REPORT ON INVESTMENT FUND REGULATION

Introduction and Summary

The legal and regulatory investment fund infrastructure in Macedonia consists of the Law on Investment Funds (the Law) enacted on February 20, 2000 and a set of regulations passed by the Securities and Exchange Commission (the Commission) October 16, 2000, pursuant to authority granted the Commission in Articles 5, 7, 16, 53, 55 and 57 of the Law.

Notwithstanding the availability since early 2000 of an enacted legal framework permitting the establishment of investment funds in Macedonia, no fund has yet come into existence and, more disquieting, there is no suggestion that anyone in the country is contemplating establishment of a fund. The high hopes that lack of a legal framework was holding back the launch of this investment product, key to capital market fund development, have not been sustained.

In a sense, therefore the Law and the regulations exist in a vacuum, their efficacy not yet put to a practical test of a fund registration application and regulation of fund operations.

The Task Order directs the undertaking of legal and regulatory review of investment fund management and custodian services. Such a review is presented below. However, a consideration of the adequacy of regulation applicable to these services necessarily involves a review and assessment of the investment fund legal infrastructure in light of conditions on the ground. This review discloses to the author substantial structural and technical deficiencies in the Law that may inhibit the introduction of investment funds at such time as Macedonia persons exhibit an interest in launching such funds.

In these circumstances, It seems self-evident that that it would be inappropriate for the Report to focus exclusively on subsidiary administrative issues and to ignore over- arching and important impediments to fund establishment in Macedonia

In the circumstances, as well as fulfilling the narrowly focused Task Order requirements, the Report addresses investment fund development in Macedonia and proposes a governmental initiative to kick start the launch of such funds. It also includes a comprehensive Article by Article review and comments on Law provisions.

The Report is divided into the following parts:

Introduction and Summary

Section One: Development of an investment Fund Industry

Section Two: Analysis and Comment on the Investment Fund Law

Section Three: Analysis and Comment on Regulations to the Law

Section One focuses on the lack of a investment fund industry in Macedonia. It outlines the degree of regional development in peer group countries and assesses the potential for launching of fund products in Macedonia.

The Section points to the government's initiatives in enacting a Pension Fund Law and the Directive issued by the government that joint stock companies list on the Macedonia Stock Exchange. The Report regards these actions as precedents for a similar pro-active governmental initiative to jump start the launch of an investment fund product by the issue of an instruction that such a fund be established not later than a date designated in the instruction.

The recommendation is tempered by an acknowledgment that a Directive should no be issued prematurely. It is a precondition of fund establishment that investable securities be available in Macedonia whose growth prospects, market capitalization, and trading liquidity warrant inclusion in a diversified fund investment portfolio. ,

By reason of its unique and innovative structure it establishes, the enactment of the Pension Law is highly relevant in relation to the prospects for investment fund development. The organizational scheme adopted in the Pension Law circumvents the traditional pension structure of a single national state run pooled fund. In its place, proposes the establishment of a several funds, each organized and its assets managed by a private sector pension management company.

The management company is responsible for all elements of operation of a pension scheme including keeping track of contributions and pension entitlement of plan participants. In order to ensure a competitive environment, the Pension Law provides investors can be a shareholder of only one management company at a time. Thus, competition and choice are the policy hallmarks of the scheme.

The Pension Law authorizes pension fund investment in listed company equity and debt securities listed on a Macedonia stock exchange. Further, of great importance for fund industry purposes, it also permits in investment in participation units and shares of Macedonia investment funds.

The Section makes the point elements of the pension scheme proposal are relevant from an investment fund industry perspective. First, in so far as the scheme establishes a pool of financial assets derived from contributions by individual Macedonian employee citizens, it is functionally an investment fund. Second, by virtue of the fund entitlement to invest in debt and equity instruments of companies listed on the stock exchange, the fund is capable of acting as the same kind of demand side stimulus as functionally would derive from investment fund investment.

Further, the management companies to be established by the Pension Law will undertake functions and activities largely identical to the functions and activities undertaken by a management company responsible for operation of an investment fund.

In the circumstances, the Report regards the pension companies formed to establish pension funds as logical and appropriate candidates to take the lead in launching public investment funds. In discharging such a role, the pension companies would draw on its pre-existing portfolio investment and administrative resource infrastructures.

Taking into account the adage investment funds are sold not bought and that funds are a retail product necessitating a retail distribution network, the three largest and best established banks are the second category of logical candidates to launch the first Macedonia investment fund.

Section Three consists of a close Article by Article scrutiny of the Law. It discloses a large number of Law deficiencies of both substantive and technical character. In particular, it notes the lack of harmonization of provisions in the Investment Fund Law and the Securities Law. This is acute with respect to the regulation of investment advisory activities. An additional example is the failure of the two statutes to recognize that a closed-end fund in corporate form is a joint stock company and as such is subject to regulation not only in the Investment Fund Law but also in the Securities Law and as a listed company, under the Macedonia Stock Exchange rules.

A technical weakness is lack of a definitions section. In order to furnish regulators and practitioners alike with terminology precision and clarity derived from inclusion in the Law of defined terms.

The Report asserts that a core weakness of the Investment Fund Law is its straight jacket approach to fund organization models. Ideally, the Law should permit establishment in Macedonia of fund organizational forms in common use in the European Union. This is not the case. The inclusion in Macedonia fund regulation of the closed-end fund contrasts with EU fund regulation which concentrates on regulation of open-end funds, and leaves it to individual Member States to regulate closed-end funds to the extent the Member regards as necessary. In practice some states (Switzerland) do not regulate closed-end funds; others (Germany) include such funds within domestic fund regulation.

The problem is not so much that Macedonia regulates closed-end funds but that it regulates them on a basis identical to open-end funds. For example, the investment diversification rules are identical for both types of funds.

The diversification rules prohibit a fund investing more than 20% of its assets in securities of any one issuer. It can be argued that the restriction is unsatisfactory in relation to both open-end and closed-end funds. For closed-end funds, imposition of the limit is problematic. For open-end funds, a 20% limit is substantially greater than the generally accepted investment ceiling. The norm for such funds is a 10% cap; some jurisdictions permit up to 15% of fund assets. The Law on Investment Funds of Croatia (on which the Law is said to be modelled) provides a 5% limit on investment in the securities of one issuer, subject to an increase to 10% "as an exception. The 20% threshold means an open-end fund hold only four or five stocks.

