Fall 1994

The Engines of Privatization: Investment Funds and Fund Legislation in Privatizing Economies

Matthew J. Hagopian

Follow this and additional works at: http://scholarlycommons.law.northwestern.edu/njilb

Part of the Banking and Finance Commons

Recommended Citation
I. INTRODUCTION

The mass privatization programs of Eastern Europe and the former Soviet Union have been designed as the centerpieces of the momentous transformation of the region's command economies to principles of market forces. The programs are designed to distribute shares in thousands of state-owned enterprises amongst hundreds of millions of citizens for free or for nominal payment, thereby creating a revolutionary class of citizen-shareholders with a strong stake in the privatization process. From the inception of the first wave of large-scale privatization in Czechoslovakia, investment funds have played a central role in the successes and failures of the varying mass privatization programs of Eastern Europe and the former Soviet Union.

This article presents the major issues and policy options to be considered in preparing investment fund legislation for privatizing economies. The conclusions drawn herein are based upon the experience of government officials, World Bank representatives and the author and other attorneys of the law firm of White & Case gained in connection with the establishment of investment fund legislation in the Czech and Slovak Republics, Russia, Poland, Armenia, Lithuania and Kazakhstan.2

1 The term "investment fund" as used in this article generally refers to an enterprise which is owned by a large number of persons and which is primarily engaged in the business of investing in securities. Different types of investment funds are referred to in various countries as investment companies, management companies, investment trusts, unit trusts, open-end funds, closed-end funds, mutual funds, money market funds, options funds, growth funds, index funds, or emerging market funds, depending upon the specific features of the fund and the types of securities in which it invests.

2 This article has been adapted from a report prepared by the author for the Ministry of Economy of the Republic of Armenia and from his work in connection with White & Case's
This article focuses on the role and regulatory framework for investment funds formed in the context of mass privatization programs to accept privatization vouchers and cash and invest in the shares of privatized companies. The article is divided into four sections. Part II discusses the role of investment funds in the voucher privatization programs of the Czech and Slovak Republics, Poland and Russia. Parts III and IV discuss the main benefits and dangers which investment funds may present to privatizing economies. Part V presents recommendations regarding the main objectives of investment fund legislation and options for achieving such objectives.

II. INVESTMENT FUNDS IN THE VOUCHER PRIVATIZATION PROGRAMS OF THE CZECH AND SLOVAK REPUBLICS, POLAND AND RUSSIA

In the countries of Eastern Europe and the former Soviet Union, investment funds have usually been organized as joint stock companies which issue their shares to citizens in return for the contribution of money or privatization vouchers. It is intended that the investment funds will invest the money and vouchers received from their shareholders primarily in the shares of privatized state-owned enterprises. The funds may then manage their investments in different privatized companies by trading their shares to other funds and on the emerging stock markets, by voting at the general meeting of shareholders of the companies in which they hold shares, and by appointing managers and supervisory board members for these companies.

Investment funds have been designed to fill different roles in the several different types of voucher and mass privatization programs which have been established in the countries undergoing privatization.

3 A joint stock company is the civil law equivalent of a United States corporation with limited liability for all shareholders and a multi-tiered management structure usually consisting of a management board (acting as executive officers), a supervisory board (equivalent to a United States board of directors), and a general meeting of shareholders.

4 As used herein, the term "privatization voucher" refers to the various types of government-issued vouchers, coupons or investment points which citizens receive for free (or for a nominal fee) and may use to purchase shares of privatized companies or of investment funds which invest in privatized companies.
in Eastern Europe and the former Soviet Union. Following is a brief
discussion of the differing role of investment funds in the voucher and
mass privatization programs that have been adopted to date in the
Czech and Slovak Republics, Poland and Russia. These programs
have been the main models for other countries and have generated a
large amount of information and analysis which can prove helpful in
designing appropriate investment fund legislation for other privatizing
countries.

A. The Czech and Slovak Republics

The Czech and Slovak voucher privatization programs were
among the first such programs implemented in the former communist
countries and were accordingly designed without the benefit of prior
experience that other countries have been able to refer to. Despite
this fact, the Czech and Slovak programs are generally agreed to have
been tremendously successful in quickly privatizing a large number of
companies with the participation of more than seventy-five percent of
all qualified citizens.\(^5\)

Under the Czech and Slovak programs, citizens were issued
voucher points which they could use to purchase shares in state-
owned enterprises privatized through an auction process. The almost
fifteen hundred enterprises subject to voucher privatization were first
transformed into joint stock companies and then a majority of their
shares (61.4\% on average) was publicly offered for purchase with
vouchers in a single auction referred to as the “first wave” of voucher
privatization.\(^6\) A second auction of additional companies and shares
is expected to be completed by the end of 1994.

Voucher points were issued only for use in buying shares in the
companies being privatized through the auction process. The owner-
ship of voucher points was registered through central computers, and
the voucher points were not freely tradable. Voucher holders could
only transfer their voucher points to an investment fund or use them
to directly buy shares in the privatized companies.\(^7\)

Investment funds in the first wave were originally formed as joint
stock companies under permissive interim regulations.\(^8\) Investment

\(^5\) J. Mladek, Voucher Privatization in Czechia and Slovakia 12 (Feb. 1994) (prepared for the
of the Results,” Paris, Mar. 2-4, 1994).

\(^6\) Id. at 26.

\(^7\) See id. at 11-12.

\(^8\) Decree No. 383/1991 on the Issuance and Use of Investment Vouchers, as amended by
funds were not created by the government but were left to develop if justified by market forces. This relieved the government from the time, effort and expense of establishing and staffing the investment funds.9

Prior to each auction round, a period was established during which citizens could transfer their voucher points to investment funds. The investment funds, because they were privately established, had to compete for citizens' voucher points by offering them attractive management strategies.10 Investment funds played a central role in the first wave of voucher privatization. Approximately seventy-two percent of all voucher points were transferred to the more than 400 investment funds which were created.11 Investment funds used those vouchers to become the owners of approximately sixty-three percent of all shares privatized through the voucher privatization program.12

B. Poland

The Polish mass privatization program is centered around the role of special investment funds established by the Polish government, referred to as “National Investment Funds”. The government will establish ten to twenty National Investment Funds and choose the managers of each fund from a competitive tender open to widely known investment consulting firms from around the world. Citizens who pay a nominal fee will receive a type of voucher which they will be able either to freely trade or eventually exchange for a package of shares consisting of one share in each National Investment Fund.

