

INVESTMENT FUNDS ON ROMANIAN CAPITAL MARKET

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Abstract

National laws governing collective investment undertakings were updated as a result of European secondary law modernization with a view to approximating the conditions of competition between those undertakings at Community level, while at the same time ensuring more effective and more uniform protection for unit-holders. Such coordination intended to facilitate the removal of the restrictions on the free movement of units of UCITS in the internal market. For the purposes of internal regulation UCITS means an undertaking: (a) with the sole object of collective investment in transferable securities or in other liquid financial assets of capital raised from the public and which operate on the principle of risk-spreading; and (b) with units which are, at the request of holders, repurchased or redeemed, directly or indirectly, out of those undertakings' assets. The UCITS may be constituted in accordance with contract law (as common funds managed by management companies), trust law (as unit trusts), or statute (as investment companies). Key investor information should be provided as a specific document to investors, before the subscription of the UCITS, in order to help them to reach informed investment decisions. Investment funds enjoy in Romania a new regulatory framework: the contract of common society hosted by new Civil Code and the new Emergency Ordinance regarding UCITS.

Keywords: *capital market, investments, undertakings for collective investment in transferable securities (UCITS), financial supervisory authority, key information*

Introduction

The Romanian Capital Market Act (Law no 297/2004) thoroughly regulated the undertakings for collective investment in transferable securities (UCITS) since 2004 till 2012. Following the amendments made on European level since 2009 (beginning with Directive 2009/65/EC of the European Parliament and of the Council on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS)) Romanian legislator has chosen to recast the rules in an independent act, outside of consolidated Capital Market Act intended to comprise all the capital market regulations: GEO no 32/2012. This normative act encompasses

many measures designed to rebuild the trust in a capital market continuously shaken by an endless economic crises.

The establishment of a financial supervisory authority (European Securities and Markets Authority, hereinafter 'ESMA', agreed by Regulation (EU) No 1095/2010 of the European Parliament and of the Council) is a strong signal of determination on European stage to coordinate the measures converging to build a uniform and efficient framework for capital market.

One of the new elements of the UCITS regulation is key investors information: the new law requires that an investment company and, for each of the common funds it manages, a management company draws up a short document containing key information for investors. Such information

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is intended to rapidly inform the investors on key information they need to make their investment decision.

The new law introduces specific rules and concepts which need scientific scrutiny in order to crystallize a convergent approach.

1. Undertakings for collective investment in transferable securities (UCITS)

Common forms of investment entities on the capital market are UCITS (Undertakings for Collective Investment in Transferable Securities), represented by open-end funds and investment companies. Although there are "closed" investment companies, too, the law does not use linguistic form of "open" investment company, investment company designation remains to be understood implicitly as open-end investment company¹.

The essential characteristics of the UCITS are underlined by the law: the purpose of the entities (sole purpose pursued is conducting "collective investment", investing of fund money collected in financial instruments under conditions prescribed by law, including the principles of risk diversification and prudential management) and financial instruments issued (units are redeemable continuously to a value determined by reference to net assets value, at the request of holders)².

Redeemable character (continuous) of units issued by UCITS is an immanent mechanism, the essential element of the definition of these entities. This feature explains the open-end approach of the UCITS. Issuance and redemption of units, in a continuous manner, is the main mechanism of these investment vehicles.

The units will be issued on the capital market following the favourite principle "delivery versus payment". Symmetrically, withdrawal (redemption) implied payment of the amount of money calculated at the date of application for redemption, using a transparent algorithm designed for price fixing: by determining the net asset value per unit. Payment induced by such repurchases will be made within a "reasonable" time set by law to ten days of the filing date of redemption.

The distinction between investment funds and investment companies resides in the legal form of the entity: civil contract or incorporated company.

The law lays down a principle of non-reciprocity between large species of collective investment undertakings, UCITS and non-UCITS which are close-end funds and investment companies. Thus, UCITS can turn into non-UCITS but vice versa transformation is prohibited³.

2. Authorization of UCITS

Undertakings for collective investment in transferable securities are regulated entities of the capital market, subject to the approval of the authority of the market, ASF (Financial Supervisory Authority, former CNVM).

Authorization of UCITS is a gradual process that is preceded by the designated administrator authorization (such administrator being a management company), statutory documents authorization - i.e. civil contract and rules for the common fund and articles of

¹ See C. Gheorghe, *Capital Market Law*, Bucharest: CH Beck, 2009, p. 121.

² GEO no 32/2012, Art. 2, paragraph 2.

³ *Ibid.*, Art. 2, paragraph 6-7.

association for the company - the choice of Depository and approval of the prospectus⁴.

The undertakings for collective investment are subject to multilevel scrutiny including their establishment, commencing of effective operations (continuous public offering of units) and continuous administrative supervision throughout the period of their existence.