The Report does not propose precise changes to the Law. The central thesis is that the there are substantial flaws in the Law apparent to the naked eye. The Commission should not defer making necessary changes until the time it receives a fund registration application. Apart from technical issues, the principal need is to accommodate in Macedonian fund regulation the variety of fund structural and organizational models in use in the European Union. The fund rules should facilitate the reasonable needs of fund sponsors not force sponsors to utilize Law mandated organization structures mandated for no better reason than the Law's lack of recognition of practices in other jurisdictions.

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SECTION ONE

DEVELOPMENT OF AN INVESTMENT FUND INDUSTRY

The central investment fund fact on the ground in Macedonia is lack of a fund product. Not only is there not yet a single investment fund available for retail investment, but at the moment -- (July, 2002) -- no organization has indicated a plan or even an interest in establishing an investment fund. This void contrasts with a significant degree of equity market development. The Macedonia stock exchange was established in March, 1996. At end June, 2002, there were 83 issuers available for trading on the Official and Unofficial boards of the Exchange.

Capital markets do not emerge full blow day one, but develop in an incremental fashion, step by step. The availability of investment in a professionally managed diversified investment funds is a watershed event in the evolutionary process. For Macedonia to sustain its market development momentum, it is imperative that investment funds come into existence at the earlier possible moment.

The benefits of a presence of an investment fund constituency are so well known, indeed self-evident, to scarcely warrant outlining in this Report. At December 31, 2001, the Investment Company Institute estimates assets of United States based mutual funds as approximately 7 trillion dollars. FEFSI, the European equivalent of ICI, estimates as at September 30, 2001, the assts of European investment funds at about 4.6 trillion Euros. These enormous fund investment pools demonstrate the advantages of fund investment – basically professional management and diversification – have persuaded millions of individual investors to entrust their personal financial resources to the fund industry.

Simplistically, equity markets can be divided into “demand” side and “supply” sides. The demand side consists of persons seeking investment; the supply side is represented by the instruments available for investment. The demand side can be divided into retail investor, investment fund and institutional categories. The supply side consists of equity and fixed income instruments issued by listed and unlisted issuers, bank deposits and term instruments and units of investment funds.

Uniquely, investment funds are key players on both demand and supply sides. Absent such funds, the market is denied investment demand otherwise represented by the fund subscriptions made by individual investors. To a limited extent only do the retail investor and investment fund investor constituencies overlap. Generally, individual investors sufficiently sophisticated to understand the market and select individual companies for investment do not participate in investment funds. Conversely, the reason individuals participate in the market via a fund intermediary is because the individual lacks sufficient knowledge or confidence to buy individual stocks. The result is that absent fund investment a key category of investor is denied equity investment and in turn, the market is denied access to a significant investment base.

It is often not appreciated the collateral benefits to a market place represented by the presence of investment funds. Fund investment managers represent a powerful constituency in support of transparency, full disclosure and corporate governance. Further, fund portfolio managers analytic skills and intensive examination of company business and affairs and prospects bring professionalism to the investment process.

Potential for Fund Development
In Macedonia

The point is made that the establishment of an investment fund industry is appropriate at a point when market preconditions are in place, primarily a sufficient supply of instruments in which a fund may invest and a sufficient investor base interested in fund investment. However, simply because the preconditions are present does not necessarily result in establishment of a fund industry. Launching a fund is a substantial business initiative, involving the commitment of capital, expertise and indeed the reputation of the fund sponsor. It is also a long term investment, not capable of short term profit generation. There is the further difficulty that banks -- the logical institutional fund sponsors -- may well regard establishment of a fund, particularly money market or bond funds, as competitive to bank deposit and term instrument financial products. The perception that investment in a fund product will “cannibalize” a bank’s deposit base has dissuaded officials of numerous banks from undertaking investment fund initiatives.

The business reality is that given the magnitude and profit uncertainties of fund establishment, the principal reason a given institution will start a fund is competitive pressure. In other words, if a competitor starts a fund, pressure is asserted on its competitors to follow suit. However, if no one launches a fund, then no one else launches one. The music may play but only after the first couple takes the floor do others join in.

In some countries, the first persons onto the dance floor, so to speak, were non-financial institution entrepreneurs; however, that is not the usual experience. Given the substantial commitment of resources, the need for investor confidence in the fund sponsor and the built in branch distribution net work availability, the logical fund sponsors are banks. That is certainly the case in Macedonia.

To date, however, Macedonia banks have shown no particular interest in fund establishment. Whether such initiatives will be forthcoming in the short term is doubtful. The reason is probably not so much that the banks have considered and rejected a fund initiative, as it is that the subject simply does not have a high priority.

Government Stimulus Initiative

It is unlikely launching a fund will attract more bank attention in the future than it has in the past. Assuming this pessimistic scenario is realistic, the question arises whether in the circumstances it is appropriate to consider a governmental initiative to stimulate industry development. In this respect, two precedents are relevant: the government's pension fund initiative and its decision to oblige joint stock companies to list their securities on the Macedonia Stock Exchange. In both instances, the government has demonstrated it is prepared to take pro-active steps to advance capital market development in Macedonia. The admirable philosophy underlying government policy is not to involve government in the activity but to stimulate the private sector to play the role of which it is capable.

Pension Law Precedent

The Pension Fund Law (Law on Mandatory Fully Funded Pension Insurance) enacted on April 24, 2002 establishes a pension and disability fund scheme in Macedonia and provides for its regulation. The scheme is supportive of and supplementary to a more traditional model. Participation in the pension scheme is mandatory for newly employed individuals. As a consequence, over time, the funds will represent a large pool of investment funds in Macedonia and thus dramatically augment the demand for equity market investment.

The organizational scheme adopted in the Law circumvents the traditional pension structure of a single national state run pooled fund. In its place, the structural model adopted proposes the establishment of a several funds, each organized and its assets managed by a private sector management company. Employee contributions would be compulsory; however, employees will choose the fund to which they make contributions.

The model is perceived as a means of achieving the policy objective of avoiding the beaurocracy and investment rigidities associated with state run pension schemes, through establishing competing pension funds and granting employees the opportunity to select the plan best suited to their retirement needs and perceived as likely to achieve the best investment returns. Thus, competition and choice are the policy hallmarks of the scheme.

