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INVESTMENT FUNDS IN RUSSIA

I. 1. INTRODUCTION

In the late 1980's a fascinating transformation began in all Eastern European countries. Radical reforms of the financial system were necessary, due to the transition to a market economy. In October of 1994, after three rounds of privatization, half of Russian industry was in private hands (1). Investment funds have had a major role in privatization. Everybody recognized the need to shift ownership of the majority of state assets to the private sector; the problem was to choose the proper means for efficient privatization. Through the voucher program, whose principal objective was to divide state property among the citizens, all people had an opportunity to be active participants in the transformation to a market economy. The personal vouchers could be used to buy shares in investment funds.

"Of the 147 million vouchers that have been issued, 44% ended up invested in voucher fund, the special purpose bodies created to act as institutional investors on behalf of individual voucher holders. In ownership they are similar to western mutual funds, but unlike their western counterparts, which are generally limited to 5% of company's share capital, they can hold up to 25%". (2)

This paper will analyze the development and the legal framework for investment funds in Russia. It opens with a review of problems inherited from the centrally-planned economy and examines the role of investment funds in privatization. The next section scrutinizes the investment funds' types, structure and regulation, concentrating on capital structure, registration of securities issues and licensing of investment funds, investment activities, investor rights and protection, funds' board of directors, management and control, and safeguarding of fund assets. The final part presents current legal developments in the securities market and discusses possible solutions and challenges that Russian investment funds will face in the future.

2. PRIVATIZATION

In order to understand investment funds it is also necessary to understand the economic conditions under which the privatization program was introduced. Russia has faced macroeconomic difficulties from the beginning of its economic transition. The first

(1) P. Lewis, *The Russian Funds Are Coming*, N.Y. TIMES, December 18, 1994.

(2) *Reuters telexline, Euromoney*, July 19, 1994.

concern was inflation, caused by the reduction or elimination of subsidies and decontrolled prices. Political and economic disintegration of the USSR contributed to the budget deficit, growing unemployment and declining industrial output. Some problems inherited from the period of centrally-planned economy that caused difficulties in privatization process were: many state enterprises had a significant portion of non-productive assets, there were no capital market and no other source of capital but the state, and the methods for valuation of state enterprise were designed for a socialist economy, not a market economy.

Most East European countries began their transition to a market economy before Russia was able to. Several years of debate and hesitant half-measures delayed the replacement of old economic structures with new institutions. One reason for Russia's gradual approach is that it has never had a significant capitalist tradition. In addition, there was strong political and intellectual opposition to market-oriented reforms and a powerful industrial and agricultural bureaucracy (3).

In late 1992 the government of enthusiastic young reformers introduced radical changes through the privatization of many state enterprises, the liberalization of prices, and the development of tight fiscal and monetary policy. The initial idea of privatization was to revitalize the economy and improve the efficiency of enterprises. The government's goal was to implement the privatization program quickly and involve a large percentage of the population.

Investment funds have had a major role in privatization. Their main purpose has been to reduce risk for their shareholders and to help create a securities market. In the first phase of privatization, state property funds were established as a transitional vehicle for transferring state property to private ownership. In the second phase, voucher investment funds were introduced to provide a larger scale of population participation in the privatization process. In the current third phase, other types of investment funds are envisioned as the Russian financial market evolves.

II. 1. PROPERTY FUNDS

The Russian Federation (RF) Privatization of State and Municipal Enterprises Act of 1991 (4) provided the legal and organizational principles for privatization in Russia. In addition, a set of laws, presidential decrees and regulations of various ministries and committees were issued as privatization proceeded (5).

The privatization process was entrusted to two different governmental agencies: the RF State Committee for the Management of State Property (in Russian - Goskomimuschestvo, of GKI) and Federal Property Fund (6). The GKI has been responsible

(3) Marek Dabrowski, *The First Half-Year of Russian Transformation* in CHANGING THE ECONOMIC SYSTEM IN RUSSIA, at 5, (A. Aslund and R. Layrad, eds., 1993).

(4) The privatization Act was adopted in July 1991 and amended in June 1992. *A translation of all Russian legal regulations referred to in this paper is found in Business and Commercial Laws of Russia*, (J.P. Hupp, and M.C. Swords, eds., McGraw-Hill, Inc., 1993) at the Law Firm Hale and Dorr, Boston.

