may be a person or a company. Occasionally, this paper uses the term "affiliate" in connection with non-United States funds to indicate generally persons or entities with influential relationships with the fund. See also note 20.

determine unit value and carry out the manager's instructions unless contrary to law or the fund's rules. The depositary must be subject to "public control" and its registered office must be in the same Member State as the management company (or the investment company, if the fund is the corporate form). The depositary is liable for losses if it does not exercise a reasonable standard of care.

C. Dealings of the Fund with Insiders or Affiliates

In the United States, limitations on the ability of insiders, or "affiliates," to engage in transactions with the fund are considered to be at the heart of the Investment Company Act.[20] Although certain revisions have been adopted over the more than 50 years of the statute's existence, the basic restrictions remain in place.[21] Under the Act, insiders are prohibited from selling securities or property to the fund, and from purchasing securities or property from the fund.[22] These restrictions recognize the potential for insiders to use their power over the fund to sell or purchase assets at unfair prices.[23] It should be noted that under this restriction, an affiliated broker/dealer may not sell securities as a "principal" to the fund, that is, securities that the broker/dealer owns, or purchase securities from the fund. An affiliated broker/dealer can, however, receive "customary" commissions, or fees, from the fund for brokerage transactions. Also prohibited by the statute are loans from the fund to its affiliates. The statute prohibits, as well, an affiliate from engaging in a "joint transaction" with the fund. That prohibition recognizes the danger of an affiliate using the assets of the fund unfairly in a joint venture or arrangement.[24]

Other jurisdictions with investment funds generally also place limitations on fund transactions with related persons. But the extent of those prohibitions in the United States exceeds what most regulation elsewhere imposes. Nonetheless, it

20. Under the Investment Company Act, an affiliate (or "affiliated person") of a company includes its directors, officers, the investment adviser, any person owning five per cent or more of the company's voting securities, and any person "directly or indirectly" controlling the company. ("Person" can refer to an individual or a company.)

21. While the United States Investment Company Act severely restricts affiliated (and various other) transactions, it is important to remember that the statute also includes provisions permitting the SEC, the regulatory authority, to exempt transactions, upon written application. The application must establish that the proposed transaction is fair, and is consistent with the interest of investors, the fund, and the statute. The SEC must give public notice of any exemptive application prior to granting it, and must give "interested" persons the opportunity to object.

22. Normally, a fund will have little or any "property" other than its portfolio securities and currency on hand.

23. This discussion does not relate to the prices of securities that the fund itself issues. The price at which those securities must be sold and redeemed by the fund depend upon their net asset value, as previously discussed, and are covered by other provisions of the Investment Company Act. Affiliates may purchase securities issued by their fund, and redeem those securities, like any other investors.

24. A general prohibition also exists against a securities underwriter affiliated with the fund selling to the fund any security during the time the underwriting group is offering the security for sale. The obvious danger in such a situation is that the underwriter/insider may be tempted to "dump" into the fund's portfolio a security that is proving difficult to sell.

is undeniable that the prohibitions on dealings by or with affiliates have played an enormous role in maintaining the honesty of United States fund operations and public confidence in the funds.[25]

In France, the depositary (custodian) and the management company must act for the sole benefit of the fund investors. One of the depositary's duties is to ensure that the fund's transactions are in accordance with the law. Under French law, the depositary and management company must take "appropriate measures to assure the safety of their transactions." French law places percentage limits on a fund's acquisition of certain pools of securities where a controlling entity of its management company transfers the assets to the pool.

Under German regulation, a German fund may not purchase assets from, or sell assets to, members of the executive and supervisory boards of its management company. There is, however, no direct regulation against transactions with related parties, such as shareholders of the management company. In Germany, these shareholders are commonly banks, the major securities traders. The management company is held to the general standard of "the diligence of ordinary businessman" for any such transaction with a related bank or other party. In addition, purchases above market prices and sales below market prices are prohibited. Germany has also adopted for its own funds (with certain exceptions) restrictions contained in the UCITS Directive against a fund's purchases of securities of another fund managed by the same management company or by a management company with certain connections to the first fund's management company.[26]

Regulations in the United Kingdom do prohibit certain transactions or services between the fund manager or trustee (or their affiliates) and the fund. Exemptions are available where the proper price or value of the asset may be independently determined, or the best available deal is obtained (where the asset is exchange traded), or where the deal meets certain principles of fairness by satisfying what is often referred to as "arm's-length" standards.[27] Brokerage transactions with affiliates that meet standards of fairness are permitted. United Kingdom regulations do not address joint transactions. United Kingdom funds may not engage in lending.