Each National Investment Fund will be formed as a joint stock company and will be governed by the general rules of the commercial code and special regulations relating only to investment funds.13 The manager of a National Investment Fund will be a separate legal entity and will initially manage the investment fund under the terms of a form contract drafted by the Ministry of Privatization.14 The four hundred to six hundred Polish state-owned enterprises that will be privatized under the Mass Privatization Program will be initially transformed into joint stock companies. Their shares will then be assigned by the government to the various National Investment Funds. Thirty-

---

9 Mladek, supra note 5, at 16.
10 Mladek, supra note 5, at 16.
11 Mladek, supra note 5, at 21.
12 See Mladek, supra note 5, at 22 (Table No. 5).
13 Law on National Investment Funds and Their Privatization § 2.2 (Pol. 1993).
three percent of the shares in each enterprise will be given by the government to one fund, twenty-seven percent of the shares will be divided equally between all the remaining funds, between fifteen and thirty percent of the shares will be distributed for free to workers and farmers, and ten to twenty-five percent of the shares will be retained by the state.

The National Investment Funds are expected to take an active role as shareholders in the companies in which they own thirty-three percent of the shares, a percentage intended to allow the National Investment Funds to have a significant influence upon the companies while still requiring the cooperation of other shareholders to make majority decisions. To encourage the National Investment Fund managers to actively govern and restructure the companies in which their fund holds shares, the managers' compensation is directly related to the financial performance of their funds.

It is important to note that only the ten to twenty National Investment Funds established by the government will be entitled to participate in the Polish mass privatization program. While privately-sponsored investment funds exist in Poland, citizens will only be able to redeem their privatization vouchers for shares in the government-sponsored National Investment Funds, and only the government-sponsored funds will receive shares in companies privatized under the program.

The Polish mass privatization program may be the most complex and considered of the several programs adopted in the region to date. It is important to note, however, that while the development of the program began in 1991 and was passed into law in April 1993, the program has not yet been put into force due in part to its complexity and the political and bureaucratic resistance which it encountered.

C. Russia

The Russian voucher privatization program for large enterprises is similar in many basic respects to the Czech and Slovak programs. In the Russian program, designated state-owned enterprises are transformed into joint stock companies, and a portion of their shares is sold at public auctions for vouchers.

---

15 Law on National Investment Funds, supra note 13, § 10.
16 See Law on National Investment Funds, supra note 13 at § 4.2; Ministry of Privatization of the Republic of Poland, supra note 14, § 2-1.
17 See Ministry of Privatization of the Republic of Poland, supra note 14, § 9.3.
18 Law on National Investment, supra note 13, § 37.
The Russian vouchers were offered to every citizen for a small fee. The vouchers have a face value of 10,000 rubles and are freely tradable, unlike the Czech and Slovak voucher points. The tradability of the Russian vouchers quickly created a large voucher exchange market and provided an alternative to citizens' investment of their vouchers directly in investment funds or privatized companies.\(^\text{19}\)

As in the Czech and Slovak Republics, the government did not create investment funds as part of the program but allowed these funds to be privately created in accordance with model forms and licensing requirements. Approximately 650 of these funds have been formed, and more than thirty million citizens have become shareholders in these funds through the contribution of nearly fifty million vouchers, about one-third of the total.\(^\text{20}\) Investment funds were allowed to receive both vouchers and cash contributions from their shareholders; in practice, however, it appears that less than five percent of the equity of most funds has been contributed in cash.\(^\text{21}\) An investment fund is expected to enter into model contracts with both a management company to manage the business of the fund and with another company, referred to as a depositary or custodian, to hold the shares, vouchers and cash of the fund.\(^\text{22}\)

The Russian voucher privatization program differs significantly from the Czech and Slovak program in the level of ownership and control possessed by workers and management in the companies privatized through the Russian auction process. As a result of the special share purchase rights, Russian workers and management were given or allowed to purchase between sixty and seventy percent of the company's shares while only fifteen to twenty percent of the shares of a Russian enterprise were offered for voucher sale to citizens and investment funds.\(^\text{23}\) In contrast, an average of 61.4% of the shares of a Czech company were publicly offered for sale at the first wave voucher auction, and only two to three percent of the company's shares were reserved for workers.\(^\text{24}\) In Poland, investment funds will


\(^{21}\) St. Giles and Buxton, supra note 19, at 15.

\(^{22}\) See Regulations For Specialized Investment Funds, App. 2 to Decree No. 1186, §§ 15, 17 (Russ. 1992).

\(^{23}\) Boycko, supra note 20, at 11, 15.

\(^{24}\) Mladek, supra note 5, at 26.
receive sixty percent of the shares of the privatized companies while workers will be allotted only between fifteen and thirty percent of the shares. The dominant ownership by workers and management of Russian companies, and the political strength which it represents, is expected to significantly limit the role of investment funds in influencing the operations and restructuring of privatized companies.

The creators of the Russian voucher privatization program were able to refer to both the Polish and the Czechoslovakian voucher privatization models when designing their program. As the preceding discussion indicates, the Polish model was not followed in Russia. When considering the applicability of these models in other privatizing economies, it may be helpful to consider the reasons why the Polish model was thought to be inappropriate or impractical in Russia. First, it was believed that such a complicated program would be too technologically difficult and time-consuming to implement in Russia. Second, it was believed that by allowing citizens to choose their investments freely, the Russian program would be more popular and that citizens would be more active in its support. Third, Russian enterprise managers possess significant political influence in the Russian parliament and were unwilling to accept a program which would create shareholders in their companies as strong as the Polish investment funds are intended to be. Finally, there was a fear that large state-sponsored funds owning large stakes in Russian companies would be subject to political control and become little more than government ministries acting under a different name.

III. BENEFITS OF INVESTMENT FUNDS IN PRIVATIZING ECONOMIES

This section examines the primary economic benefits which investment funds can bring to privatizing economies. The extent to which each of these benefits may be realized depends largely upon the type of privatization program in which the investment funds operate and the particular provisions of a country's investment fund regulations, discussed in Part V below.

A. Corporate Governance

Privatization theory is based on the assumption that companies will perform more efficiently when they are controlled by private own-

25 Law on National Investment Funds, supra note 13, § 10.
26 Boycko, supra note 20, at 4.
ers than when they are controlled by governmental bodies.  

In order to cause a company to act efficiently, however, private owners need to own a sufficiently large share of the company to exercise influence or control. This may be particularly true in economies in which dramatic restructuring changes are required, such as replacement of company management, dismissal of large numbers of workers, discontinuance of production lines, and the undertaking of new investments.

In the context of a mass privatization program, in which company shares are sold or exchanged for vouchers held by all citizens, the danger exists that company shares will be owned by an extremely large number of small shareholders and that none of these shareholders will own enough shares to exercise significant influence over a company and its management. In such situations, the expected efficiency benefits from privatization are unlikely to be realized since company managers will be able to operate without significant accountability or supervision.