(5) The following six forms of privatization were introduced:

- sale of shares in joint-stock companies,
- sale of enterprises at auctions,
- sale of enterprises on a competitive basis,
- sale of enterprises on the basis of non-commercial investment tenders,
- sale of property (assets) of liquidated enterprises or of enterprises due to be liquidated,
- a buy-out of leasehold property.

(6) The Russian administrative structure is similar to the of Czechoslovakian model, under which the privatization process is split among three separate bodies. See, Bernard Scheifele, *Privatizing Russia*, INT. FINANCIAL L. REV., April 1992, at 33.

for governing and supervising privatization while the Federal Property Fund, has been responsible for the sale of company shares and for distributing the proceeds from the sales (7). The GKI is also responsible for the assignment of property to the Russian Republic, the communes and towns (8).

Since the entire economy had to be privatized, both the GKI and Federal Property Fund established more than a hundred local offices at the state, commune or town level, known respectively, as State or City Property Committee and State or City Property Fund. Each Property Fund is responsible for the local sale of small and medium-sized enterprises, under the supervision of the corresponding City Property Committee (9).

In the first phase of privatization, ownership of all government-owned enterprises scheduled for privatization was transferred to an appropriate State Property Committee, which served, according to some authors, as their founder (10). The second step was to convert those enterprises into a corporation (11). The State Property Committee would then allocate assets and liabilities to these corporations, and then transfer all the shares to the appropriate State Property Funds (12).

Therefore, the shares in the privatized companies were initially issued to funds under the control of the appropriate property committees, which held them until the shares were sold to workers, managers, and investors. A portion of the shares in each entity was issued to the factory workers and to management, with favorable terms (13). For example, members of the workforce were granted 30 percent of equity free of charge and a 30 percent reduction on 10 percent of the equity (14). The rest of the shares (sometimes even the large portion of shares, including the controlling block) continued to be held by the State Property Fund for later sale to outside investors, including foreign buyers, through a combination of auction and tender (15).

The statute of Investment Funds enacted in 1992, imposed the following restrictions: a) investment funds cannot swap issued shares for shares of joint-stock companies established in the process of privatization which are held by the respective properties funds, in an amount in excess of five percent of the authorized capital of the investment fund, b) the properties fund may not hold more than five percent of the total number of shares of the investment fund (16).

(7) IMF (1993), *Economic Review*, Russian Federation, Washington D.C., at 47-51.

(8) See, Bernard Scheifele, *supra* note 7.

(9) See, IMF (1993), *supra* note 7, at 47.

(10) See, Bernard Scheifele, *supra* note 6, at 32. But compare with, M. Bornstein, *Russia's Mass Privatization Programme*, 6 COMMUNIST ECONOMIES & ECONOMIC TRANSFORMATION, at 425 (1994). According to Bornstein, the Federal Property Fund founds joint-stock companies.

(11) Almost all medium and large enterprises (formal criteria is number of employees (greater than 100) or book-value of assets (more than 50 mln rubles in 1992) and some smaller enterprises were transformed into joint-stock companies. A number of exceptions exist in the military industry, infrastructure, transport, etc., where privatization is restricted or prohibited. See, "Overview of the Russian Securities Market", study by RINACO Plus, October 30, 1994 (Internet).

(12) See, Bernard Scheifele, *supra* note 6 at 32.

(13) See, M. Bornstein, *supra* note 10 at 429.

(14) See, Bernard Scheifele, *supra* note 6, at 32.

(15) D.M. Ayer, Gibson, Dunn & Crutcher, Moscow, "Privatization Overview", in *Business and Commercial Laws of Russia*, (J.P. Hupp, and M.C. Swords, eds., McGraw-Hill, Inc., 1993), at 2-10.

(16) Clause 21 Statute of Investment Funds, *infra* 24.

2. PRIVATIZATION VOUCHER PROGRAM

The privatization program moved along more rapidly after the implementation of the voucher program (17). Privatization vouchers with a nominal value of 10,000 rubles were issued in late 1992 to each Russian citizen. The voucher program permits each voucher holder to invest in a company being privatized, either directly, by exchange of the voucher for shares in the company, or indirectly, by investment through a mutual fund (18).