While the UCITS Directive does contain a number of requirements pertaining to UCITS operations including qualifications of directors, investment advisers,

25. The SEC has used its exemptive authority frequently to permit transactions with affiliates that are shown to offer no problems.

26. Under United States law, purchases by an investment company of shares of other investment companies are significantly restricted. The reasoning behind that policy is the fear that an investor would not only pay the various fees, charges, and expenses of the investor's direct fund investment, but would indirectly pay similar charges of the funds in which the first fund was investing. It is also believed that the benefits of one fund investing in other funds are questionable, and generally do not outweigh the disadvantages.

27. An "arm's-length" transaction refers to a situation where the parties reach an agreement that is fair by objective standards, and is not influenced by the relationship of the parties. One way to achieve such a result is to retain independent experts to determine value.

and custodians, there are no provisions expressly regulating transactions and possible conflicts of interest between a fund and its manager, other affiliated parties, or its custodian.

D. Regulation of the Fund Manager's Fees

In the United States, the Investment Company Act imposes a "fiduciary duty" upon a fund's investment adviser, that is a duty of trust and faith, with respect to the amount of payments or fees paid to the adviser. A fund security holder as well as the SEC may bring a legal action against the adviser claiming that amounts paid to it were excessive. It should be noted that the law does not apply only to the amounts received for advisory services, that is, the selection of the fund's investments; rather, the amounts received by the adviser (or its controlled companies) for any non-advisory services may also be included for purposes of an excessive payment determination. The excessive fee provision applies even though the law also requires the adviser to receive the approval of the fund's independent directors and shareholders before it can receive payments under a new advisory contract. In addition, after an advisory contract has been in effect for two years, the law requires the directors or the shareholders to re-approve it annually.[28] The adoption of the excessive fee provision in the statute arises from its underlying philosophy that there is a potential conflict between the manager and the fund as to fee levels, which is not solved by the required shareholder and director approvals of advisory fee contracts. Therefore, the statute should provide a remedy to the fund and its shareholders. Although all fees and charges are required to be clearly stated in fund prospectuses, full disclosure has never been considered a solution for conflict issues and other problems of substance that relate to investment companies.

French law does not place any limits on fees paid to the sponsor/manager by French funds.

Similarly, German law does not provide limitations on the amount of charges that a fund may pay from its assets. The philosophy, which is the general approach in those jurisdictions where the unitary or non-corporate form of fund prevails, is that the amount of charges is a pricing issue which can best be decided in the marketplace. The contract conditions, which are a part of the prospectus, and the purchase application must clearly disclose all charges.

In the United Kingdom, the regulations allow a periodic charge against a fund's assets for management compensation. The regulations require that the trust deed authorize the charge, state the maximum rate, and specify the method of calcula-

28. Court cases alleging excessive fees have been notably unsuccessful. One reason is undoubtedly the relatively low fee structure in the United States fund industry. Certainly the existence of the fiduciary standard in the statute has played an important role in restraining fees, although the intense competition among funds to attract shareholders with lower costs has also played a part, particularly in recent years.

tion. The requirement that funds present this information in a uniform manner is intended to enable investors to compare fee structures of different funds. The Financial Services Act specifically prohibits regulations from setting any maximum fee level. While the trust deed states the maximum charge (two per cent is common), the prospectus-like document called the "scheme particulars" may specify a lower percentage. However, the fund manager can itself increase the level of charges up to the stated maximum upon notice to investors. The increased charges take effect from 90 days after revised scheme particulars are published. Any amendment of the maximum fee rate in the trust deed requires the approval of investors with 75 per cent of fund units.

The UCITS Directive does not specifically set maximum fee rates. However, it does provide that the law or fund rules must set forth the compensation and expenses that an investment adviser may charge, and the method of calculating those payments. There is no limitation as to management fee structure. It would appear that an "incentive" fee as well as an all inclusive type is permissible.[29]

E. Disclosure and Information Relating to the Fund for Potential and Existing Fund Investors

Investors or potential investors in an investment fund should receive correct, current, and adequate information about the fund. In this respect, investment funds are no different from any company that has sold or proposes to sell its securities to the public. In general, therefore, many of the information requirements of securities laws apply equally to investment funds.[30] But, as indicated previously, investment funds present a number of issues which differentiate them from other undertakings.