The actual authorization of UCITS is preceded by assessment of reliability and professional experience of the persons in charge within the management company and their ability to impose prudential rules, the reliability of the depository and its capacity to maintain accurate records of the UCITS's asset.

Operations of investment funds begin with a public offer of their own units. Authorization required for public offer of units implies verifying the legality of the prospectus (available in a plain format and a concise and simplified form, format known as key information). In a general manner it is acknowledged that prospectuses must contain all the information necessary for investors to independently assess units offered for investment, in terms of potential gains and risks involved⁵.

3. Investment funds

Investment (common) funds are civil contracts, unincorporated association, directed of a management company, authorized by ASF. Titles publicly offered are fund units, redeemable continuously at a price based on the net asset value of the fund⁶.

From the legal point of view the civil contract establishing the fund is an adhesion agreement whereby investors become part (of the contract) by subscribing units and signing a declaration in accordance with article 93, paragraph (3) of GEO no. 32/2014 regarding the prospectus. At present, the new Civil Code extensively regulates the "contract of society" (partnership) and "common society" (common partnership), an unincorporated association⁷. Even such rules cannot regulate entirely the articles of association, the civil contract of the investment fund. Despite contractual principles, the investment fund issues shares (units) continuously (and redeemable) ignoring the consent of the other members of the fund. Free entering and withdrawal from the contract (association) are inappropriate for "contract of society" and contractual matter in general. At their will investors can choose the time of withdrawal from investment fund, without the consent of the other parties, and without the payment of compensation.

4. Statutory framework

Along with the partnership agreement (civil contract), an investment fund has a statutory framework including the fund rules (annex to the prospectus⁸) and the prospectus itself. The Capital Market Act induces statutory limitations for common funds. Units issued by open-end funds shall be of one type, fully paid upon subscription, registered, dematerialized and shall give equal rights to their holders⁹. The holding of fund units is attested by a certificate confirming ownership. These units are

⁴ *Ibid.*, Art. 63, paragraph 2.

⁵ GEO no 32/2014, Art. 93 paragraph 1.

⁶ GEO no 32/2014, Art. 71.

⁷ Civil Code, Art. 1890-1948.

⁸ GEO no 32/2014, Art. 68, Art. 93 paragraph 2.

⁹ *Ibid.*, Art. 69. Old law prescribed units on material support.

purchased at the issue price and the open-end funds do not issue other financial instruments except for units.

Civil contract. The essence of the common fund rests in its unincorporated nature, in its pure contractual basis. Thus, all subscribers of units shall adhere to civil contract. In this way the legal “contract of society” - a mutually binding promise, a multilateral legal deed - suffers a continuous modification of the parties and its content (related strictly to extinguish or existence of rights and obligations of the parties who withdraw or adhere to partnership). The particularity of the partnership, ignored by the law, is the demand of the parties’ consent in order to amend the initial contract. In Contact Law doctrine, concluding, modification or extinction of a contact rests in the parties’ consent, any exception being insulated with prudence. Capital market law doesn’t pay much importance to that old civil principles and easily removes the unanimity rules, the parties’ consent; what remains is the new investor’s (subscriber of the fund) consent to statutory framework of the investment fund. Legal innovation is an extreme one, but governed by rules laid down for investment funds¹⁰.

Although the absence of express provision to compensate lack of consent of the parties is embarrassing, we cannot fail to notice that this mechanism ensures a uniform approach of the UCITS. In the case of an investment company, the nature of share raises no question in purchasing or selling company’s share. The nature of transferable securities permits the continuous withdrawal and entering the company without the shareholders’ consent. Units in investment funds are declared transferable securities, too. Thus explained the functioning of the investment fund is hard to accommodate with the contractual

nature of the investment fund. We have to assume that the act of subscription (entering into a civil contract) means consent of the person to future amendments to the articles of association of the fund, regarding the parties, without his express consent. Interpretation should be strictly limited to the parties’ person of the common fund because the partnership cannot suffer other material changes, in its content or subject, without all the parties’ consent.

The minimum provisions of the partnership of the fund is fixed by the law¹¹ and concern: the name of the fund, the legal foundation, the duration of the fund, the objectives, the units (definition, description, initial value), the management company and its maximum management fee, the Depositary and its maximum fee, clauses for liquidation and merger of the funds (procedure for investors protection), litigation (method of settlement, competence), termination clause, the rights and obligations of the parties (specifying in principal that investors become part of the contract by signing the subscription form and a declaration confirming that they have received, read and understood the fund prospectus).

All these provisions should be accepted as special contractual arrangements overlapping the common provisions regarding civil contract, “contract of society” from Civil Code.

Fund rules. Besides the partnership agreement investment fund is preparing a document describing its objectives and entities involved in its activities (management company and depositary company). This document is known as the fund rules.

The importance of rules does not end with declaring the management company and the depositary. This document contains

¹⁰ See C. Gheorghe, *Capital Market Law*, Bucharest: CH Beck, 2009, p. 124.