Each citizen is free to use vouchers to invest in shares of whatever company he or she chooses or to exchange them for a share in a mutual fund. The voucher may be used to acquire shares in a company located anywhere in Russia, regardless of where the voucher is issued (19). Under the Statute of Privatization Vouchers, the privatization voucher is a specific-purpose state security. Each voucher is made out to the bearer, and it may be bought and sold without restriction. A privatization voucher which has been used once as means of payment in acquiring a privatization object is thereby redeemed and withdrawn from circulation (20). In addition, "vouchers collected by voucher investment funds can be used by "strategic" outside investors seeking a significant control stake in a privatizing firm" (21).

3. LEGAL FRAMEWORK FOR VOUCHER INVESTMENT FUNDS AND "OTHER" FUNDS

RF President's Edict No. 1186 of October 1992 provides for two types of investment funds: a) voucher investment funds, as a kind of specialized privatization investment funds, and b) "other" type of investment funds. The first one - "*voucher investment funds*" is controlled, regulated and licensed by the RF State Committee for Management of State Properties (GKI) on the basis of two Statutes: Statute of Specialized Privatization Investment Funds Accumulating (for the collection of) Citizens' Privatization Vouchers (22) and Statute of Registration of Shares Issued by Specialized Investment Funds Accumulating Citizens' Privatization Voucher (23).

Provisions for the "*other*" type are contained in the Statute of Investment Funds (24) which governs the establishment and operation of all types of investments funds in the Russian Federation (except specialized privatization investment funds for collecting citizens' privatization vouchers). The RF Ministry of Finance regulates, controls them and issues licenses.

The GKI keeps a state register of the shares of voucher investment funds. Registering agencies have to submit copies of share registers once every quarter to the GKI, and

(17) Edict Enacting RF System of Privatization Voucher; Statute on Privatization Vouchers, RF President's Edict No. 914, August 14, 1992 (Vouchers Edict).

(18) The vouchers issued in 1992 were valid until the end of 1993, at which time they expired if unused. But the expiration date was extended to June 30, 1994, See, Morris Bornstein, *supra* note 10, at 437.

(19) Vouchers may also be used to purchase apartments and certain types of agricultural land or may be sold or transferred or exchanged for goods.

(20) A. Postnikov, "*Commentary: Privatization Vouchers*", in *Business and Commercial Laws of Russia*, (J.P. Hupp, and M.C. Swords, EDS., McGraw-Hill, Inc., 1993), at 2-248.

(21) See, M. Bornstein, *supra* note 10, at 437.

(22) Statute of Specialized Privatization Investment Funds Accumulating Citizens' Privatization Vouchers is enacted as Annex No. 2 to RF President's Edict No. 1189, October 7, 1992.

(23) Goskomimushestvo Order No. 695-r, November 11, 1992.

(24) The Statute of Investment Funds is enacted as Annex No. 1 to RF President's Edict No. 1186, October 7, 1992.

also to the RF Ministry of Finance, for entry on the single state register. Even though two different government agencies are responsible for these two types of investment funds, the law entrusted the RF Ministry of Finance to maintain a single register of all investment funds. The reason for such a regulatory solution is to prevent the following investment activities:

- voucher investment funds cannot exchange stock issued by them for stock in joint-stock companies created during privatization and held by property funds
- investments funds cannot exchange stock issued by them for stock in joint-stock companies (created in the process of privatization and held by property funds) in sums exceeding five percent of the charter capital
- the number of shares of an investment fund held by property funds may not exceed five percent of the total number of shares of this investment fund (25)

4. VOUCHER INVESTMENT FUNDS

The voucher investment funds acquire vouchers and use them to invest in privatizing enterprises (26). Their investment activities are limited to shares only of newly privatized companies, not in real estate, futures and options, deposits, bills or other obligations. So far 650 private investment funds have been created, and compete for vouchers and convert them to diversified share holdings in newly privatized enterprises (27).

Initially they were organized as closed-and investment companies with the possibility to reorganize to open-end investment companies or mutual funds (28). With the consent of the licensing agency the voucher funds may be reorganized within three years of their establishment. Before giving a consent, the licensing agency has to verify whether the rights and legitimate interests of the shareholders are observed and whether any possible concealment, such as bankruptcy or indebtedness to creditors, occurred.

