

IS THE IDEA OF BULGARIAN MUTUAL FUNDS STILL BORN?

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The latest amendments to the Public Offering of Securities Act were promulgated on May 10th 2005. They seem to have created a new investment niche on the Bulgarian capital market for small and medium-sized investors – these are the mutual funds or contractual funds as the legal term is. This way of making joint investments by a group of people with similar predispositions to the market is new for Bulgaria and was highly acclaimed by Bulgarian fund managers. Mutual funds are similar to the already familiar open investment companies. Both mechanisms to organize investment activities are based on the principle of raising capital from the public in a strictly regulated environment – through public offering of their securities on the floor of the Bulgarian Stock Exchange.

Just like open investment companies, the mutual funds (the general term for which is “collective investment schemes) invest in different types of securities under certain legal restrictions and under the control of the Financial Supervision Commission. The management of assets in both forms is carried out by a managing company licensed by the FSC (or another supervisory institution within the EU). Within the restrictions imposed by the legislation, each fund manager invests the assets following a risk profile set by the prospect of the investor scheme (high-yield, balanced, conservative).

One of the greatest advantages of collective investment schemes is their exceptional liquidity – the company or the fund (to an extent) are obliged by the law to buy back all securities issued by them at the end of each working day at a price set through transparent methods and published at least twice a week. These are the chief similarities between the two types of investment schemes.

What are the differences and what are the advantages of contractual funds? The fund, as is made clear by its legal definition, is not a separate legal entity, but is a designated group of assets and liabilities. The assets owned by the contractual fund are separate from the assets of the managing company and those of the rest of its clients and therefore its creditors cannot enforce their rights against them; the managing company shall draft an independent report on the fund, which shall be subject of an independent audit by a registered auditor; the restrictions on the fund’s expenses that are valid for open investment companies are also in force – not more than 5% of the average annual net value of the fund’s assets. Other than that, however, the contractual fund has no management bodies, thus it has no legal capacity. This means a shorter and more flexible procedure for taking managerial decision (there is no necessity to pay remuneration to board members or executive directors, to call general meetings and to carry out registration procedures) as well as no risk of hostile takeover of the fund and replacement of the managing company, which are the chief sources of worry for open investment companies because of their public nature and high liquidity.

Another chief difference between the two kinds of collective investment schemes is the obligatory minimum capital of 500,000 levs, which open investment companies must have by the date they receive their operational licence (it is not a secret that the raising of the initial obligatory capital of an investment company is carried out entirely by the shareholders of the managing company). There is no such requirement for contractual funds and the public offering of their shares can begin practically without any assets and the minimum obligatory threshold of the net value of the assets of the funds, 500,000 levs, can be reached within a year as of the issuing of a licence to organize and manage a contractual fund.

From an investor’s point of view, contractual funds mean minimization of expenses on management, while from the point of view of a managing company they are an opportunity to create a multitude of schemes with different investment profiles and different possibilities for investors as setting up funds is quicker and cheaper than setting up investment companies, there is no threat of a hostile takeover, there are no clumsy legal procedures and the founders of the investment scheme do not have to raise the initial capital themselves. Such a relief for the major players on the financial services market presupposes a more fierce competition on this market and the opening of more and more attractive investment opportunities, which predetermine a better return on investments, spur the development of the entire capital market and of the entrepreneurs who seek fresh capital.

This sounds great. However, the whole idea has been corrupted by a single legislative slip, be it intentional or accidental). The transitional and final regulations of the POSA, which have to harmonize all the other laws with the latest amendments, do not put on an equal footing the taxation of incomes coming from making capital profits from trade (and/or) buyback of shares of open investment companies on the one hand, and shares of a contractual fund, on the other hand.

This means that if you buy shares in an investment company and later sell them to a third person or to the investment company itself at a profit, this profit will not be subject to taxation. If, however, you buy shares in a contractual fund (which are also traded on the Bulgarian Stock Exchange) and sell them at a profit, this profit will be included in your taxable income. Given that open investment companies and contractual funds have the same economic sense and only their organizational structure is different, this difference is in contradiction with Article 19, para.2 of the Constitution, according to which the law guarantees to all individuals and legal entities **equal legal conditions for economic activities**. Regardless of this, what you rather invest in – in shares of open investment companies, the profit from which will not be subject to taxation, or in contractual funds?

The situation is not going to change until the time a new parliament is elected and once it starts functioning, the amendments to POSA are not likely to be among its top priorities. Thus, under the most optimistic of all scenarios, a good idea will be nothing but an idea for at least six months. The time has probably come to think about who benefits from this situation and whether the attempts at simulating harmonization with EU legislation could be of any use given such legislative “slips”...

This article is analytical in nature and cannot be interpreted as an individual consultation, which takes into account concrete situations and participants. Despite our efforts to offer accurate and up-to-date information, there is no guarantee that it will remain so after the publication day. For more information on the above mentioned issues and for individual consultations, please contact the author – attorney at law Mandazhieva, at mandazhieva@tmlawoffice.bg or office@tmlawoffice.bg