Investment funds present a solution to this problem by gathering widely dispersed resources (vouchers and cash), using those resources to purchase significant blocks of shares in privatized companies, and exercising the rights associated with these shares to monitor and supervise company management. By acting as a significant shareholder in a company and exercising the rights of control associated with those shares, investment funds should provide the "corporate governance" necessary to enact the economic reforms which the privatization process is designed to bring about.

B. Risk Diversification

By investing their vouchers or money in an investment fund rather than a single operating company, citizens may reduce the risk of their investment. By investing in an investment fund, a citizen becomes an indirect owner of shares in the many companies in which the investment fund has invested. Alternatively, the direct investment


28 The problem of effective corporate governance in the mass privatization context is not entirely resolved by the interface of investment funds: the funds themselves are corporate entities owned by a widely dispersed class of small shareholders and may thus have similar deficiencies in their own corporate governance. However, the shift of the corporate governance problem to the investment fund level allows the issue to be addressed within one industry in a focused manner by the type of regulatory measures discussed infra at Part V.A.

29 In the Czech Republic, for example, investment funds own shares in as many as two hundred different companies. R. E. Anderson, Voucher Funds in Transition Economies: The Czech and Slovak Examples 4 (Feb. 25, 1994 draft).
of the same amount would usually make that citizen an owner of the shares of only one or two privatized companies. This is especially true for citizens investing only small amounts of voucher points or cash. Ownership of shares in an investment fund which owns shares in many different companies reduces a citizen’s investment risk because it is much more likely that an individual company in a particular industry may fail than that an investment fund may fail, as its success is based upon the performance of many companies in different industries. In effect, this type of risk diversification is imposed on citizens in the Polish mass privatization program as a result of the fact that the Polish vouchers may only be exchanged for shares in the investment funds and may not be directly invested in privatized enterprises.30

C. Financial Sophistication/Portfolio Selection

Investment funds in privatizing economies also provide benefits to citizens and the economy through their management’s business and financial expertise. Properly qualified and licensed investment fund managers should be better able to choose which companies to invest in than individual citizens who do not have the same financial training and knowledge of the market. In addition, investment funds can better afford the high cost of gathering and analyzing information about the performance of different companies. Investment funds which are managed by banks, as is frequently the case in the Czech Republic, may have especially reliable knowledge of the value and prospects of companies on the market as a result of their prior relations with such companies.31 As a result of management’s expertise, the investment funds should make better investments than individual citizens, and the share market should be more stable and efficient.

D. Access to Financial Resources

It is expected that investment funds in some developing economies will also be able to assist the companies in which they invest in obtaining financing as a result of the investment fund managers’ contacts with financial institutions and large investors. In Poland, for example, investment fund managers will be chosen from among the most prominent investment consulting firms in the world and are expected to use their international contacts and experience to assist the companies in finding necessary resources for restructuring.32

30 Law on National Investment Funds, supra note 13, § 37.
31 See Mladek, supra note 5, at 22-23; Anderson, supra note 29, at 5.
32 See Ministry of Privatization of the Republic of Poland, supra note 14, § 2.
E. Foundations of Securities Market

The involvement of investment funds in voucher privatization programs has also helped to increase the public's general interest in vouchers and establish organized markets for vouchers and for the shares of privatized companies. In the Czech Republic, for example, citizens did not register for their voucher booklets in large numbers until investment funds emerged offering guaranteed returns. The Czech investment funds were then motivated to play central roles in the establishment of the two organized stock exchanges in the Czech Republic in order to facilitate their trading of securities. In Russia, where vouchers are bearer documents which are freely tradable, investment funds have also acted as major traders on the voucher exchanges which have been quickly established. In addition, through their role as an intermediary in choosing shares and attracting vouchers and cash, investment funds also simplify the process through which citizens invest in the new securities market.

IV. Risks Posed by Investment Funds

As indicated earlier, investment funds may play important and central roles in economies undergoing transformation and privatization. However, investment funds also occupy a very sensitive position in transforming economies, particularly because of the large number of privatization vouchers that they can be expected to accumulate. (Investment funds hold approximately seventy-two percent of all vouchers in the Czech and Slovak Republics and thirty-three percent of all vouchers issued in Russia.) Abuse of this position of trust may threaten society's faith in the privatization program, the new securities market and the government itself. Following is a brief description of several of the main risks which may be posed by investment funds if they are not appropriately regulated.

34 St. Giles and Buxton, supra note 19, at 16.
35 Triska, supra note 33, at 9.
36 Boycko, supra note 20, at 17.
A. Embezzlement, Fraud and Insider Trading

One of the most immediate dangers connected with investment funds is that the funds may be founded or operated by dishonest individuals who will either steal directly from the investment fund or use their positions in the investment fund to profit unfairly. The most serious cases to date have taken the form of pyramid or "ponzi" schemes wherein enormous sums have been collected through promises of fantastic returns. In such schemes, a few lucky initial investors receive payoffs from a portion of the capital contributed by subsequent investors while remaining funds are siphoned away. Problems of this type have arisen repeatedly in Russia in the last year, as millions of dollars' worth of privatization vouchers have unaccountably disappeared along with the arrest or disappearance of the individuals entrusted with their safekeeping and management. A longer-range danger also exists that managers of an investment fund will manipulate the fund's activities or use their confidential knowledge of the affairs of the fund and of its portfolio companies to engage in insider trading for their own profit.

B. Ineffective Management

A second danger that investment funds present is that their managers may not be sufficiently active in promoting the interest of the fund's shareholders but may instead be satisfied to simply receive their management fee for little effort. As discussed in Part III.A. above, a problem in corporate governance exists where a company is owned by many small shareholders and none of these shareholders has a large enough number of shares to control or influence the management of the company. Investment funds may reduce the problem of corporate governance in the companies in which they own a significant block of shares, but a similar problem of corporate governance

---


39 The most notorious Russian scandals of alleged investment fund fraud and embezzlement have involved the MMM, Neftalmazinvest (Oil and Diamonds), Tibet, and Russki Dom Selenga (Russian House of Selling) investment funds, each of which had millions of shareholders; See Russian Investment Fund Closes, UPI, Aug. 25, 1994, available in LEXIS, Nexis Library, UPI File; Malpractice Revealed by Audit of Neftalmazinvest Voucher Fund, BBC, June 17, 1994, available in LEXIS, Nexis Library; Chrystia Freeland, Russian Court Suspends Fund, FINANCIAL TIMES, Aug. 18, 1994, at 2. The problem, however, has not been confined only to Russia. See Moldavia Forms Commission to Battle Local MMM, TASS, Aug. 22, 1994, available in LEXIS, Nexis Library.
may arise within the fund itself as a result of the fund's widely dispersed share ownership.