Reorganization can take the form of a merger of affiliation (takeover). The reorganization in the form of affiliation is effected by joining the assets of one fund to the assets of another, with an equivalent swap of shares and consolidation of balance sheets. The merger is achieved through the amalgamation of the controlling blocks of shares of the funds and assignment of the property rights and obligations of each to the newly merged fund (29). Since the period of three years of establishment for some of voucher investment funds has elapsed, it is reasonable to expect that many of them will reorganize into mutual funds. As a result of this new regulation to reorganize the voucher investment fund, the distinction between voucher funds and "other" investment funds will become blurred (30).

Due to the current difficult economic situation, most investment funds are not paying dividends. The enterprises in which funds' shares are invested are not profitable, and private investors have become impatient with the funds' ability to pay the expected

(25) Cluses 4 and 5 of the President's Edict No. 1186 of October 7, 1992.

(26) Some voucher investment funds are created for the purpose of protecting the population, in which more than 50 percent of shares belong to citizens needing special social protections, such as single pensioners, disabled persons, orphans, etc., See, *Decree on Vouchers for Social Protection* in ITAR-TASS, World Service, 28 October, 1992.

(27) See, D.R. Francis, *Ruble's Fall Roughens Russia's Reform Path*, in CHRIST. SCI. MONITOR, October 14 1994, at 9.

(28) In January 1994, RF State Committee for Management of State Properties Order No. 44-r enacted rules on coordinating reorganization of voucher investment funds.

(29) *id* Clause 3.

(30) RF State Committee for Management of State Properties Order No. 44-r, January 10, 1994.

dividends. As a result, many funds have stopped functioning or are selling vouchers on the stock exchange in the hope of making at least a one-time payment to investors (31). On the other hand, some funds are making high dividend payments out of investors' capital (32). According to some authors (33), information about the competitive potential of privatizing enterprises exists, but is not disclosed. Rather, the kind of information that investors might find useful has not been made public (34). Accounting issues are an additional concern, such as how to calculate net asset values, accounting for unrealized gains, merging of funds, and the valuation of vouchers as the privatization program moves into a new phase (35).

Due to their specific purpose and character, voucher investment funds' regulations differ in certain aspects from the regulations of "other" investment funds. The main differences exist in relation to restricted activities, capital structure, and compensation limits for the manager. These will be underlined while describing the provisions for the second type of investment funds.

5. "OTHER" INVESTMENT FUNDS

Clause 2 of the Statute on Investment Funds defines them as:

"any publicly held joint-stock company simultaneously engaged in activity consisting in the attraction of means through the issue of its own shares, investment of its own means in securities of other issuers, trading in securities, and also holding investment securities whose value comes to 30 and more percent of the total value of its assets in the course of more than four months, in sum, within one calendar year".

Clause 7 stresses again that investment funds shall be funded exclusively in the form of a publicly held joint-stock company. Therefore, other forms of legal structure, such as unit trust form, is not permitted.

Only two types of "other" investment funds are possible: open-end and closed-end funds. Open-end investment fund is defined as:

"investment fund issuing securities with obligation of their redemption i.e., giving the holder of securities of this fund the right to obtain, on demand, in exchange for these securities a sum of money or their property in conformity with the Bylaws of the fund".

Closed-end investment funds issue securities without obligation to redeem them. As already described, the voucher investment funds are organized as closed-and investment funds with no obligation to redeem their shares to shareholders, but with a possibility to reorganize to open-end investment fund (36).

One or more founders may establish an investment fund. The number of founders is not limited. Persons including properties funds, except limited organizations and institutions, may be founders and shareholders of investment funds (37).

Banks and insurance companies may not act as investment funds (38). But a bank, insurance company, or enterprise in whose authorized capital the share of banks or

(31) L.D. Nelson and I.Y. Kuzes, *Evaluating the Russian Voucher Privatization Program* in 36 COMP. EC. STUDIES no. 1 (1994) at 62.

(32) The four big voucher funds are: First Voucher Fund (worth \$168m - according to its estimate), Moskovskaya Nedvizhimost (Moscow Property) (worth \$50m - according to its estimate), Alfa Capital (with nominal capitalisation \$7,5m) and Neft-Almaz (Oil-Diamond) (with nominal capitalisation \$4.5m). See, Gregory Gransden, *Voucher Funds Come of Age*. EIU EASTERN EUROPE, November 14, 1994 at 8.

(33) id at 61.

(34) See also, M. Bornstein, *supra* note 10 at 443.

(35) See, *Russians seek accountants*, FIN. TIMES, E.E. MARKET, August 19, 1994.