One matter that requires special consideration is advertising. Unlike other companies, it is common for funds that issue redeemable securities to offer their securities continuously to the public. In addition, the only "product" sold by an investment fund is its securities. Whereas industrial companies, such as automobile or clothing manufacturers, are generally free to advertise what they sell, an advertisement by an investment fund of its "product" is really an effort to sell its securities. As such, it is essential that fund advertisements do not contain

29. Under an incentive fee, the adviser's payments depend directly on the fund's performance. In other words, if the fund's portfolio rises in value, the adviser shares, often substantially, in the gains. This type of structure is in contrast to an all inclusive manager's fee, or to an advisory fee as a fixed percentage of fund assets. Of course, even in the fixed percentage fee situation, an increase in value in the fund assets will result in greater fees to the adviser. However, the percentage of the fee to total assets remains constant. Also, a decrease in value of fund assets will cause a proportionate decrease in fees. With certain exceptions, incentive fees for fund managers in the United States are not permitted. That prohibition arose mainly from experience with fund managers taking undue risks with fund assets in hopes of realizing substantial gains, and, therefore, substantial advisory fees. The result frequently was that the fund suffered substantial losses resulting from the adviser's speculation.

30. See *A Concept Paper on Securities Regulation for Bulgaria*, especially the material therein under Disclosure Regulation.

misleading information. Another advertising issue is whether to allow readers of a fund advertisement to purchase securities on the basis of the advertisement before receipt of a formal prospectus (the practice in a number of European countries) or whether the advertisement should serve only as a means for the potential investor to send for a prospectus (the United States practice).[31] In addition, if sales are allowed from the advertisement, the specific information it should contain must also be determined.[32] Since advertising is outside the areas covered under the UCITS Directive, it will be necessary for UCITS to comply with the advertising requirements of the Host State.

Clear disclosure of an investment fund's investment policies and objectives is essential for investors. They must be able to understand the types of securities the fund intends to invest in, its goals in making those investments, and whatever risks may result. It is important for the potential investor to understand policies and objectives and equally important for the existing investor to be aware of any changes proposed by the investment manager. A number of jurisdictions require approval of security holders before management may change certain policies.

In the United States, when a fund registers with the SEC, it must set forth its investment policies and a number of other "fundamental" policies, that is, those that cannot be changed without a vote of its security holders. Among these are whether it will have a "diversified" portfolio, and whether its investments will be concentrated in a particular industry.[33] As is true for public sale in the United States of any securities, the buyer of fund shares, if not already in possession of a current prospectus, must receive one before or at the time of investment. The prospectus must contain information as to policies, objectives, fees, past performance, and other matters. Funds also are required to keep their investors informed of material information on a regular basis and must send them semi-annual financial statements.

In France, among the materials a fund must file with the Commission des Operations de Bourse ("COB") when making a public offering of its securities is a description of its investment objectives. The fund must describe its objectives in any selling document for its securities, and also in periodic reports, required

31. The type of information required in a prospectus is normally determined by the fund regulatory authority.

32. In the United States, the SEC staff has recently recommended statutory changes that would allow sales to be made from advertisements, prior to receipt of a prospectus. The advertisement would be required to contain information such as fees and expenses, the fund's performance record, investment objectives, and investment risks. Furthermore, the fund would still be required to deliver a formal, or statutory, prospectus. Also the advertisement, to the same degree as the formal prospectus, would be subject to liabilities for misstatements.

33. Under United States law, a "diversified" fund refers to one that (except for 25% of its assets) does not have more than 5% of its assets in securities of a single issuer. It is noteworthy that, in the United States, a fund's investment objectives or the types of securities it may invest in are not "fundamental" matters requiring a shareholder vote. Of course, the manager has the obligation under general securities law principles to disclose changes in those matters.

under law annually as well as semi-annually or quarterly. The reports must also describe certain financial and other information.

German funds must set forth investment policies and objectives in the conditions of contract between the manager and investors, and the prospectus must explain the policies and objectives. Any changes must be approved by the Federal Banking Supervisory Authority. Changes in policies and objectives usually do not take effect for three months, which enables investors who disapprove of the changes to redeem their investment. German law contains a number of investment restrictions for German funds, in accordance with the UCITS Directive. Also, German funds must issue and keep current a prospectus containing all material information relating to the evaluation of fund securities. In addition to policies and objectives, this requirement includes, among other things, information on management and the custodian, issuance and redemption of securities, and tax regulations. Also, the funds must publish annual and semi-annual reports and make them available free of charge to investors.

In the United Kingdom, the scheme particulars (the prospectus-like document) must set forth the investment objective and policies of the fund. The trust deed (a basic document of the fund) must contain any investment restrictions relating to geographic areas or economic sectors. Unitholders must approve, at a general meeting, any changes to the above. (Trust deed changes require at least a 75 per cent vote of unitholders participating.) Fund managers must also comply with a number of regulations relating to investments, derived from the UCITS Directive. Generally, the disclosure system in the United Kingdom under its Financial Services Act is similar to that in the United States. The scheme particulars must be kept current and amended at least annually. Unlike in the United States, the scheme particulars do not have to be delivered, but must be offered to an investor before purchase. In practice, scheme particulars are often not requested by investors, who may purchase on the basis of advertisements. If an advertisement is the type inviting purchase, it is required to disclose a number of items of importance.