A management company is responsible for all elements of operation of a pension scheme including keeping track of contributions and pension entitlement of plan participants. In order to ensure a competitive environment, the Law provides investors can be a shareholder of only one management company at a time.

It is proposed to introduce the scheme in a phased incremental manner. In the first ten year stage two funds only would be established and only two management companies would be licensed. The Pension Board regulator would select two pension companies from a short list of pre-qualified applicants to manage the two funds.

The Law authorizes pension fund investment in listed company equity and debt securities listed on a Macedonia stock exchange. Further, of great importance for fund industry purposes, it also permits in investment in participation units and shares of Macedonia investment funds.

From a capital market perspective, the Law investment diversification criteria are remarkably generous, providing pension funds may investment up to:

- 40% of assets in debt instruments of listed issuers;
- 30% of assets in listed equities;
- 20% of assets in investment funds.

There are several important elements of the scheme proposed in the Pension Law of more than passing interest from an investment fund industry perspective. First, in so far as the scheme establishes a pool of financial assets derived from contributions by individual Macedonian employee citizens, it is functionally an investment fund. Second, by virtue of the fund entitlement to invest in debt and equity instruments of companies listed on the stock exchange, the fund is capable of acting as the same kind of demand side stimulus as functionally would derive from investment fund investment.

Further, the management companies to be established by the Pension Law will undertake functions and activities largely identical to the functions and activities undertaken by a management company responsible for operation of an investment fund.

Only institutional entities such as banks, insurance companies are eligible to be licensed as pension companies. However, these entities are the logical candidates to establish investment funds.

The Pension Law in Article B4 provides the only permitted activity of a pension company is the administration of a pension fund; however, there is nothing in the Pension Law prohibiting the shareholders of the pension company from forming a second company to function as the management company of a public investment fund and drawing on the same administrative and portfolio investment resources as are in place in relation to the pension company's pension fund responsibilities.

Stock Exchange Listing Precedent

The second precedent is the initiative of the Government in mandating listing of securities of Macedonia joint stock companies on the stock exchange. Undoubtedly not every single company is a suitable candidate for full listing on the exchange. At this moment, the exchange is developing guidelines that will enable it to sift through the universe of * companies registered with * to determine a subset appropriate for listing. This is a process that will take some time. However, it appears reasonably certain that by 2002 year end, the roster of listed companies will be significantly augmented.

The benefit of the government's activism is to oblige a group of companies to list whose scale of business and quantity of outstanding and tradable securities warrant listing, but out of indifference, neglect or reluctance to comply with listing disclosure requirements, have not yet listed.

It is a central recommendation of this Report that the government consider adopting the same pro-active approach to the establishment of investment funds in Macedonia as it has taken with respect to the listing initiative. This could consider of an instruction that funds be brought into existence not later than a date designed by the government edict.

Practical Considerations

Without intending to dilute the clarity and simplicity of the recommendation, the Report's governmental intervention recommendation is tempered with a range of qualifications and caveats. The instruction to companies to list is a useful precedent but not an exact parallel. The companies and securities instructed to list their securities were in existence. The action – listing – the instruction commanded was a not overly intrusive requirement. Requiring a party to establish an investment fund is a substantial imposition. No matter how appropriate in principle the making of such an order may appear, it should not be undertaken unless and until the government is satisfied several preconditions are satisfied. These include:

- Availability of Investible Securities;
- Candidate to Establish a Fund; and
- Amendment of Investment fund Law and Regulations.

Availability of Investible Securities. It would be counterproductive to establish an equity fund for investment in Macedonia listed securities if there is an insufficient supply of such securities to either warrant investment or to enable a manager to assemble a diversified investment portfolio. Two or three investment grade securities are not sufficient to warrant establishment of a pooled fund, or at least not an open-end fund, that would meet Law investment diversification criteria.

If the quantity and qualify of securities is insufficient, then establishment of a public investment fund must wait the time when the Macedonia market has matured to the point where such securities are in existence. Or at least governmental action compelling formation of a fund should be deferred until the moment has arrived. Of course, if a private person concludes the time is ripe to take the plunge, it should not be denied the opportunity to try its luck.

As for whether the listed securities meet quality and quantity tests is a judgment the author of this Report is not in a position to make. It is an assessment that should be carefully made by persons with appropriate familiarity with the listed companies, their prospects and the future of the Macedonia economy.

Candidate to Establish a Fund. As emphasized above, establishing a public investment fund is a complex and costly step with an uncertain profit outcome. The government should not impose an obligation to establish a fund until and unless it is certain there is an organization or firm appropriate for the task, as it were, needing a nudge or incentive to proceed to take a step that it might otherwise have determined to undertake on its own.

It is possible but unlikely that regional or international investment company could determine to sponsor a domestic Macedonia fund. Otherwise, there are two categories of candidates: Macedonia banks and investment companies formed to establish and operate pension funds pursuant to the Pension Law.

Taking into account the adage investment funds are sold not bought and that this is a retail product necessitating a retail distribution network, one of the three largest and best established banks are the logical candidates to bear the burden of breaking the Macedonia investment fund ice.

The second category is pension fund management companies. As noted, the operational activities of such companies are functionally virtually identical to the activities of an investment fund management company. What is particularly interesting is that the pension management company is responsible for all elements of operation of a pension scheme including keeping track of contributions and pension's entitlement of plan participants. The role of the depository as outlined in Chapter 14 of the Pension Law is solely to protect and deal with fund portfolio assets. This approach contrasts with the more broad based role assigned to a fund depository and the limited role of the management company in fund administration contemplated in the Investment Fund Law.

Amendment of Investment fund Law and Regulations. An assessment of the Law discloses a number of critical deficiencies. These are of a generalized character and specific character. The generalized weakness is an inherent rigidity and inflexibility. The Law is drafted as if there was a single investment fund organizational and operational model. This is emphatically not the case. The investment fund world is marketed by organizational diversity offering sponsors the opportunity of selecting a model best suited to market circumstances. Not only does the Law limit Macedonia sponsors to single fund models but in a number of respects it fails to allow sponsors to administer the fund models it permits, in an efficient and cost effective manner.