(36) Clause 9 and 45 of Statute of Specialized Privatization Investment Fund, *supra* note 22.

(37) Clause 8 of Statute of Investment Funds, *supra* note 24.

insurance organizations is at least 60 percent, and which is not a depository of this fund, may be its manager. In order to get licensed to manage investment funds, banks and insurance companies have to meet minimum requirements issued by the RF Ministry of Finance and contained in the Regulation of Investment Fund Licensing.

5.1. Bylaws

Besides the statutory requirements on the content of joint-stock companies, the investment-fund bylaws (39) must contain the following provisions:

- designation of the investment fund as a publicly held joint-stock company
- the type of investment fund: open-end or closed-end; (*voucher investment funds* can be only closed-end)
- an investment declaration laying down the main purposes and restrictions of investment activity, maximum and minimum portions of authorized capital which may be invested certain types of securities
- the procedure for attraction of loan funds
- a statement to the effect that all the investment fund shares shall be ordinary shares with equal votes, participation in management, right to receive assets at the windup of the fund, and limited or unlimited periods of investment fund activity
- prohibition from creating any kind of special or reserve funds
- information on the place, procedure and dates of payment of dividends
- title of the investment fund must include the words "investment fund" or ("*voucher investment fund*") (40).

5.2. Capital

Clauses 12 and 13 of Statute of Investment Funds regulates the funds' capital. The authorized capital shall be determined at its founding from contributions by founders, and must constitute at least one million rubles (for *voucher investment funds* 500,000 rubles (41)). Founders have a duty to pay up 100 percent of the value of the authorized capital not later than 30 days after registration of the investment fund. The first subscription to investment fund shares shall be made not later than three months after the day of the investment fund registration. The capital may be paid only in cash, securities or real estate (for *voucher investment funds* regulation provides privatization vouchers as an additional means) (42). The proportional of real estate is limited to 25 percent of the funds capital.

The amount of authorized capital of *voucher investment fund* may be increased through the additional issue of shares and their sale or swap for money and privatization vouchers (43).

5.3. Registration of Securities Issues and Licensing of Investment Fund Activity

The investment fund can conduct its activity, i.e. issue, purchase, sell securities, advertise their activity and announce the sale of shares through the mass media, only upon obtaining a license. Registration of the share issue and licensing of investment fund activity is within the domain of RF Ministry of Finance for structures which have an authorized capital of not less than 1 billion rubles (44). All other Russian funds are licensed by finance

(38) *id* Clause 3.

(39) *id* Clause 9.

(40) Clause 10 of Statute of Specialized Privatization Investment Funds, *supra* note 22.

(41) Clause 13 Statute of Investment Funds, *supra* note 24.

(42) *id* Clause 14.

(43) Clause 14 Statute of Specialized Privatization Investment Fund, *supra* note 22.

(44) Clause 19 Statute of Investment Funds, *supra* note 24.

agencies of Russian constituent republics. Among other reasons, a license authorizing an investment company's activities can be suspended or recalled for:

- failure to provide authentic information, insolvency, a finding of guilty by a court of inflicting damage upon the fund's shareholders,
- stripping the manager (legal entity) of its license for certain types of activities,
- revoking the license of a manager (private person) or specialist who is subject to obligatory testing of its qualification certificate,
- and, violation of tax laws.

Registration of the share issue and licensing of *voucher investment fund* activities is within the domain of the State Property Committee (45).

5.4. Restrictions of Business Activity

The provisions of clauses 20 through 22 of the Investment Funds Statute limit the activities of investment funds.

In regard to issuance, investment funds cannot issue bonds, debt obligations, preference shares and other monetary obligations giving owners priority assets, as compared with holders of ordinary shares. Issuing guarantees of any kind and performing mortgage transaction is also prohibited.

Investment activity is restricted to securities with the exception of investment in state debt obligations. Funds cannot invest in securities of affiliated persons of the investment fund. *Affiliated person* is:

"natural or legal person (joint-stock company, partnership, state enterprise) its manager, directors and officers, founders, and also shareholders owning 25 and more percent of its stock, or an enterprise in which this person owns 25 or more percent of voting shares. Among the affiliated persons of a manager included are all investment funds concluding contracts with the manager on the management of fund" (46).