The UCITS Directive contains detailed requirements concerning UCITS investment policies. With limited exceptions, a fund's investments must consist of transferable (liquid) securities admitted to listing on a Member State stock exchange or traded on another regulated exchange. A UCITS generally may not invest more than five per cent of its assets in transferable securities of a single issuer (company). UCITS may acquire securities of other UCITS that are governed by the UCITS Directive.[34] A UCITS may generally not acquire voting securities of any issuer that give the UCITS or its manager "significant influence" over the management of that issuer.

A UCITS must publish a prospectus (which must be kept current) as well as prescribed periodic reports. The prospectus must enable investors to make an

34. But see note 26 concerning investments by a fund in other funds.

informed judgment of the investment.[35] The annual report must contain audited financial statements and other information.[36] There is no requirement for delivery of any documents prior to or at time of purchase of the fund's securities. However, the prospectus and the latest reports must be offered without cost before the contract is concluded. The fund's periodic reports must be available to existing fund security holders, at specified locations, without cost. The reports must be supplied without charge to security holders who request them.

F. Limitations as to Capital Structure, Particularly Classes of Securities

As a general rule, it is extremely important that a fund's capital structure be kept simple. The most simple structure would be a single class of securities, which means that each investor has the same rights, and is getting exactly the same type of interest as every other investor. When a fund is allowed to issue different classes of securities, the rights and privileges of each are often difficult for investors to understand. Furthermore, the classes may have competing and/or unfair provisions. While fund borrowings result in the issuance of a type of debt security, they are generally allowed. However, it is the general practice for fund regulation to restrict severely the extent of fund borrowings.

Funds in the United States may issue one class of redeemable common shares with equal voting rights. The issuance of "senior securities" (debt and preferred stock) is prohibited except that a fund may borrow from banks. Immediately after the borrowing the fund must have a 300 per cent asset coverage.[37]

France permits its funds to issue only one class of shares, essentially non-voting. Thus, shareholders in French funds have no control over management. A fund may borrow up to 10 per cent of its assets.

Germany allows its funds to issue only a single class of certificates, each representing an equal share of fund assets. Borrowings are limited to the UCITS Directive requirements, that is, up to 10% of assets and on a temporary basis.

In the United Kingdom, the permitted capital structure is similar to that in the United States. Borrowing is limited to 10 per cent of fund assets, and, essentially, may be only for temporary purposes.

It is not clear whether the UCITS Directive permits the issuance of more than one class of security. Borrowing, as previously noted, is substantially limited and must be temporary.

35. The prospectus must contain at a minimum the information provided for in Schedule A of the UCITS Directive.

36. Required information is set forth in Schedule B of the UCITS Directive.

37. Thus, for example, a fund with $2 million in assets could borrow $1 million from a bank or banks. After the borrowing, the fund would have $3 million in assets and $1 million in borrowings, a three to one ratio and, therefore, a 300% asset coverage.

V. Other Regulatory Matters

The Bulgarian regulatory authorities should also consider how they wish to approach the following issues.

A. Merit Regulation of Fund Managers

Regulation of the competence or qualifications of fund managers, often referred to as "merit" regulation, is not included in United States law. Although investment advisers must register with the SEC, there are no requirements under the law as to education, training, or experience. Only a history of dishonesty or criminal behavior in securities related matters will disqualify a person from serving as an investment adviser.[38]

In contrast, merit regulation of fund managers is much more common in Europe, and may well become universal in view of the UCITS Directive which requires local regulators to pass upon the qualifications of investment managers.

B. Exemption of Certain Funds from Regulation

Regulatory authorities may wish to consider if the investment fund statute should exempt certain categories of funds from regulation in whole or in part. In the United States, for example, the Investment Company Act expressly provides, in effect, that funds that do not attempt to make a public offering, and do not have more than 100 security holders, are not regulated as investment funds under the statute. The idea behind this provision is that it is impractical to attempt to regulate every private investment company, such as groups with family or other close personal relationships. Of course, a danger exists that some promoters or managers will try to use such an exemption in situations where it is not warranted.[39]

C. Taxation

The approach to taxation of investment funds must also be considered. As a general matter, every country where investment funds are sold tries to put fund investors in the same tax position as if they owned fund portfolio securities

38. Such behavior also disqualifies anyone from serving as employee, officer, director, or underwriter of an investment company.