The Law fails to recognize that there exist a range of structural and operational models established in other jurisdictions and accommodated in regulation that differ from the rigid models prescribed in the Law. Thus, the core problem is not that Law provisions are necessarily wrong – although some provisions are mistaken – but that it fails to accommodate alternative fund organizational approaches.

The net effect of the inflexibility is to deny to potential Macedonian fund sponsors an entitlement to organize a fund in a manner accepted in other countries that the sponsor may regard as best responding to the needs of potential investors. The objective of fund regulation is not to force sponsors to adopt a fund model the regulator may regard as desirable, but to accommodate a sponsor's legitimate structural and organization preferences. Currently, the Law blocks fund structural and organization models not for valid investor protection reasons but because the draftsman may have utilized an out of date precedent from another jurisdiction.

As a first drafting principle, the Law should accommodate the utilization in Macedonia of fund organizational models acceptable to European Union regulators. EU UCITS (collective undertakings in transferable securities) regulation permits formation of contractual funds established by investment companies and funds in corporate form (SICAVs). Macedonia regulation should accommodate these valid organizational forms and does not

A second core rigidity in the Law is its regulation of closed-end funds. The Law inappropriately regulates such funds on a basis largely identically to its regulation of open-end funds. The gap between this approach and the EU approach is graphically demonstrated by the fact that closed-end fund are not subject to UCITS regulation but left to regulation by individual Member States.

Impact of Inappropriate
Closed-end fund Regulation

As noted, the Law imposes investments diversification rules on closed-end funds identical to rules applicable to open-end funds. This approach contrasts with the view taken in most other jurisdictions. The EU UCITS sees no need to regulate such funds in any way, leaving regulation, if any, to Member States. Some States impose rules; others such as Switzerland do not bother.

It is not as if the ostensibly lax regulatory approach reflected indifference to the needs of investors for protection from improper activities of fund sponsors. There is a rational explanation for the exclusion of funds from conventional fund regulation, namely that the basic need for imposition of diversification rules is to limit the prospect a fund suffering precipitous decline in value of a few securities in its investment portfolio would lack the cash to respond to requests for redemption. Such circumstances are not hypothetical. Declines in portfolio values and a rash of redemptions invariably track and reinforce each other. However, since closed-end funds are not by definition subject to redemption, the need for diversification regulation on this ground does not exist.

This is a simple but compelling explanation for the absence in some jurisdictions of inclusion of closed-end funds in investment fund regulation. That is not to say the experience is all one sided. In Europe, as indicated, some Members States regulate closed-end funds as investment funds; others do not. Canada excludes closed-end funds from mutual fund regulation. As stock exchange listed issuers, the funds are regulated on a basis identical to other listed companies. Although not regulated identically to regulation of open-end funds, the United States Investment Companies Act brings closed-end funds within its regulatory ambit.

Benefit of Closed-end fund
In Macedonia

The point is made above that until there are sufficient Macedonian listed issuers whose profit prospects, market capitalization, share float and trading liquidity are deemed appropriate to form fund portfolios, is unrealistic to expect sponsors to launch investment funds. In relation to an open-end fund, the precondition is absolute. In order to guard against the redemption risk and to fulfill investor expectation of diversified portfolio investment, the roster of available securities meeting the investment threshold must equal a number that is it is not possible to identify in terms of numbers, but is significantly greater than the number needed to meet the initial portfolio needs of a closed-end fund not subject to unnecessary concentration rules.

The Report does not necessarily propose diversification rules applicable to closed-end funds be removed in their entirety. There may be a middle ground between rules concentration rules identical to open-end funds and no rules whatever. There are mid points available for selection. To some extent, the answer as to the form of limitation is dependent on the kind of holding out and identification a fund sponsor proposes. It is argued quite legitimately that investment diversification is an inherent characteristic of an investment fund. If this premise is accepted and a sponsor advertises its product as an investment fund, then a diversification imposition may be appropriate.

In any event, the point is that permitting the portfolio of a closed-end fund to consist of a small number of securities may well enhance the time at which investment funds are launched in Macedonia.

As reflected elsewhere, the EU UCITS rules permit the utilization of the SICAV corporate form of fund vehicle. Replication this flexibility in Macedonia and thereby furnishings potential investment fund sponsors flexibility in selecting which ever form of fund vehicle the sponsor found attractive, would enhance the prospects for development of a fund industry.

In many jurisdictions, open-end funds are organized in corporate form; investors hold redeemable preference shares, the fund sponsor hold all of the common shares. In the United States virtually all open-end funds are in corporate form.

The asset management company structure, although based on Continental European precedents are widely used in EU countries, from corporate governance and other perspectives, is not a particularly satisfactory form of investment fund form of organization.

The regulatory approach is where possible to draft rules to apply equally to both fund types, and to impose different rules only where a clear reason relating to the particular characteristic of the fund warrants differing regulatory treatment.

In designing its closed-end fund regulation, Macedonia may usefully take into account that in developed markets, two basic closed-end fund models have developed. One model perceives the closed-end fund as a type of investment fund exhibiting the same investment diversification and expert management characteristics as open-end funds, differing only in not permitting investors to redeem their invest at fund NAV value.

The other approach perceives the investment company has not inherently different from other exchange-listed companies except that instead of undertaking a business of automotive assembly or textile manufacture, the company invests in other stock exchange listed companies. Issuers so perceived are not subject to mutual fund diversification criteria. Other than compliance with requirement for registration of the investment adviser, the issuer is not subject to fund rules generally.

With respect to the 90% payout requirement, in many jurisdictions, a provision respecting payment of designed percentages of income is not a fund regulation requirement but a taxation issue. At the time of fund establishment, the fund sponsor determines whether the company’s income will be taxed at the company level or at the shareholder level. If the former is chosen, then the company will pay income tax on its income, and declare shareholder dividends on the same footing as companies undertaking other kinds of businesses. If the latter is chosen, annually the company will pay out 90% of its income to shareholders, and thereby in accordance with taxation law qualify for taxation at the shareholder level. The point is that the 90% rule appears in the tax laws and not in fund regulation. In order to grant sponsors a choice as to what kind of fund to establish and investors a choice as to which kind of fund to invest in, it is recommended below the 90% payout rule be eliminated from fund regulation.