C. Monopolization

A third problem may arise where one or more investment funds may effectively control several companies in the same industry or market and influence the companies to cooperate in setting prices instead of competing. An additional monopoly danger may arise when one or several related investment funds control a large percentage of the voucher or share market and manipulate market forces through their dominant position, though such a danger may also be posed by other large investment groups.

D. High-Risk and Unwise Investments

Danger also exists that investment fund managers may engage in high-risk or unwise investment strategies that could cause the fund to fail. Such a situation not only affects the fund's shareholders but may also have a destabilizing effect upon the securities markets and the privatization program.

V. GOALS AND OPTIONS FOR INVESTMENT FUND LEGISLATION

The many provisions of investment fund legislation may be organized around the following basic goals:

(a) promote the efficient operation of investment funds;
(b) prevent investment fund managers and founders from acting dishonestly;
(c) ensure that investment funds serve legislative objectives and act conservatively;
(d) prevent the investment fund from exercising monopolistic or domineering powers in the economy; and
(e) ensure that the legislation creates a complete and consistent framework for the establishment and operation of investment funds.

Following is a discussion of the principal types of regulatory provisions which may be enacted to achieve these goals. Where an issue has been addressed differently in several countries, recommendations are outlined regarding which of these approaches may prove best in privatizing countries.

A. Promote Efficiency of Investment Funds

The efficiency and motivation of the managers of the investment fund may be promoted by the following types of regulations.
1. **Restrict the Legal Form of Investment Funds**

Strict control of the legal form under which investment funds may be organized is a linchpin to the entire investment fund regulatory structure. Requiring investment funds to be organized in a well-established legal form enhances the force of the regulations by appropriating the practice and grounding already established for such form and removing an element of uncertainty and potential manipulation from the hands of those seeking to avoid application of the regulations.\(^4\)

Investment funds are typically established as one of two different types of enterprises. Investment funds in most developing economies have been formed as joint stock companies. This has been the case for the great majority of investment funds formed in Russia, the Czech and Slovak Republics, Kazakhstan, Lithuania and Poland. These investment funds operate under the same general rules which apply to other joint stock companies and are governed by a shareholders’ meeting, supervisory board and management committee.

In the Czech and Slovak Republics, however, investment funds may also be established as a form of joint property without separate legal personality.\(^4\) Such property is managed by an investment manager under a contract. Such an investment fund is commonly referred to as a “unit trust,” and the persons contributing to the fund are called “participants.” These participants possess no voting rights and have no direct control over the managers of the property. Investment funds were presumably allowed to be formed as unit trusts in the Czech Republic because the relatively few regulations governing the operation of a unit trust make it easier to issue and redeem shares than in a standard joint stock company.

The poor control held by participants in a unit trust makes it preferable to prohibit such types of investment funds and forego their need by modifying the regulations governing the issuance and redemption of the shares of investment funds formed as joint stock companies.

2. **Closed-End vs. Open-End Investment Funds**

Both joint stock companies and unit trusts may be formed as “closed-end” investment funds or “open-end” investment funds. A closed-end fund is a fund in which a shareholder may not redeem his

---


shares and can leave the fund only by selling his shares to another person. An open-end investment fund is a fund in which a shareholder may redeem his shares and require the company to pay him back an amount in cash equal to the book value of his share of the investment fund. Managers are thought to be more responsive to the interests of the shareholders of an open-end fund, since shareholders can directly and dramatically indicate their displeasure with the management of an open-end fund by redeeming their shares, thereby reducing the size of the fund. To redeem these shares, however, the investment fund must keep a sufficient amount of its assets in very liquid form to be able to pay shareholders when required. The share markets in most of the countries presently undergoing transformation from communist economic systems are unlikely in the near future to be sufficiently liquid for open-end investment funds to be able to operate without keeping a significant amount of their capital in cash, which would largely defeat the purpose of having investment funds play a role in the privatization process.

In light of the above, investment funds should be required to be initially formed as closed-end joint stock companies. When the share market becomes liquid enough to also allow open-end joint stock companies to operate and meet their redemption obligations, closed-end funds may be allowed to be transformed into open-end funds upon the resolution of their shareholders and permission from government authorities. Though this approach may delay the formation of open-end joint stock companies beyond the time in which they might develop naturally if left purely to market forces, such a delay should be more than balanced by the reduction in the number of investment funds that may fail to meet their redemption obligations and the effect that such failures may have on the developing securities markets.

3. Model By-Laws and Special Shareholder Powers

Special provisions may be required to enhance the protection of shareholders' interest and to strengthen the powers of shareholders in the fund because the ownership of an investment fund is likely to be so widely dispersed among citizens. This has typically been done by requiring the funds to be formed in accordance with model by-laws set forth in the investment fund legislation. The model by-laws

42 See Anderson, supra note 29, at 29-30.
43 The Polish, Russian and Kazakh investment fund legislation require all investment funds to conform their charters to model charters appended to the main legislation. In contrast, the Czechoslovakian legislation only requires funds to include several basic categories of informa-
strengthen the shareholders' control by typically requiring a resolution of the fund's general meeting of shareholders for the following actions:

a. amending the fund's by-laws;

b. establishing or amending investment directions stating the main types of securities in which the fund will invest;

c. executing or amending contracts to hold the securities, cash and other assets of the fund and establishing the level of fees paid under such contracts;

d. executing or amending contracts to manage the fund and establishing the level of fees paid under such contracts;

e. accepting the annual report of the fund's management;

f. deciding to distribute dividends from the profit of the fund;

g. appointing the officers, supervisory board members and auditors of the fund; and

h. liquidating the fund.

The powers of the shareholders in an investment fund may also be strengthened by making it easier for shareholders to exercise their power through certain procedural provisions included in the model by-laws. Such provisions may, for example, lower the percentage of shares necessary to call an extraordinary meeting of shareholders or relax the general rules for obtaining proxy rights to vote on behalf of shareholders who cannot attend shareholder meetings.

4. Disclosure of Information

Regulations can promote the efficient operation of an investment fund by requiring the fund to fully disclose the details of its activities to its shareholders, thereby allowing them to exercise their voting and sale rights in a knowledgeable way. In Russia, for example, detailed audited financial statements of each investment fund must be published every quarter in the newspapers. In addition, shareholders may review all agreements entered into by the fund as well as information about the members of the fund's corporate bodies and the employees and directors of the companies which manage the fund and hold its securities. In addition to allowing examination of managers' efficiency, record keeping and disclosure requirements can also serve as important tools for the detection of fraud.
5. Management Contracts

The vast majority of investment funds established to date in Eastern Europe and the former Soviet Union have adopted the approach frequently followed in the United States and Western Europe whereby the investment fund is managed by a separate company acting under contract.\textsuperscript{47}

There are several advantages to this approach. First, the organized financial expertise of the management companies may give the fund access to better services than can be provided by officers whom the fund locates and hires on an individual basis. Second, this approach establishes an additional level of monitoring within the fund since the fund's executive officers will be responsible for monitoring the outside management company. Third, these contracts may place the burden of all administrative costs upon the manager, thereby insulating the fund from unexpected costs which may erode the fund's capital.