39. Another consideration is whether to exempt funds that offer their securities only to individuals or entities that are financially sophisticated and/or possess significant financial resources. The basis for that approach would be that such persons themselves possess the necessary knowledge and experience to judge the merits of fund securities. While this approach has not yet been adopted in the United States, it is presently being given serious thought. It is, however, probably wise to defer consideration of this type of exemption until the fund industry has reached a relatively mature condition. It should be stressed that any funds exempted from the specific fund regulatory statute because of the limited number of investors and/or their financial sophistication should nonetheless remain subject to general securities law anti-fraud provisions that prohibit material misstatements or omissions in connection with the sale of securities.

directly. If there were a double tax, that is, on both the fund and the investor, investment in funds would be discouraged. Accordingly, every country with a fund industry has enacted tax provisions that recognize the unique nature of investment funds.

In the United States, as a general matter, if a fund distributes annually substantially all of its income and realized capital gains to its shareholders, it is entitled to so-called flow-through tax treatment. By that, it is meant that the fund shareholders pay taxes on those amounts, while the fund does not. Although some European countries do not go quite so far as the United States, others, such as Germany, virtually ignore the fund as a separate entity for tax purposes. It is worth emphasizing once more that the goal of all countries with funds is fair tax treatment of fund investors, without which the industry would be unlikely to thrive or even survive.

D. Closed-end Funds

Unlike an open-end fund, a closed-end fund does not issue redeemable securities. Instead, its securities are traded on the market, like any other company. (See note 8 above.) While the UCITS Directive (notes 3 and 8 above) requires UCITS securities to be redeemable, closed-end funds could exist within Bulgaria, absent specific statutory prohibition. If closed-end funds, whose purpose is investing in securities, are permitted, then they, like open-end funds, would warrant comprehensive regulation.[40]

However, there may also develop a type of company whose status is less easy to define, but which has some of the characteristics of a closed-end fund, and therefore, raises some of the same concerns. This type of entity would be a limited liability company, publicly owned, with a large part of its assets consisting of "investment securities." Such a company should be made subject under the investment funds statute to special requirements or regulation in addition to those applicable to companies engaged in ordinary trade or commerce. For this purpose, investment securities may be understood to include all securities except securities of majority-owned subsidiaries, securities issued or guaranteed by the national government or national bank, bank deposits, and short-term debt instruments.

While the threshold, or beginning point, for applicability of the special requirements may be defined in various ways, one approach would be to subject a company to those requirements if the fair value of its investment securities were to exceed 40 per cent of the value of the company's total assets. This calculation should be made monthly or quarterly. Since it may be difficult for the regulatory authority to be aware of the asset composition of every company, each company

40. A major regulatory difference would relate to the pricing of securities. As noted, securities of closed-end funds trade on the market whereas those of open-end funds are sold and redeemed at net asset value.

itself should bear the responsibility to ascertain at the end of each period whether its investment securities have exceeded the 40 per cent limit. Any such company should be subject to at least two requirements in addition to the customary requirements for ordinary business entities. First, it should be required to publish quarterly, or even monthly, the fair value of its investment securities. Second, it should be subject to the same restrictions as are investment funds on transactions with related, or affiliated, parties.[41]

E. Enforcement of Regulation

A regulatory statute will not be effective unless it can be enforced. Thus, any law regulating investment funds must provide remedies for those who are harmed and penalties for those responsible for the harm. Since enforcement and remedies pertaining to securities law violations generally will apply to similar violations concerning investment funds, reference should be made to the *Concept Paper on Securities Regulation.* As to specific violations of the investment fund statute that are not covered under other securities laws, the regulatory authority must be given the power to bring legal proceedings, to impose monetary penalties, and to suspend or even prohibit persons from serving or managing investment funds, depending on the seriousness of the violation. As with other securities laws, a decision must be made whether to give fund security holders themselves the right to sue the fund management for wrongdoing. The alternative would be a requirement that security holders bring the matter to the attention of the regulatory authority, who would then take legal action, if deemed appropriate.[42] In addition, the statute must give the government authority to bring criminal actions for serious wrongdoing, such as fraud, theft, and embezzlement.

41. At what point the special requirements should apply is an issue that must be settled. One approach would be to require compliance if the 40 per cent limit is exceeded for two consecutive reporting periods. The requirement could be removed thereafter only if investment securities were to fall below 40 per cent for two consecutive reporting periods.

42. See the discussion in the *Concept Paper on Securities Regulation* pertaining to legal actions by security holders (paragraph 3.d.).