¹¹ CNVM Regulation no 15/2004; Annex no 4, still in force.

information of the utmost importance for investors represented by financial goals. All financial objectives - as planned capital raised, expected income, investment policies, the main categories of transferable securities suggested for investment, portfolio protection systems (hedging techniques), the minimum recommended duration of investments, risk factors associated with the investments policy of the fund - are elements of distinction among different investment funds on the capital market.

Fund rules reveal the intentions and investment policies assumed by the management company of the fund, containing a reference point for assessing the result that shall be achieved in the future.

Fund rules contain also specific details of the mechanism of determining the net asset value of the fund (asset valuation method, net asset value, the frequency of calculating the net asset value and channel of publication of this value, the initial value of a unit).

5. Financial instruments. Prospectus.

Units in undertakings for collective investment in transferable securities are qualified as financial instruments¹². Units of investment funds are a type of financial instruments defined by the Capital Market Act. Investment funds, based on civil contracts ("contract of society"), are therefore entitled to issue securities, units of the fund. From the Civil Law perspective this is a notable exception. From the Capital

Market Act perspective this situation is totally regulated. The document governing the issue of financial instruments by investment fund is the prospectus, subject to authorization by ASF¹³.

Beyond the civil statutory framework of an investment fund, issuing units is a distinct activity of the fund, supervised by ASF. Authorization of the civil contract and the fund rules is followed by prospectus authorization and continuous supervision throughout the life of the fund.

Minimum information covered by the prospectus is laid down by administrative regulation (ASF)¹⁴. The law organizes provisions in distinctive chapter: Management Company of the fund, Depositary, preparation and distribution of financial statements, rules for the determination and allocation of income and procedure for investors' payments in case of redemption application, channel of disclosure for investment fund reports and papers. In particular, the prospectus includes information relative to fees and other charges (fees borne by investors: purchase fees, redemption fees, fees payable to the management company, the depositary), merger and liquidation of a fund (circumstances in which a fund may merge with another fund or be liquidated, and procedure implied, unit holders' rights), as well as tax system (taxes borne by the investors).

Data from prospectus contain detailed information for investors in order to have a complete picture on risks induced by the purchase of units¹⁵. The prospectus shall include a clear and easily understandable explanation of the fund's risk profile.

¹² Law no 297/2004, Art. 2 paragraph 10 d).

¹³ See C. Gheorghe, *Capital Market Law*, Bucharest: CH Beck, 2009, p. 126.

¹⁴ CNVM Regulation no. 15/2004, Annex no 8. See also Directive 2009/65/EC, Annex 1 Schedule A.

¹⁵ Directive 2009/65/EC of the European Parliament and of the Council of 13 July 2009 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS), Art. 69: The prospectus shall include the information necessary for investors to be able to make an informed judgment of the investment proposed to them, and, in particular, of the risks attached thereto.

Information regarding the fund's auditor and the group of companies - to which the management company or the auditor belong - is also revealed by the prospectus.

The prospectus of the investment fund must prevent potential investors, through a standard formula, that the investment funds "are not bank deposits", that ASF authorization "does not imply any endorsement or evaluation by ASF of securities quality" and that investment funds involve not only their specific advantages, but also the risk of failure of objectives, including losses to investors¹⁶.

Moreover, always when past returns (including advertisements) are revealed, a warning formula, which became almost solemn, is required: "the fund's past performance is no guarantee of future results."¹⁷

6. Key investor information

Key investor information should be provided as a specific document to investors, before the subscription of the UCITS, in order to help them to reach informed investment decisions. Such key investor information should reveal the essential elements for making such decisions.

Key investor information shall include information about the characteristics of the UCITS concerned, which is to be provided to investors so that they are reasonably able to understand the nature and the risks of the investment product offered to them.

The nature of the information to be found in the key investor information

should refer to the identification of the UCITS; a short description of its investment objectives and investment policy; past-performance presentation or, where relevant, performance scenarios; costs and associated charges; and risk/reward profile of the investment, including appropriate guidance and warnings in relation to the risks associated with investments in the relevant UCITS¹⁸.

Key investor information should be presented in a short format. A single document of limited length presenting the information in a specified sequence is the most appropriate manner to achieve the clarity and simplicity of presentation that is required by retail investors.

Conclusions

The European secondary law on UCITS continues a modernization process with a view to approximating the conditions of competition between those undertakings at Community level, while at the same time ensuring more effective and more uniform protection for unit-holders. Such coordination intended to facilitate the removal of the restrictions on the free movement of units of UCITS in the European internal market.

Such regulations should facilitate investment protection and national treatment in order to have a level playing field.

Romanian regulations are intended to facilitate and implement the European legislative guidelines.

¹⁶ CNVM Regulation no. 15/2004, Art. 91 paragraph 3.

¹⁷ *Ibid.*, Art. 170.

¹⁸ GEO no 32/2012, Art. 98. See also Directive 2009/65/EC, Art. 78.

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