Most investment fund legislation requires management contracts to be approved by the fund's general meeting of shareholders but does not require governmental approval of the contracts. The Polish, Russian and Kazakh laws, however, require management contracts to follow a standard form set out in the investment fund regulations. Requiring government approval or specific forms for management contracts is criticized by some analysts on the grounds that government bodies are frequently not well-suited to determine the best terms of such a commercial agreement and that such requirements may prevent contractual forms from developing which may be more favorable to the investment fund.\textsuperscript{48}

In light of the possible imbalance of sophistication between the management company and the fund officers or collusion between these parties, management contracts should be required to follow a standard form to protect fund shareholders and clearly establish the terms of the fund's relationship with its managers.

\textsuperscript{47} Countries allowing or requiring investment funds to be managed by outside firms include Russia, the Czech and Slovak Republics, Poland, Kazakhstan, Lithuania and Armenia. An exception is Romania's unique Private Ownership Funds system in which investment funds are operated directly by government-appointed boards of directors. See Commercial Companies Privatization Law No. 58/1991 (Rom. 1991); National Agency for Privatization, Overview of the Privatization Law (Rom. 1991).

\textsuperscript{48} See Anderson, \textit{supra} note 29, at 33.
6. Success Fees

A management contract may seek to promote the efficient operation of a fund by basing the manager’s fee upon the success of the fund. In the Polish mass privatization program, for example, investment fund managers are partially paid with shares in the investment fund which they manage, and the ultimate size of their fee depends upon the performance of the fund. Managers may be further motivated to promote the long-term health of the fund by regulations which prevent the managers from selling such shares for a certain period of time. Some analysts fear, however, that mandatory formulas for fees may not be as efficient as arrangements that will arise in the market and that a success-based formula may motivate fund managers to engage in high-risk investments or otherwise act in unexpected ways which could be detrimental to the economy. These analysts prefer the approach taken in other countries such as Russia and the Czech and Slovak Republics which may less directly motivate fund managers by allowing them to receive fixed fees which can be no larger than a certain percentage of the fund’s total asset value.

A possible compromise between these concerns would allow fund managers to receive a basic cash fee sufficient to cover their operational costs and then receive the remainder of their fee in the form of shares in the fund which they will be restricted from transferring for a specified period of time.

B. Prevent Dishonesty and Fraud

The following types of regulations are intended to reduce the risk that investment fund managers or founders will act dishonestly or profit unfairly from their positions with the fund.

I. Licensing Requirements

Nearly all investment fund legislation requires an individual or legal entity to obtain a special license from a governmental body before it will be allowed to create or manage an investment fund. Delay in enacting and enforcing licensing regulations has been one of the factors which has allowed scandals involving such funds as Russki Dom Selenga to reach huge proportions affecting millions of share-

---

49 Ministry of Privatization of the Republic of Poland, supra note 14, § 9.3-3.
50 Ministry of Privatization of the Republic of Poland, supra note 14, § 9.3-5.
51 See Anderson, supra note 29, at 24.
holders. While some countries have stricter licensing requirements than others, a basic requirement to obtain a license in any country is proof that the manager or founder and the fund’s employees have not been previously convicted of economic crimes.

2. Depositary Agreements and Auditors

The Russian, Kazakh, Czech and Slovak investment fund regulations also attempt to prevent the embezzlement and misappropriation of investment fund assets by requiring that the shares, cash and vouchers of an investment fund be held by a separate company called a depositary or custodian. A depositary is responsible under a contract for safeguarding these securities and recording and executing all transactions involving the fund’s securities. The depositary is often also responsible for monitoring the activities of the investment fund managers and ensuring that transactions are carried out in accordance with the fund’s investment declaration. In addition, most legislation requires that the accounts and activities of investment funds be audited annually, semi-annually or quarterly by certified auditing companies to ensure the propriety of all transactions.

In Russia, there have been some difficulties encountered to date in the implementation of the depositary system. Russian banks have thus far been hesitant to act as depositaries for investment funds. As a result, the funds and management companies have had to create affiliate companies to perform these depositary functions, which obviously reduces many of the safeguards which the depositary system is designed to achieve. In addition, while a depositary agreement must follow a specific model frequently set forth in the investment fund regulations, the Russian legislation does not require a company to obtain any license or government approval to act as a depositary. This fact may have contributed to one of the recent investment fund scandals in Russia where fourteen million dollars worth of vouchers apparently disappeared from a fund; the managers claimed that the

52 See Chrystia Freeland, Russian Court Suspends Fund, FINANCIAL TIMES, Aug. 18, 1994, at 2; David Hearst, MMM Boss Puts Case From Jail, GUARDIAN, Sept. 12, 1994, at 8 (“By insisting all investment funds had to be licensed, the president provided the funds with an excuse to stop trading, reneging on their promise to redeem all shares issued, and allowing them to keep the money.”)

53 See, e.g., Regulations on Investment Funds, supra note 44, § 18.

54 St. Giles and Buxton, supra note 19, at 10.
vouchers had been handed over to a foreign company to hold as the fund's depositary.\textsuperscript{55}

In light of the experience in Russia, it may be advisable to allow depositary fees to be sufficiently large to encourage responsible institutions to act as depositaries while requiring all depositaries to be licensed or to file a guarantee or bond insuring the performance of their duties. The practicality of this approach may depend upon the existence of a sufficient number of institutions which may be willing to provide such services and the extent of resources and manpower which the government can devote to licensing and monitoring these institutions.

3. Limits on Manager Compensation

Most investment fund laws adopted in the region place a limit on the fees which may be paid to investment fund managers to avoid situations where the management has taken effective control of the fund away from the fund's shareholders and seeks to pay itself excessive fees at the fund's expense.\textsuperscript{56} It may also be advisable to require the fund managers to be responsible for all costs arising in the administration of the investment funds and to prohibit them from receiving payment beyond their fee in compensation for such costs. Otherwise, the fund may be exposed to escalating fees, and the manager may divert monies from the fund in the form of claimed costs which may be difficult for shareholders to monitor.\textsuperscript{57}

4. Minimize Potential Conflicts of Interest

An important role of investment fund legislation is to prevent conflicts of interest which may cause managers, depositaries or auditors to act against the interest of the fund. Investment fund regulations frequently prohibit company managers, workers' groups and certain state bodies from founding or managing investment funds in order to avoid situations where these groups may manage the funds to promote their own political or financial interests rather than those of

\textsuperscript{55} See Voucher Fund Accused of Mass Fraud, MOSCOW TIMES, Mar. 26, 1994, (concerning the collapse of the Neftalmazinvest investment fund).

