

Bulgaria

Brief Overview of the Bulgarian Legal Framework for the Funds Industry

30 December 2005

Bulgaria is scheduled to join the European Union on 1 January 2007. After few years of hard work, currently the Bulgarian funds legislation is to great extent harmonized with the related EU directives. Modern legal rules enforced by a powerful unified non-banking financial industry regulator – the Bulgarian Financial Supervision Commission (the “Commission”), ensure high degree of protection for local and foreign investors and strives to implement the best international practices for funds industry.¹

On the other hand, the economic growth and political stability in Bulgaria contribute for huge profit opportunities from capital market investments in the country at an acceptable risk. Investors’ confidence increases and more and more local and foreign investors of different sizes invest in securities. As a result the liquidity at the Bulgarian Stock Exchange (“BSE”), especially for the blue chips, improves significantly. Since its launch 5 years ago the BSE index SOFIX has boosted 800 per cent. For the first 10 months of 2005 SOFIX has grown up 43 percent. Accordingly, the 2004 annual rate of return of Bulgarian UCITS mutual funds investing in the Bulgarian capital market is 10-13 percent for conservative funds and between 35 and 80 percent for balanced and high yield funds. Moreover, as a principle that income is tax exempt (see more about taxation in the last section of this report).

Currently, a hot topic in Bulgaria is real estate investments as well. Real estate prices tripled in the last 2 years, but still there is a potential for significant profits in the sector. Consequently, the number of Bulgarian public funds investing in securities has increased dramatically and that process still continues.

Types of investment funds established under Bulgarian law

The Bulgarian capital market law regulates only investments funds that offer their securities to the general public and invest in securities, as well as funds that invest in real estate or receivables. The securities issued by the funds have to be fully transferable and in book-entry form (dematerialized) registered at the Bulgarian Central depository.

UCITS funds

Bulgarian UCITS funds, under the meaning of Art. 1 (2) of EU Directive 85/611/EEC and its consequent amendments up to date (“UCITS Directive”) may be constituted under two forms: as open-ended investment companies or contractual funds. Both they are governed by the 2000 Law on the Public Offering of Securities (“Law on Securities”). The funds are licensed by the Commission and operate under its ongoing supervision. Their transformation and liquidation of the funds is conditional to the Commission’s approval.

(1) *Open-ended investment company (“IC”)*. It is a legal entity (a special type of joint-stock company). The IC has variable capital, but in order to be granted a license its initial paid in

¹ The establishment and further improvement of the Bulgarian capital market legal framework took several years of continuous considerable efforts of the securities regulator, assisted by USAID and other international donors.

cash capital shall amount to at least BGN 500,000 (approximately Euro 250,000). The IC issues only ordinary shares and each share of the IC gives one vote in the general meeting of shareholders.

One third of the IC's board has to consist of independent directors. However, all board members have to meet their duties of care and loyalty as defined in the law and are required to act in the best interest of all shareholders. The board chooses the depository bank, the broker-dealer and the auditor of the investment company. The board is required to outsource the portfolio management to a management company. The management company takes the investment decisions and gives orders for execution directly to the authorized broker-dealer. The IC net asset value is calculated by the depository or by the management company under the control of the depository. The IC is subject to an on-going capital adequacy and liquidity requirements.

(2) *Contractual fund* ("CF"). As of the mid of 2005 a UCITS in Bulgaria may be constituted in the form of a CF as well. A Bulgarian CF differs from an IC in the following aspects. First, the CF is not a legal entity, but a pool of assets established, organized and managed by a management company. The CF's pool is divided in units, which provide investors with liquidation quota, redemption right and other rights as laid down in the CF's rules. A CF is established after a Commission's permission. A CF may be established without any contributions from unitholders, but the CF's net asset value must reach BGN 500,000 one year after its establishment, otherwise the Commission shall revoke the CF's permission.

The CF has no bodies; instead, the management company that has organized the CF takes the investment decisions and all other decisions necessary for the operation of the CF. The management company represents the CF as well. The law requires the management company and the CF's depository in act in the interest of all CF's unitholders. The management company is liable before the unitholders for all damages suffered by them as a result of a guilty failure to carry out its obligations.