In considering how best to restructure closed-end fund regulation, it is important to recognize certain artificiality of the current rules. For example, the Ordinance definition provides an investment company as one in which 80% of net assets are invested in the share capital of other companies. Presumably, a company that holds 20% of assets in real estate and the balance in shares of other companies is not subject to regulation.

SECTION TWO

ANALYSIS AND COMMENT ON

THE INVESTMENT FUND LAW

Terminology

The Law would benefit from a review focused on securing accuracy and consistency in terminology. The lack of an article defining terms employed in the Law is a serious drawback. For regulators and persons establishing and administering funds, clear and consistent terminology is essential.

Terms that warrant review for clarity and consistency include:

- net assets;
- fund assets;
- asset value;
- total net asset values;
- debt securities;
- nominal value;
- monetary assets;

Reconciliation of Securities and Investment Fund Law

The relationship between the Securities Law and the Law on Investment Funds is metaphorically reminiscent of two ships passing in the night, each one unaware of the presence of the other. What are clearly necessary are revisions both laws that recognize that each instrument's regulation of securities markets must take into account the scope and content of the other.

Article 5 of the Law provides:

> 5. (2) Closed-end funds shall be incorporated solely for the purpose of raising money by public announcement for the sale of stocks (shares.)

The Securities Law defines securities in terms of shares in a joint stock company. There is no allowance or recognition that the definition includes the shares of closed end funds in joint stock company form.

Presumably, the closed-end fund company would seek a listing on the stock exchange, and would in that event become subject to a third level of regulation, the exchange listing rules.

A closed-end fund is subject to prospectus requirements found in the Securities Law and in the Law. The requirements of the two laws are quite different. It would also be subject to disclosure requirements, again not consistent in securities Law or in the Law and directed at quite different audiences.

Regulation of Investment Advisory Services

The activities of investment advisors are dealt with in the Securities Law in a relatively cursory manner. The function of investment advising is surprisingly not defined in the Securities Law. The regulation that is included consists of only two provisions in Articles 125 and 126, providing the operations of an investment advisor may be carried out by an investment advising company, the activities of investment advisors and investment companies are subject to control by the Securities Commission and the Commission may revoke the operations of investment advisors.

It is unclear whether an "investment company" as defined in the Law is an "investment advising company" as referred to (but not defined) in the Securities Law. Individuals employed by investment advising companies must demonstrate to the Securities Commission that they have passed a professional exam for investment advising. There is no corresponding direct requirement under the Law applicable to individuals hired to manage a fund portfolio on behalf of an investment company.

A reference to the advisory functions appears in the provision applicable to registration of brokers. The activities permitted to brokers include:

> "Advising clients on issuing and purchasing or selling long-term securities (investment advice)"

The functions referred to could otherwise be characterized as underwriting and brokerage, and are generally regulated within separate registration categories. It is not wrong to refer to advising company clients as to issuing of securities as "investment advice"; however the term underwriter is usually applied to the function.

A brokerage firm may provide "investment advice"; however, a person acting as an investment advisor must register having first passed a special examination and demonstrated qualifications and capability to the satisfaction of the Commission. Logically there is an inconsistency between these two approaches. If investor protection concerns warrant ensuring an individual satisfy capability criteria prior to offering investment advice – as is suggested by the requirement for advisors to register and demonstrate such capability -- why are individuals permitted to undertaken the same function within a broker house without demonstrating such capability.

Although not implemented with technical clarity in the Securities Law, the answer is that the kind of advice given clients in a brokerage firm is historically regarded as incidental to the trading of the securities, whereas the advice given by an investment advisor is perceived as provided on a free-standing basis by a person whose sole function is advising and who is not involved in trading i.e. the actual mechanics of buying and selling securities.

The reality is that the concepts which underlie the drafting of the Securities Law are somewhat outmoded. In many countries, the function that is important to the broker's client is less and less the trading function and more and more the advice giving function. Hence, the traditional concept that advice giving is "incidental" to trading is subject to a striking reversal -- increasingly the trading function is incidental to the advice giving function. As markets evolve and in particular as the trading function is increasingly mechanised, the broker's capabilities as investment adviser become central to its value to his clients and to its economic viability.

Particularly, taking into account both statures are administered by the Securities Commission, these anomalies are capable of being resolved internally by the regulator. However, it is desirable to sort out and resolve the anomalies through transparent changes to applicable regulation, thereby providing prospective sponsors with clear guidelines as to regulatory requirements.

Integration and rationalization of adviser regulation in the Securities Law and the Law is important for the reason that it is desirable over time to build investment advisor expertise and professionalism in Macedonia. A logical situs for this expertise is within an investment company. It would encourage the development of a critical mass of expertise should the investment company be permitted to deploy its expertise over a wider client base than merely investment funds. The client base could include pension funds to be established pursuant to the newly enacted Law on Mandatory Fully Funded Pension Insurance or the portfolios of high net worth individual Macedonians.

Structure of the Law

This structure accords to continental European practice. It contemplates the investment fund universe consists of closed end funds in corporate form and open-end funds in unit certificate form. The closed-end fund is established by a management company, and the closed-end fund is structured as a limited liability company by the investment company responsible for its formation.

(The English translation of the law states in Article 4 that investment funds may be “incorporated” as open-end or closed-end funds. The term is unfortunate. Closed-end funds are incorporated in the sense of structured in corporate i.e. joint stock company form; however, open-end funds are not incorporated and are not legal entities but are technically merely a legal fiction with no legal status. To avoid confusion, it is preferable to translate the Macedonian term as “established” rather than “incorporated.” The terms better reflects the somewhat ambiguous legal status of the differing structures.)

Although replicating structural norms in place in the 1980s and earlier, the rigidities in dictating an open-end fund may only take a unit form and a closed-end fund must be formed as a corporation, are unfortunate. As reflected below, Continental Europe is recognizing the superior attributes of the open-end fund in corporate form. Particularly in Luxembourg – the home jurisdiction of a vast number of fund – the closed-end fund in corporate form is increasingly the template structural model.

The investment funds industry stands in remarkable contrast to the global interdependent world of which so much is currently made, Over the 50 of so years of a recognizable existence, the investment funds industry has retained its essential domestic and local character. In virtually all jurisdictions, domestic firms offer domestically established funds. This circumstance is as true for funds that investment in foreign securities as for funds investing in domestic securities.