\textsuperscript{56} See Regulations for Specialized Investment Funds, supra note 22, § 34 (limiting annual management fees of a voucher investment fund to no more than ten percent of the average net asset value of the fund); Act on Investment Companies and Investment Funds, supra note 41, § 27 (limiting annual management fees to no more than two percent of a fund's net asset value or twenty percent of its profit).

\textsuperscript{57} This approach has been incorporated in the Armenian investment fund regulations. See Regulations on Investment Funds, App. B § 5 (Arm. 1994).
the fund. Affiliates of an investment fund's management company and depositary are usually restricted from constituting the majority of the supervisory board members of the investment fund. In addition, investment funds are frequently required to obtain supervisory board approval prior to investing in or entering into agreements with any entities in which the managers, depositaries or auditors have an interest.

5. Full Disclosure

As the full disclosure of information regarding the activities of the investment fund and its managers may encourage the efficiency of the fund's operations, disclosure is also expected to be a major tool in preventing fraud and theft from the fund. In addition to the publication of audited financial statements, regulations should also require the disclosure of all prices paid and received for shares held by the fund and the disclosure of any ownership connections or agreements between the management company, the fund and the companies in which the fund owns shares.

C. Promote Legislative Objectives and Minimize the Chance of Failure of the Fund

Drafters of investment fund legislation in privatizing countries have proposed the following types of provisions to ensure that investment funds serve their intended purpose and to minimize the chance of the funds' financial failure:

1. Restrict Types of Investments and Activities

Investment fund regulations commonly impose the following types of restrictions on the investment and activities of investment funds:

(a) funds may invest only in securities;
(b) funds may not invest in the shares of any enterprise with unlimited liability;
(c) funds may not invest in bonds other than government bonds or bonds traded on licensed exchanges;
(d) funds may not invest in precious metals, commodities, options or futures contracts; and
(e) funds may not speculate by agreeing to sell shares they do not yet own.

58 See, e.g., Regulations For Specialized Investment Funds, supra note 22, §§ 8, 12.
59 See, e.g., Regulations For Specialized Investment Funds, supra note 22, § 31.
60 See, e.g., Regulations For Specialized Investment Funds, supra note 22, § 33.
The Polish investment fund legislation restricts investment funds from investing more than five percent of their assets in real estate or in companies engaged primarily in real estate investment. The Russian and Kazakh investment fund legislation prohibit any investment in real estate by requiring that all investments be made in securities. The Czechoslovakian regulations, however, place no limitation on the percentage of a fund's assets that can be invested in real estate. As an investor in real estate, an investment fund does not fulfill its desired purpose of providing corporate governance and access to financing for privatized companies. In addition, real estate investments are often viewed as inherently volatile and are difficult to accurately value, a problem that complicates the already difficult issue of assessing the value of an investment fund's assets.

The Russian and Kazakh investment fund laws also prohibit investment funds from taking loans or issuing bonds, guarantees or other agreements which entitle another party to a first right to the fund's assets. Such a restriction can prevent fund managers from risking the failure of the fund by making commitments which the fund may not be able to satisfy.

Investment fund legislation adopted in the Czech and Slovak Republics also prohibits investment funds from investing in securities which are not traded or deemed acceptable for trading on a licensed stock exchange. This type of restriction, however, was not imposed in Russia because of the undeveloped stage of their stock exchanges and does not seem practical to impose in many of the transforming countries.

2. Limit Percentage of Fund Assets Invested in One Company

Investment fund legislation usually attempts to ensure that investment funds will have diversified portfolios by prohibiting investment funds from investing more than a small percentage of their total assets in the shares of any one company. In Russia and Kazakhstan, for example, an investment fund cannot invest more than five percent

---

61 Law on National Investment Funds, supra note 13, § 44.8.
62 Regulations For Specialized Investment Funds, supra note 22, § 25; Statute of Investment Privatization Funds, Supp. to Decree No. 1290, § 26 (Kaz. 1993).
63 The Czechoslovakian Act imposes a five percent limit on investments in any one piece of real property but imposes no limit on aggregate real estate investments. See Act on Investment Companies and Investment Funds, supra note 41, §§ 18, 24(2)(b).
64 Regulations For Specialized Investment Funds, supra note 22, § 25; Statute of Investment Privatization Funds, supra note 62, § 26.
65 Act on Investment Companies and Investment Funds, supra note 41, § 17.
of its assets in the shares of one company and must thus spread its assets over at least twenty different investments.66

3. Restrict Forms of Advertisement and Guarantees

Investment funds may also attempt to engage in high-risk investment strategies to fulfill promises and guarantees of high returns made in advertisements soliciting contributions to the fund. Such promises have unrealistically raised the expectations of shareholders and have lead to widespread dissatisfaction and political difficulties when not fulfilled.67

Investment fund advertising and guarantees, however, have been both blessings and curses to the region's mass privatization programs. In the Czech and Slovak Republics, the aggressive advertising campaign and promised returns of investment funds are widely credited as the main factors leading to the high level of public participation in the program.68 In Russia, the "pie in the sky" television ads of investment funds, promising annual returns of up to three thousand percent, have been at the center of the mass privatization program's biggest scandals.69

Most investment fund laws, including the Russian regulations, have tried to specifically prohibit the types of guarantees made by the Russian funds and have attempted to restrict the type of statements that investment funds can make in their advertisements.70 In Russia, however, such regulations have been difficult to enforce. The ineffectiveness of the Russian authorities in controlling investment fund advertising was dramatically demonstrated when the highly controversial advertisements for the MMM investment fund continued even after the fund's founder had been jailed, the fund ordered closed and the ads ordered stopped, apparently because the Russian television sta-

66 Regulations For Specialized Investment Funds, supra note 22, § 25; Statute of Investment Privatization Funds, supra note 62, § 26. Czechoslovakian legislation limits investments in one issue to no more than ten percent of the net asset value of the fund. Act on Investment Companies and Investment Funds, supra note 41, § 24.
70 See, e.g., Regulations on Investment Funds, supra note 44, § 40.
tions found it preferable to defy the authorities' injunction than to risk returning the advance payments received for the ads' placement.\textsuperscript{71} In response to such examples, Armenian investment fund regulations require all investment fund advertising to be pre-approved by the authorities and subject both advertisers and the media to liability for contravening this requirement.\textsuperscript{72}

4. Investment Declarations and Disclosure

By requiring investment funds to operate in accordance with the investment declarations which the shareholders have approved and to disclose to its investors the investments and trades made by the fund, regulations do not necessarily prevent funds from following high-risk strategies but at least allow shareholders to monitor fund activities to ensure that the investment strategy which the managers have pursued reflects the shareholders' wishes.