Moreover, investment in securities issued by the manager, depository, independent auditor, founder of the fund, or by shareholders in possession of five or more percent of fund shares, or by enterprises controlling or controlled by these persons is restricted. In addition, the fund cannot invest over five percent of its net assets in the securities of one issuer.

The fund cannot acquire voting shares of any joint-stock company where, upon their acquisition, an affiliated group of the investment fund (47) will own over 10 percent of that company's voting shares. Neither can it acquire and have in its assets:

- over 10 percent of the securities of one issuer (at nominal value)
- more than 15 percent of all bonds or debt obligations of one issuer
- the shares of other investment funds

Investment funds cannot swap issued shares for the shares of joint-stock companies founded in the process of privatization which are held by the respective properties funds, in an amount in excess of five percent of the authorized capital of the investment fund. The properties fund may not hold more than five percent of the total number of shares of the investment fund.

In addition to above restrictions, the *voucher investment funds* may not conduct the following activities:

- make investments in the securities of enterprises not registered in the Russia or whose core activity is not conducted on the RF territory

(45) Clause 22 Statute of Specialized Privatization Investment Funds, supra note 22.

(46) Clause 4 Statute of Investment Funds, supra note 24.

(47) Affiliated group of investment fund is defined in clause 4 of State of Investment Fund, as investment fund, manager of investment fund, and also affiliated persons of the given investment fund and its manger.

- make transactions not connected with investment activity, purchase option or futures contracts
- attract loan funds or issue bonds, preference shares or other pecuniary obligations
- acquire and have in its assets shares of other investments funds
- swap shares issued by the fund for shares of joint-stock companies founded in the process of privatization of which properties funds are holders

A *voucher investment fund* may not give investors guarantees, either in writing or through advertisements, of receipt of profit or income, or of appreciation in the value of fund shares (48).

5.5. Board of Directors

Between general meetings of the fund's shareholders, the board of directors is the governing body and has oversight responsibility. Shareholders determine the number of board directors, and legally it has to be an odd number, a minimum of five persons. The manager, the independent auditor, and also affiliated persons of the fund's manager may not make up the majority of the board of directors. Directors and officers of both the fund and the manager are required to:

- keep confidential any information obtained from the fund
- ask for the board of director's permission before consulting and contracting with any third person from the enterprise in whose authorized capital the fund has a stake
- ask for approval for any transaction where a conflict of interest (economic interest is a term that is used in Russian legal text) can arise (49).

Conflicts of interest are deemed to exist when members of the board of directors and the manager, as a result of a transaction, have working (labor) or civil-law relations, or have or will have the rights of an owner or creditor with respect to a legal person in whose authorized capital the investment fund owns a stake of five or more percent or which owns five or more percent of fund assets.

The board of directors is entitled to make decisions concerning all matters of Fund activity, with the exception of matters pertaining to the exclusive competence of the shareholders. It cannot delegate its powers to other persons or agencies.

Members of the board of directors are liable to the fund for any damage caused to it as a result of nonperformance or improper performance of their duties, as defined by the bylaws, and may also be liable to criminal and other prosecution under the RF law (50).

5.6. Management and Control

Management of the investment fund and control of its activity is regulated by RF regulations for joint-stock companies and provisions of the Statute of Investment Funds (51). An officer of the investment fund, authorized by the general shareholders, concludes a contract with the manager on the management of the investment fund, formation of the fund's securities portfolio and investment advice under the terms of the contract. The requirements of the fund's investment declaration (52) is binding on the manager (53). The manager's activity is controlled by the board of directors and by the depository.

(48) Clause 24-27 Statute of Specialized Privatization Investment Funds, *supra* note 22.

(49) Duties of Funds' board of directors are regulated in Section VII (clauses 19-22) of the Annex No. 3 to RF President's Edict No. 1186, called Model Bylaws of Investment Funds.

(50) *id* Clause 22.

(51) Clause 23 Statute of Investment Funds, *supra* note 24.

(52) The investment declaration is a part of a investment fund prospectus in which main purpose and investment policy is described as well as restrictions on investment activities.

(53) Clause 29 Statute of Investment Funds, *supra* note 24.

The fiduciary duty of the manager (54) is to ensure efficient management of the fund investments, securities portfolio and other assets to the best interest and benefit of all its shareholders. In addition, the manager has to: notify the board of directors about all of its decisions on fund investments, report on the fund activities, ensure that the fund's records and reports are correct and made in due time, do his utmost to safeguard the fund's interests, promote advertisement of the fund's activity, etc.