Even in North American environment in which there is a high degree of market integration, it is illegal for the giant United States fund companies to offer investment in their fund families in Canada. And the reverse is the case; no Canadian funds are qualified for distribution in the US. In those cases, where a US fund company – Fidelity is an instance – determines to enter the Canadian market, rather than seek to qualify the fund for sale in Canada, the firm went to the expense and trouble of establishing a brand new Canadian domiciled fund. This pattern was followed even in cases where the fund objectives were investment in United States securities.

Regulation of Foreign
Investment Funds

It is striking that the Law does not include provision for registration of foreign funds offering in Macedonia. The oversight on doubt relates to the practical circumstance that no effort has been made by a foreign company to sell funds in this country.

Article 4 provides:

> "Investment funds shall be incorporated and managed by fund management companies (hereinafter companies) in accordance with the fund Charter and the provisions of this Law"

Investment Fund
Prospectus Requirements

Article 7 imposes a requirement for investment fund prospectus to contain the same information as mandated for inclusion in the fund charter. The Article includes a prohibition on including in the prospectus "false and misleading information which may mislead investors." This is not a modern standard for prospectus disclosure. It fails to make clear which individuals are responsible for prospectus preparation, does not set a sufficiently clear standard for what constitutes insufficient disclosure and does not grant aggrieved investor redress.

A substantial revision is needed that would clarify that the management company in the case of a open-end fund and such company or the management of the closed-end company or both, are to sign the prospectus, that the prospectus must disclose all relevant material information and grant investors civil remedies.

Investment Fund
Audit Requirements

The Article requiring preparation and distribution to fund investors of audited statements includes interesting and constructive provisions intended to enhance auditor independence. An auditor in the course of a single year may act as auditor for no more than three funds. Further, the auditor may not prepare statement for the same fund for more than four consecutive years. The firms eligible to undertake fund audits are limited to a roster of firms approved by the Commission. These provisions are excellent safeguards to increase prospect of audit independence. The establishment of a Commission approved list of auditors is a reform considered in a number of jurisdiction but actually adopted in only a few instances.

The text of the article states an auditor may not prepare financial reports for more than three funds. A management company may establish any number of funds. Is the intent is to confine the auditor to management of funds sponsored by three management companies? Should a management company establish four funds, it would seem unreasonable to require it to engage one auditor for three funds and another auditor for the fourth fund.

The financial reporting requirements also includes a detailed outline of the content of annual fund financial reports, perhaps more detailed than might be regarded as appropriate for a Law as opposed to a regulation implementing Law provisions.

Article 8 imposes on the management company the obligation of prepare financial reports. With respect to the open-end fund, directly established by the management company, it is appropriate to impose the requirement on the company? With respect to a closed-end fund, the question arises whether the responsibility for preparation of statements lies with the company itself or with a third party company? It does not appear a provision of Macedonian Company Law relieves the directors of a joint stock company established as a closed-end fund from preparing such statements. The confusion between responsibility for closed-end fund company affairs between its directors and officers and the management company bedevils the closed-end fund structure in this and other respects.

Material Information Disclosure

Patterned after similar requirements for listed stocks, Article 10 requires a management company to report material changes within three days of the corporate development.

There are difficulties with the provisions. First, we are met again with ambiguity between fund and a management company. The text of the Article does not make it clear as is presumably intended that the obligation to report arises only in relation to an event material to the fund and not necessarily to the management company. Or perhaps that is not the intention. If, for example, 40% of the shares of the management company are transferred, although such a change in ownership is material to the management company, is it material to a fund established by the company?

Another problem is the obligation to "distribute such reports to members of the fund at the same time the report is delivered to the Commission." Assuming distribution means a mailing to each investor, a distribution is an expensive and substantial undertaking. It is not realistic to print and mail to all holders at the same time as delivery is made to the Commission. An obligation, not included in the Article, is a requirement to issue a press release and to publish news of the material event in local newspapers. In the case of an event of marginal importance, this form of notice to unit holders may suffice.

Delivery of Prospectus

Article 11 provides:

> "Investors intending to purchase share certificate or subscribe for and purchase stocks shall receive free of charge at least 7 days before such purchase or subscription the prospectus … "

There are problems here. The first issue is to determine whether the provision is to apply to investment in both open-end fund and closed-end fund investment fund. With respect to a closed-end fund there is no problem in principle with a requirement an investor receive and review a prospectus prior to investment. The reason is that the investment is presumably a once in a lifetime investment at the time of establishment of the closed-end fund. However, investment in open-end funds in an entirely different matter. Where fund entry is permitted once a month or once a week, the requirement for a week's delay in subscription may not unreasonably delay an investor unfamiliar with fund investing making an investment decision. However, with respect to existing certificates holders and therefore a person's familiar with the fund, it does not seem necessary to oblige the investor to delay investment until after he or she has received another prospectus. At the least, it is appropriate to exempt current holders from the prospectus delivery obligation.

Fund Assets

Article 12 provides fund assets shall include securities cash and other assets. The fund entitlement to hold "other assets" is interesting. It does not quite square with other provisions in the Law providing *

Article 12 with respect to investment in securities, Article 13 confines securities a fund may invest in to securities listed or traded on a stock exchange. There is no problem with the requirement as such. The question is whether there should be some flexibility in the requirement that 100% of the fund securities assets must be listed securities. This issue is discussed in connection with concentration issues, considered in relation to Article *

Concentration Requirements

Concentration criteria are established in Article 14. These are interesting limits, surprising by their relative flexibility in comparison to limits applicable in fund regulation generally. The concentration norm applicable to fund in EU regulation and in North America is a 10% ceiling on investment in a single stock and a 10% limit on investment of fund assets in a single security. In contrast, the Law provides a 20% threshold. On the face of it, permitting twice the flexibility permitted in mature markets may seem undue. However, the few stocks available for investment in the immature Macedonian market place must be taken into account.

It is not unusual in emerging markets for a single strong issuer to represent a large proportion of market capitalization of the domestic market. In such circumstances, limiting managers by imposition of shareholders even as generous a threshold as 20% may unduly restrict a manager's capacity to include a market leader in its portfolio. Further, the restriction prevents the manager replicating market capitalizations. It may not be possible to establish an index fund in this environment.