D. Prevent Monopolistic and Anti-Competitive Behavior of Investment Funds

Three types of provisions are usually included in investment fund legislation to prevent investment funds from using their powerful positions in an anti-competitive manner or in other ways harmful to the economy:

1. Limitation on Percentage of Total Vouchers Owned by an Investment Fund

Investment funds are frequently restricted from receiving more than five to ten percent of all vouchers issued in a voucher privatization program to ensure that one investment fund does not control such a large percentage of vouchers that it can control or manipulate the trading of vouchers, the voucher privatization auctions or the securities market.\textsuperscript{73} Such a restriction also tends to ensure that citizens will have a choice of several competing funds in which to invest their vouchers.

The experience in the Czech and Slovak Republics, where related groups frequently formed and managed more than one investment


\textsuperscript{72} See Regulations on Investment Funds, supra note 44, § 16.

\textsuperscript{73} Regulations For Specialized Investment Funds, supra note 22, § 25 (five percent); Act on Investment Companies and Investment Funds, supra note 41, § 24 (ten percent); Statute of Investment Privatization Funds, supra note 62, § 26 (five percent).
fund, indicates that it may be advisable to restrict not only the percentage of vouchers which may be owned by an individual investment fund but also the total percentage which may be owned by a group of related investment funds.\(^{74}\) Alternatively, regulations may prohibit an enterprise and its affiliates from forming more than one investment fund. The potential for investment fund groups to control significant portions of the voucher market is shown by the fact that although more than four hundred investment funds have been formed in the Czech and Slovak Republics, the thirteen largest funds and their affiliates control seventy-seven percent of all voucher points given to the investment funds (which represents fifty-five percent of all voucher points distributed in the entire first wave of the program).\(^{75}\)

2. Limitation on the Percentage of a Company's Shares Which One Investment Fund May Own

The most frequently debated point included in investment fund legislation is the limitation placed on the percentage of shares which an investment fund and its affiliates may own in a company. These limitations are apparently intended to prevent an investment fund from becoming a dominant shareholder in a company, thereby causing the company to take actions which benefit that fund but harm the company and its other shareholders. For example, a majority shareholder with cash flow problems may cause a company to liquidate a significant portion of its assets and pay out liquidation dividends even though such an action may be harmful to the health of the company and interests of other shareholders. To address such concerns, investment fund regulations have imposed the following widely ranging limitations on the percentage of shares which an investment fund may own in a company:

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Czech Republic</td>
<td>20%</td>
</tr>
<tr>
<td>Slovak Republic</td>
<td>20%</td>
</tr>
<tr>
<td>Russia</td>
<td>25%</td>
</tr>
<tr>
<td>Poland</td>
<td>33%</td>
</tr>
<tr>
<td>Lithuania</td>
<td>50%</td>
</tr>
</tbody>
</table>

The problem raised by such limits, however, is that the smaller the percentage of shares which an investment fund owns in a company, the less ability the investment fund has to exercise its important role in the corporate governance of the company. As discussed in

\(^{74}\) Several Czech investment groups established more than ten funds each. Mladek, supra note 5, at 22.

\(^{75}\) Mladek, supra note 5, at 22.
Part II.A., *supra*, this role is seen by many to be central to the success of a voucher privatization program. In addition, an investment fund which has only a small percentage of shares in a company may have little motivation to try to assist that company.

It is significant to note that in Russia the ownership limit was originally set at ten percent as a result of the strong political influence of the managers of state-owned enterprises (who were opposed to corporate governance which could interfere with the managers’ control of “their” companies) and a general reluctance to let unknown financial institutions such as investment funds play such a strong role in the governance of industrial companies. The limit was increased to twenty-five percent in the 1994 Privatization Program, however, after it had apparently become clear that investment funds were needed to create some form of corporate governance in the privatized companies and prevent company managers from operating without supervision or accountability.

The experience in the Czech and Slovak Republics has indicated that investment funds may play an active role in corporate governance when subject to twenty percent ownership limits. When the first wave of voucher auctions had been completed, it appeared that three or four funds together owned a majority of shares in many companies and therefore had the responsibility of appointing members to serve on the companies’ supervisory and management boards. Though it is still too soon to know the results of the funds’ exercise of their powers as large shareholders, evidence is beginning to appear that the funds are cooperating to actively encourage and monitor the managers of the companies in which they own shares and are causing these managers to be replaced if they prove to be corrupt or incompetent. The funds’ intention to play active roles in corporate governance is also indicated by the fact that the funds have frequently chosen to directly appoint their members to positions on companies’ management boards, which typically meet more frequently and are more deeply involved in the details of the companies’ operations than their supervisory boards.

It may also be significant to note, however, that while nine of the thirteen largest Czech and Slovak investment fund groups were

---

76 Boycko, *supra* note 20, at 8.
formed by banks, investment funds have not yet appeared to play a significant role in arranging access to capital for the companies in which they hold shares. One theory which may explain this reluctance is that regulations prohibiting a fund from owning more than twenty percent of the shares of any company discourage a fund from undertaking costly activities such as the arranging of financing since the fund will receive only a limited percentage of the benefits from such efforts.

A thirty-three percent ownership limit was set in the Polish legislation on the theory that such a percentage should prevent an investment fund from passing resolutions without the agreement of at least one other shareholder but was high enough to allow and motivate the investment fund to appoint representatives to the corporate bodies of the company and play an active role in monitoring and supervising the company.

In Lithuania, most investment companies have sought to secure their investments by purchasing the maximum of fifty percent of shares in a company and strongly exercising their rights as shareholders. Even when in a position of control, however, the investment funds usually do not directly manage the companies in which they invest because they do not have enough personnel. In most cases they limit their direct involvement to electing the members of the supervisory board who then appoint and supervise the executive officers of the company. The investment funds apparently have been active in supervising and replacing company managers.