The manager cannot, directly or through third persons, make transactions for investment of funds assets in securities issued either by the manager himself or by persons either controlling the manager or under his control, or, without preliminary written consent of the fund's board of directors, in securities of enterprises in which the manager has an economic interest. Moreover, the manager may not transfer (delegate?) (55) his rights and duties to a third party.

Compensation (56): The maximum annual compensation is limited to five percent of the average annual value of assets. This sum includes the reimbursement of all the manager's expenses specified by statute. For voucher investment fund manager the maximum limit is ten percent (57).

Liability (58): The regulation of liability has a very general form and is not yet worked out in detail. It establishes that the fund manager is liable for damage caused by his acts to the investment fund and shareholders. In conformity with the RF legislation, under Clause 24 the manager has to reimburse any losses caused to the fund by nonperformance or improper performance of his obligation.

5.7. Depository

The investment fund has to keep all its monetary assets and securities in the safe custody of the depository (59). In addition all money settlements and transactions involving securities may be effected only through the depository. The fund's depository can be a bank or other legal person which is not an affiliated person of this investment fund. The relationship between fund and depository is regulated by contract which must be in accordance with the Basic Provisions of Depository Contract. The fund can have only one depository which can not be an investment fund creditor or guarantor.

5.8. Investors Rights and Protection

Under Clause 13 of the Statute of Investment Funds, each share gives shareholders one vote at all meetings of shareholders (in person or by proxy), and on par with other shares - the right to receive dividends and a proportional part of fund assets. Shareholders have the right to review information concerning all contracts concluded by the investment fund, transactions performed, and payments made between the manager or any affiliated person and any person in whose securities the investment fund has made investments in

(54) Annex No. 5 to RF President's Edict No. 1186, October 7, 1992 regulates contracts of investment fund management.

(55) While the board of directors cannot delegate its power to other persons or agencies, the manager cannot transfer his rights or duties. The law does not have a specific provision for a question whether the manager can delegate his duty.

(56) *id* Clauses 8-12.

(57) Clause 34 Statute of Specialized Privatization Investment Funds, *supra* note 22.

(58) Clauses 19-28 Statute of Investment Funds, *supra* note 24.

(59) Clauses 40-52 of Annex No. 5 to RF President's Edict No. 1186, October 7, 1992 regulate rights and duties of depositories.

the reporting year (60). The investment fund is prohibited from giving investors guarantees of positive income, either in writing or by advertisement (61). It is the duty of funds to publish information on the value of fund assets (including the value and number of unused privatization vouchers for *voucher investment funds*) (62) quarterly, based on the findings of a certified independent auditor (63).

The general meeting of shareholders is the top governing body of the investment fund management, and the following functions are within its exclusive competence:

- amendments and addenda to the bylaws
- election of the board of directors of the investment fund
- confirmation of the annual results of investment fund activity
- approval of the investment declaration, depository contract, contract with the manager on the management of the fund, including the procedure for determining the amount of compensation to the depository and manager, and amendments and addenda thereto
- confirmation of the procedure for calculation of dividends
- adoption of the decision windup of the investment fund, formation of a liquidation commission, and confirmation of its report (64)

5.9. Valuation of Net Assets and Distribution of Profit

The investment fund profit is formed from dividends and interest on fund securities, and also from capital gains (65). Part of the fund's net profit, prior to its distribution as dividends, may be used to increase the fund's authorized capital upon a decision by the board of directors and within the limits established in the bylaws and investment declaration.

5.10. Liquidation and Reorganization of Investment Fund

Clause 42 specifies the following ways to liquidate an investment fund:

- by a decision taken at the general shareholders meeting
- by order of an arbitration court
- on other grounds provided for in the Bylaws
- reorganization (upon agreement with the license issuing agency)

A *voucher investment fund* cannot be wound up by a decision of the general shareholders meeting during the first three years of the fund's existence. Its reorganization during the first three years of its activity will be possible only with the licensing agency's consent (66).

III. CONCLUSION

The securities system in Russia is regulated by laws enacted in 1991, before major radical changes in the Russian economy started. The securities provisions are to a certain extent unclear and contradictory, and its approach formalistic and administrative. In reality, procedural requirements are often circumvented or rendered meaningless (67).