In effect, the restrictions contemplate the establishment of a single type of fund investing in equity securities. Developed markets exhibit a range of types of funds: equity, money market, and index, bond ect. In Macedonia, there is certainly a prospect of offering of funds investing in debt securities, either a money market or bond funds. The Law should be sufficiently flexible in its provisions to accommodate the needs of such funds.

In the English translation at least, there is an apparent conflict between Article 14(2), (3) and (4). It appears that this conflict is resolved provided Article 14(4) is read to provide that *in instances where a fund invests in both stock and debt of a single issuer* …" then the 15% and 10% limitations on investment established in the sub article are applicable.

The Article 15(5) provision that bank deposits and other monetary assets of a fund may not exceed 25% of the value of fund assets clearly prevents the formation of a money market fund.

Comments elsewhere identify recent EU Directives expanding the scope of permitted UCITS investments. These are precedents Macedonia could usefully follow.

Suspension of Redemptions
During Period of Market Turmoil

Permitting a suspension of redemptions during a period of market turmoil is a legitimate safety value. However, the current drafting leaves too much leeway, permitting a manager to determine from a subjective perspective what constitutes market turmoil. It is unclear if the turmoil would arise in instances of market, sector or single stock turbulence. Is the turbulence confined to trading in the affairs of an issuer or is it confined to trading in the security.

Conflict of Interest

The concentration rules include a provision prohibiting fund investment in securities issued by a depository bank. Such a provision is a measure intended to limit conflicts of interest, rather than concentration provision and is perhaps best placed in the Law together with other provisions intended to deal with such conflicts.

Open-end funds
Legal Structure

Article 18 is helpful in its clear statement of the characteristics and legal status of an open-end fund. It states the fund is a pooling of cash assets set up by a management company for investment purposes. Owners of the certificates have a right to the fund's income in proportion to their share of fund's assets and the right to request redemption of unit certificates. It then states the fund does not have the status of a legal entity.

There are certain technical deficiencies in the drafting that it would be advantageous to correct in the courser of revising the Law. The fund is not strictly speaking a pooling of cash assets. At the origin of the fund, its assets consist of cash; however, investors subscribing at later dates will invest in a pool of assets of which cash is a small portion. Unit holder certificates represent a proportionate share in the net assets of the fund.

Referring to a holder’s entitlement as a share of income is problematic. A fund’s income is a mathematical calculation. Income may or may not be distributed to investors. Particularly in an equity fund, there is no necessary relationship between a fund achieving income and the fund’s investment success. For example, a fund in a year in which it did not realize income (because it didn’t dispose of stock) but in which the value of its portfolio increased dramatically, from an investor’s perspective is preferable to a year in which it reported income because it realized a large capital gain on a single stock but in which the value of its investment portfolio declined.

The measure that investors care about above all else is a fund's NAV. Emphasis on other measures such as profit and loss detracts investor’s attention from this primary measure of investment success.

The reference to the right to the fund’s income is also unfortunate as it implies the fund will necessarily pay out the exact amount of its income in a given year.

Without wishing to over elaborate the point, the legal right of the investor is to redeem his investment. The proceeds of redemption are a function of the fund NAV at the time of redemption. Thus, strictly speaking form a legal point of view, the investor has no right to the income of the fund.

Establishment of Fund

The provisions of Article 19 that deal with procedures for establishment of a fund appear to be appropriate.

Article 20 deals with the subject of subscription and redemption of fund units. Article 20 1. refers to the “amount of expenses allowed to be deducted when unit certificates are brought in.” Presumably the word “expenses” refers to the sales commission charged to investors. Since the amount may vary, it is debatable whether the charge should be included in the fund charter. This is particularly the case where the amount of the commission may vary depending on the size of the investment and distribution arrangements made by the management company with sub-distributors. The better practice is to leave it to the Commission to determine by policy what flexibility is appropriate and to require the prospectus to state sales fees and commissions. Particularly for money market funds, the management company may decide not to charge a commission.

Unit Holder Certificates

A series of articles – Articles 22 to 25 – deal with unit certificates. Taken as a group, the Article exhibit the fundamental flaw of treating the unit certificate as if it represented in itself the investment in the open-end fund. It can not be emphasized too much that a certificate, similar to a share certificate, does not represent ownership, it is merely evidence of ownership. Actual ownership is represented by registration on a fund's unit register or a company's share register.

Over emphasis on certificates is not merely bad law, it also perpetuates historic investor focus on certificates as representing ownership and inhibits the process of computerizing ownership records reflected in efforts to immobilize or dematerialize ownership interests in equity shares and fixed income investments.

These reforms are equally relevant to fund investment. It is important the investment fund industry in Macedonia not be burdened by outmoded procedures. Achieving this objective will require an overhaul of the Articles dealing with unit holder certificates to make it clear that ownership is not represented by certificates, and indeed to either prohibition the issue of certificates or, at the least, to make the issue of paper certificates optional.

Termination of the Fund

Articles 27 to 29 deal with cancellation, termination and dissolution of an open-end fund. A management company is permitted to terminate management of fund on six months notice. The responsibilities of the depository is spelled out in some detail including a provision in Article 29 that the depository pay management company expenses from fund assets; however, in circumstances where the management company has decided to terminate the fund – possibly because it has failed to achieve reasonable investment results -- it does not seem fair that investors should bear the substantial costs associated with an event over which they have no control.

It is symptomatic of the legal uncertainties engendered by the open-end fund form of investment that Article 27(3) provides that the depository may cancel the "contractual relationship" with the management company. Since the fund is not a legal entity, how it is possible for it to enter into a contract? Elsewhere, the Law provides for the entering into of a contract between depository and management company. Article provides for the items to be included in this contract, none of which deal with investment management activities.

Closed-end Fund

Regulation

Articles 30 to 41 deal with the establishment, organization, administration, management and activities of closed-end funds.

Article 31(1) states categorically that closed-end funds shall be incorporated and managed by a management company. Such a provision conforms to an approach adopted at an earlier point in time, but does not take into account the popularity and general acceptance of the so-called self-management company. In a self-managed fund the directors either utilize internal resources to make investment decisions or by contract engage a third party to manage the resources. The difference is that the company runs its own affairs rather than a third party -- the management company -- running its affairs.