The management company separates its assets from the CF's assets and prepares separate financial statements for the CF. The law expressly provides that the creditors of the management company and the depository have no rights against the CF's assets.

A Bulgarian management company has the full scope of activity as laid down in Art. 5 (2) and (3) of the UCITS Directive. A management company needs Commission's license to start up business and operates under the permanent supervision of the regulator. The management initial capital must be at least BGN 250,000 (approximately Euro 125,000) and is subject to an on-going capital adequacy and liquidity requirements.

In general, with some insignificant deviations, the legal framework for UCITS funds and management companies is in compliance with the UCITS Directive, including the authorization and structure requirements, the obligations of the depository, the investment policies of the undertakings and their general obligations. However, still there are some discrepancies between the Bulgarian rules and regulatory practices compared with the EU directives and practices in developed capital markets. For instance, what is not exactly clear under the Bulgarian law is whether an investment company may have different investment compartments.

Close-end investment companies investing in securities

Bulgarian closed-ended ICs are required, like UCITS, also have the sole object to be a vehicle for collective investment in transferable securities of capital raised by the public and operate on the principle of risk-spreading, though their diversification criteria are more relaxed. The main difference between the UCITS IC and the closed-end IC is that the former does not redeem its shares at the request of their holders. Also, in contrast to a UCITS, the closed-ended ICs could be self-managed, but its board may delegate to a management company the portfolio management and other services. The closed-end IC is required to list its shares at the BSE in six month period after being licensed by the Commission and registered by the court.

Special funds investing in real estate or receivables

The 2003 Law on the Special Purpose Investment Companies (“SPIC Law”) provides for two special types of public investment companies: (i) for investments in real estate (similar to REITs); and (ii) for investments in receivables. The Law on Securities apply accordingly to the cases, which are not expressly covered by the SPIC Law.

In a nutshell, the special purpose investment company (“SPIC”) is a pool of assets - real estate or receivables, which are purchased with funds raised by the SPIC by means of publicly offered securities. Since the price of the SPIC securities will depend exclusively on the performance of its assets, the SPIC Law provides for considerable protections of the SPIC assets and their fair valuation. First, the SPIC is prohibited to carry out general commercial activity. Further to that, the SPIC has no staff; the collection of rents and maintenance of the real estate or the collection of the receivables owned by the SPIC is performed by an outside servicing company with specific skills and resources. Second, a depository bank keeps the SPIC’s funds and controls the servicing companies. Third, the SPIC enjoys a “bankruptcy remote” status from the creditors of the seller of the assets. Forth, the SPIC assets are valued by an independent appraiser before their purchase and sale by the SPIC, as well as on periodic basis. Also, the SPIC being a type of a public company, its board operates under the duties of care and loyalty and is obliged to manage the company in the best interests of its shareholders.

The SPIC is established as a private company with minimum capital of at least BGN 500,000 (approximately Euro 250,000). At least 30 per cent of its capital must be subscribed by institutional investors, e.g. by banks, insurance companies, pension funds. In 6 months after its establishment (its entry into the commercial court register) the SPIC must apply with the Commission for license as public investment company and for approval of prospectus for stock issue amounting to at least 30% of its capital. After getting the license (which includes approval of prospectus) all SPIC stocks must be registered at BSE for public trading. The SPIC is supervised on an ongoing basis by the Commission.

As the SPIC is viewed as a pass-through structure, therefore, the SPIC Law requires at least 90 per cent of the its net income to be distributed to its shareholders. The idea is that the SPIC shall not be taxed on corporate level and only its shareholders shall be taxed for the dividends received.

Private investment funds

Although not envisaged by the securities legislation, it is possible to create in Bulgaria a private vehicle to invest in securities, real estate or other assets, generally without any legal or regulatory limitations. Such a vehicle could take the form of private joint stock company or other generally accepted legal form, but is prohibited to name itself investment fund or to

have similar name. The private entity shall be governed by the Bulgarian Law on Commerce, which is also significantly harmonized with the EU Company law directives.