Though the assets of the Lithuanian investment funds are usually not liquid enough to allow them to directly provide capital to assist companies in restructuring, some investment funds have been sufficiently motivated by their large shareholdings to actively large foreign and domestic investors to provide funds for company restructuring. The activities of the Lithuanian investment funds as large shareholders has apparently raised some concerns: the Lithuanian Securities Commission is reported to be currently drafting a new law on invest-

81 Mladek, supra note 5, at 22.
82 Anderson, supra note 29, at 10.
83 Anderson, supra note 29, at 10-11.
85 Id. at 12-15.
86 Id.
87 Id.
88 Id. at 14.
ment funds which is designed to ensure greater risk diversification by the investment funds and strengthen the monitoring and control of investment fund managers.⁸⁹

It is difficult to determine the exact limit to impose on an investment fund's ownership of shares in companies being privatized. The need for strong corporate governance by investment funds will be largely determined by the natural interests, motivation and power which the management of privatizing companies will have in taking the necessary steps to efficiently restructure their companies. Where the management itself has a significant ownership interest in the company, it may be appropriately motivated to undertake such actions. Where other employees, however, own a large portion of shares in the company, it may be extremely difficult for management to take necessary restructuring actions affecting employment without the aid of large outside investors such as investment funds.

Another factor which must be considered in setting ownership limits is whether investment funds in former communist economies will be managed by individuals and management companies who have sufficient experience and training to provide effective corporate governance to restructuring companies. If the investment fund managers do not have sufficient professional capabilities, it may be wise to limit their ability to interfere with company management.

3. Limitation on Relations Between Investment Funds

Investment funds are often limited to owning no more than a small percentage of the shares in another investment fund to avoid situations where related investment funds may cooperate in anti-competitive actions or in actions harmful to the interests of the other shareholders in the controlled fund.⁹⁰ For similar reasons it may also be advisable to prevent affiliated management companies from managing more than one investment fund. In the Czech and Slovak Republics, for example, one management company and its affiliates manage seventeen different funds.⁹¹

E. General Framework Issues

The final goal in drafting investment fund legislation is to ensure that the legislation addresses the general issues necessary to govern the basic establishment and operation of the funds and identifies the

⁸⁹ Id. at 15.
⁹⁰ See Regulations on Investment Funds, supra note 44, § 26.
⁹¹ Mladek, supra note 5, at 22.
future regulations which must be developed by the government concerning specific tax, accounting and valuation issues arising in connection with the operation of investment funds. Among such general framework issues which investment fund regulations typically address are the following:

1. Definition of Investment Funds

One of the most important provisions of an investment fund law is one which defines the scope of the law and the type of enterprises which it will govern. An excessively broad definition of investment funds may overly restrict general investment activities and overburden the government bodies responsible for licensing and monitoring investment funds. An overly narrow definition may allow enterprises to engage in substantially the same activities in which investment funds engage and present the same dangers, yet be technically exempt from the restrictions of investment fund regulations.\(^92\)

An acceptable compromise between these two concerns may be to define an investment fund as any enterprise which issues its own shares in return for vouchers or which has invested more than a certain percentage of its assets in the securities of other issuers. This is the basic form of the definitions set forth in the Russian legislation.\(^93\) It may also be advisable, however, to add a subjective factor to the definition of an investment fund, as is done in the United States, by including any company which is primarily engaged or intends to be engaged in the business of investing in securities.\(^94\) This type of clause may prevent investment funds from avoiding the requirements of the investment fund legislation during periods in which the percentage of their assets invested in securities is below the objectively defined level, such as during the formation of the fund.

Though banks, insurance companies and certain other types of financial institutions may often fall within the technical definition of an investment fund by investing a significant percentage of their assets in securities, they are usually specifically exempted from the definition because their investment activities are governed by the requirements

\(^{92}\) See Russian Government Prepares Anti-Fraud Package, TASS, Aug. 15, 1994, available in LEXIS, Nexis Library (investment fund claims to be exempt from regulations by offering “share certificates” instead of shares).

\(^{93}\) Regulations on Investment Funds, supra note 44, § 2.

of banking and insurance laws specifically tailored to their special positions in the economy.\textsuperscript{95}

If a relatively low percentage of securities ownership may qualify an enterprise as an investment fund, it may be appropriate when calculating such percentages not to consider securities which an enterprise owns in its majority-owned subsidiaries.\textsuperscript{96} Otherwise, enterprises may be unable to effectively diversify their activities through the establishment of subsidiaries or to establish holding companies to manage their various subsidiaries without being subject to the inappropriate restrictions of the investment fund law.

2. \textit{Details of Fund Formation and Governance}

The powers and duties of corporate bodies of investment funds and the detailed procedures for their formation, liquidation and issuance of shares are often set forth in the investment fund regulations in ways which may slightly differ from the standard provisions governing all joint stock companies. Such special powers, duties, and procedures are designed to accommodate the specific operations of investment funds, increase governmental oversight of the formation process and ensure that many of the optional shareholder protections of the legislation governing joint stock companies will be mandatorily applied in the case of investment funds.

3. \textit{Taxation}

The taxation of investment funds in a manner similar to other joint stock companies presents a problem of double taxation: both the operating company generating the original profit and the investment fund are taxed before that profit reaches investment fund shareholders in the form of dividends. In such situations, shareholders may receive considerably less benefit by investing in investment funds than by investing directly in operating companies. To address this problem, investment funds and holding companies meeting certain standards are usually exempted from taxation on the profits which they receive from the companies in which they invest.

4. \textit{Requirement of Further Regulations}

The investment fund legislation initially adopted in most countries sets out provisions governing the broad activities of investment

\textsuperscript{95} See, e.g., Regulations on Investment Funds, supra note 44, § 3.

\textsuperscript{96} See Investment Company Act of 1940, supra note 94, § 3(a)(1).
funds, not the detailed regulations which will eventually be required to govern many of the technical and financial issues arising in connection with fund operations. In anticipation of these requirements, initial investment fund legislation frequently assigns government bodies to begin to develop detailed regulations to govern such issues as: licensing requirements for investment fund founders, managers, depositaries and share offerings; methods to be used in valuing investment fund assets; specific accounting rules to apply to investment fund operations; and specific tax regulations to apply to the operations and profits of investment funds.

VI. Conclusion

In the end, the various legislative options discussed above will prove ineffective unless they are supported by a government willing and able to provide reliable enforcement of commercial laws. Privatization and corporate laws must be enforced to prevent company management from frustrating the efforts of investment funds to reorganize the operations of privatized companies and replace ineffective company managers. Ministries must have sufficient resources to monitor fund activity and sufficient authority to sanction and remove fund managers which violate the law. Licensing requirements must be diligently and uniformly applied to maintain public confidence and prevent unqualified persons from soliciting the vouchers and cash of other citizens. In privatizing economies where budgetary resources are in short supply and the regulation of private enterprise is a new phenomenon, the necessary translation of the theory underlying investment fund legislation into practice presents the most difficult challenge of all.