(60) Clauses 38 Statute of Investment Funds, *supra* note 24.

(61) *id* Clause 40.

(62) Clause 44 Statute of Specialized Privatization Investment Funds, *supra* note 22.

(63) Clause 41 Statute of Investment Funds, *supra* note 24.

(64) *id* Cause 24.

(65) In the translation the following expression is used "earnings from operations with securities".

(66) Clause 45 Statute of Specialized Privatization Investment Funds, *supra* note 22.

(67) See, *Russian Investment: Hot Money Hits Moscow*, EIU BUSINESS EASTERN EUROPE, October 26 1994.

The President's decrees and the ministries' regulations were ineffective. Major changes were needed in the following legal areas:

- a new role for the SEC, including registration and licensing duties
- the introduction of self-regulating organizations of securities market participants, and the delegation of certain regulatory powers to them
- new requirements concerning the disclosure of information by both the issuers and the market participants
- the protection of shareholder's rights, including a legal framework for nominee ownership and the representation of interests
- the specification of shareholders' meetings procedure, and proxy voting (68)

After the MMM (69) scandal in the fall of 1994, the President enacted a new decree (70) that set the following new goals: 1) to oversee the financial and securities market in the Russian Federation, 2) to regulate the relationships formed during the issuance and circulation of securities, and 3) to put an end to abuses and violations of the rights of citizens. In addition, the President proposed a new Federal Securities and Stock Market Commission to be established with broad regulatory, advisory, educational and adjudicatory powers (71). National and regional commissions will be entitled to set standards for issuing and circulating securities and for carrying out professional activities in the securities market for disclosure of information to investors.

Despite the scandal and public suspicion, investors continued to buy promoted shares enthusiastically. As some authors have noticed, capitalism has taken strong root among the younger generation, creating a mass equity culture overnight (72). But some investors view the stock market as another type of lottery.

Investment funds are in the evolving stage and have not gained their share in the Russian financial sector yet. They intended to reduce risk for their shareholders and to help create a securities market. But without sound regulatory structure and continuous enforcement, investors will not build confidence in such a financial system. The Russian Government recognizes that the securities market must be transparent and effectively regulated in order to attract major investments.

Currently two different drafts of a law on securities have been introduced in the Duma. One favors tough enforcement by government agencies while the other contains a self-regulatory approach. In both drafts, though, the common goal is essentially the same: to establish a clear legal framework for share ownership, investment and corporate finance (73). Self-regulation to complement direct government regulation can play an important role in protecting the public by imposing high standards of conduct in the securities industry.

(68) See, "Overview of the Russian Securities Market", supra note 11.

(69) The infamous MMM, a pyramid scheme, collapsed in September-October of 1994 causing personal losses to more than 10 million investors. After the scandal, MMM's management claimed that shares of that institution were technically not shares but only corporate promissory notes with no strict link to their face value, See, Y.P. Lambert, *Securities Trading in Banks, Oil and Gas, and Other Newly Privatized Companies*, EAST/WEST EXECUTIVE GUIDE, January 1995 at 18.

(70) See, *Yeltsin Issues Broad Decree Regulating the Securities Market*, RUSSIA AND COMMONWEALTH BUSINESS LAW REPORT, November, 1994, at 6-7.

(71) The Commission is composed of the heads of the Presidential Administration, Ministry of Finance, State Property Committee, Russian Federal Property Fund, Ministry of Justice, State Antimonopoly Committee, State Tax Service, State Inspectorate for Nonstate Pension Funds, Federal Service for the Oversight of Insurance Activity, Central Bank, and one representative of the two chambers of the Federal Assembly.

(72) See, P. Lewis, supra note 1.

(73) Sally J. March, "Regulation of the Burgeoning Securities Market", EAST/WEST EXECUTIVE GUIDE, January 1995, at 15-18.

Strict government regulation is crucial not only for development of the internal market but also for attracting foreign investors. Foreign investors value regulations which assure an orderly trading structure, swift settlement of transactions and appropriate recordkeeping (74). Foreign interest in the Russian securities market is huge, but as long as sound regulatory structure is not backed by vigorous enforcement, it will not attract serious foreign investment. Much has been achieved in the Russian financial market, but much remains to be done.

(74) David Silver, *Remarks before Conference on International Finance & Global Trade*, Bombay, India (1992), at 9-11.