Disclosure obligation of public funds

The Bulgarian public funds disclosure framework is to great extent harmonized with the relevant EU directives, IOSCO and CESR documents. The law envisages four-level disclosure system: (i) initial disclosure of information by prospectus; (ii) periodic reporting requirements; (iii) ongoing disclosure of significant events, and (iv) disclosure about major holdings.

Prospectuses

As provided for in UCITS Directive, Bulgarian public funds investing in securities (UCITS and close-end ICs) are also required by the national law to publish full and simplified prospectus with the content as required by this Directive. Similar prospectus rules apply for closed-end ICs as well. SPICs could draft their prospectus as one document or a set of 3 documents (registration document, securities note and resume) as permitted by Directive 2003/71/EC (the “Prospectus Directive”). The essential elements of the UCITS prospectuses need to be kept up to date. The SPICs’ prospectuses are generally updated once per year with their annual report.

Periodic reports

All public funds have to publish annual and quarterly reports, thus Bulgarian law imposing more stringent interim reporting requirements than the UCITS Directive and Directive 2004/109/EC (the “Transparency Directive”).

(1) *Annual reports*. The annual reports of all public funds must be published 90 days after the end of the financial year (31 December) and consist of: (i) audited annual financial statements plus the auditor’s report; (ii) annual management report; (iii) updated prospectus; and (iv) a program for application of the international standards of good corporate governance and report on the results from its application during the preceding year.²

(2) *Quarterly reports*. They must be published 30 days after the end of the respective quarter and include: (i) balance sheet, income statement, cash flow report and equity report with comparable information for the same period of the preceding year; and (ii) the material events (price-sensitive) information announced during the quarter. Bulgarian law still does not provide for interim management reports, as required by the Transparency Directive.

Ongoing information of material events and disclosure about major holdings

Public funds are required to disclose not later than the end of the next business day material events important for investment’ decisions, e.g. change of major shareholders or board members, earnings releases, material lawsuits, etc.

² This program shall be based on the 2004 OECD Principles of corporate governance.

On the other hand, investors in public funds are required to disclose not later than 7 calendar days the change of their proportion of voting rights in the fund where that proportion reaches, exceeds or falls below the thresholds of 5 per cent and multiples of it.

Foreign investment funds offered in Bulgaria

The Securities law provides that after Bulgaria becomes a member of EU foreign public funds, which seat or their management company's seat is in the EU, shall be passported in the country. Up to that moment EU funds could offer their shares/units in Bulgaria after the Commission approves their prospectuses and the funds designate a bank operating in Bulgaria as a local paying agent. So far 2 foreign funds are offered in Bulgaria: the Luxembourg Pioneer funds and the HVB Capital Invest funds.

Taxation of Bulgarian and foreign investment funds

At present the Bulgarian tax regime of public funds is not well synchronized with the 2005 Securities law amendments, which introduced the CFs as one of the UCITs forms; open-ended ICs benefit from much more preferential taxation compared with CFs and foreign funds publicly offered securities in the country.

However, recently the Bulgarian Parliament passed very important for the Funds industry taxation bills, which have effect as of 1 January 2006. Under these new rules all public funds and the investors will benefit from more equalized and in some aspects preferential tax treatment. The new tax provisions aim, at one hand, to provide neutral taxation in accordance with the nature of funds as a collective investment; on the other hand the government wishes to support further the positive trends and the development of the Bulgarian capital market.

Below are the cornerstones of the new Bulgarian tax treatment of the public funds:

- Local and foreign UCITS funds, as well as Bulgarian closed-end ICs and SPICs shall not be taxed at corporate level;
- Capital gains, resulting from BSE transactions and local and foreign UCITS funds redemptions are tax exempt;
- Dividends distributed by public funds are subject to 7 per cent final withholding tax;³
- VAT exempt financial services shall be the management of UCITS funds, closed-end ICs and pension funds, as well as investment advice related to securities.

³ The 7 per cent withholding tax does not apply to shareholders Bulgarian companies.