The difference is well illustrated in Article 31(2). It provides the management company shall adopt a charter, prepare a prospectus and enter into an agreement with a depository bank. In the self-managed organizational form, the closed-end fund company itself would adopt its charter, prepare the prospectus and enter into a depository agreement.

Anomalous Law Provisions

There are several Law provisions that warrant comment as not conforming to usual regulatory practices. Article 36 2 requires persons subscribing for shares to provide the depository bank with power of attorney to act on their behalf to keep stocks and exercise their rights. If the sub article refers to the investment assets of the company, it is not clear why a power of attorney in relation to such stock is relevant. Nor is it clear what rights are exercised by the depository on behalf of the shareholders that would warrant the delivery of a power of attorney.

Article 36(4) provides that if the closed-end fund suffers a loss because of a subscriber's failure to pay for subscribed stock, the management company shall be liable for the loss. Since the Law provides closed-end fund stock must be paid in full prior to recording on the books of the company, it is difficult to know under what circumstances the company would suffer loss. Should an individual who signs a subscription form not honour the subscription, it is possible to regard the fund as suffering a loss. The better view is to leave it to the management company to decide to attempt to enforce a subscription but not to expect it to make good a defaulted subscription.

Article 38 provides a management company shall manage closed-end funds on behalf of the fund, similarly prevents establishment of a self-managed fund structure. Nonetheless, the Article also provides the closed-end fund is to reflect its corporate organizational structure in so far as it is to have a supervisor board and assembly. It is clearly intended that the supervisory board members are to represent the interests of investor shareholders. The Article prohibits the 3 member supervisory board from including persons who are members of the management company or depository, nor are such persons to be members of more than two supervisory boards. The rationale for this last provision is not clear. Permitting individuals to service on a variety of fund supervisory boards may provide a degree of professionalism and encourage individuals to make a career of representing investor interests.

Putting teeth into the supervisory board structure, Article 39 requires the management company to report to the board as to its portfolio investments. The management company is also required, on request, to provide the board with a report on the state of the securities market and other relevant subjects.

Law provisions anticipate open-end fund companies will comply with procedures followed by joint stock companies generally. Article 40 provides the management company shall propose to the general assembly of the fund a distribution of profits. It is however up to the assembly to determine to accept the decision. In this respect, procedures do not follow company procedures that would anticipate the recommendations to be made by the board of directors not a third party.

The Law provides a closed-end fund company must prepare financial statements and report to its assembly. The Law, however, is silent on the issue of which entity – the supervisory board or the management company – is responsible for preparation of the report, and which entity is responsible for the cost of report preparation. There are arguments to be made as to which of the entities should bear the cost of preparation of the report. Perhaps, the answer is that each of these two entities should report to the shareholders – the management company as to matters pertaining to the investment portfolio and the supervisory board as to the conduct of company affairs generally.

Conflicts of Interest

Article 47 limits the rights of the management company to make self-dealing investments. It may not utilize company assets or utilize its name as guarantor in a manner that would benefit the management company or persons associated with it. Article 47 3. provides the management company shall not sell securities on behalf of open-end fund unit holders or closed-end fund certificate holders. It is not clear what circumstances would arise in which the potential for such sales to occur. In other words, the management company buys and sells securities of a fund or company; however, such actions have nothing to do with certificate holders or shareholders.

Although not strictly speaking a conflict of interest provision, the Law in Article 50 provides a management company may not acquire interests in an open-end fund or in a closed-end funds other than at the time of the initial offering stage. The provision confirms the remarkable extent to which fund rules vary from jurisdiction to jurisdiction. In some countries, the rules oblige a management company to participate in the launch of a fund by investing at least 25% of the initial subscriptions. The theory is such case is that the management company should invest its own money in a fund, thereby evidencing its commitment to the fund. There is some logic in this approach. Other jurisdictions leave it up to the management company to decide whether it will or will not invest its own resources. The Macedonia provision prohibiting investment is relatively unusual, but is an approach which presumably regards the management company as more likely to provide objective and independent investment management should it not have its own funds at stake. Why the management company is permitted to take a stake in a closed-end fund and not an open-end fund, is not clear.

Depository

The Law quite properly requires every fund to utilize the services of a fully independent depository. The responsibilities assumed by the depository outlined in Article 53 are relatively broad in scope, encompassing virtually all of the administrative and operational activities to be undertaken in the course of operating an investment fund. It appears the sole function to be undertaken by the management company is actual investment management that is the selection of what stock to buy and sell.

There is nothing inherently wrong with allocating such a broad scope of responsibilities to a depository bank. A practical concern, however, is the level of costs such an allocation may entail. Experience in other jurisdictions suggests that banks undertaking depository functions are inclined to impose a high level of costs for performance of depository services. What can happen is that in countries with modest levels of investment fund activity, there is not much bank interest in functioning as a depository. This is particularly the case where it is necessary to make application for regulatory approval to undertaken the activity. The relative bank disinterest leads to lack of competition to act as depository and consequently a high level of cost imposition by the few banks involved. In practice, there are only one or two banks prepared to take the trouble of offering the service.

Further, there is a question of the efficiency of a bank in undertaking the activities. The problem is the bank has limited incentive to perform efficiency. Its fee will relate to the extent its resources are involved. The greater bank staff involvement the larger its fee. This is not an equation that encourages efficiency.

At the earlier stages of investment fund market development, the issue of fees and costs is very important. It must be borne in mind that investors must be persuaded it is more advantageous to invest through an investment fund intermediary than to invest directly. Should a management company charge the fund 2% and a depository charge the maximum 5% permitted it by Article 51(2), it is difficult to imagine the fund would attract investors.

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An approach that would respond to this service cost problem is to permit investment companies to undertake administrative services rather than necessarily allocating performance of such services to the depository bank. In all circumstances, the depository must retain responsibility for holding fund cash and securities assets. It should probably handle all funds, maintaining the fund's bank account and at least supervising deposits and withdrawals on account of stock transactions, unit subscriptions and redemptions. However, other administrative responsibilities such as keeping track of investor records and even handling subscription and redemption requests, can be performed by the management company. Permitting the management company to discharge these functions would be subject to the management company satisfying the Commission that it had the managerial and system capacity to undertake the tasks.

The benefit of relaxation of the strict allocations provided in the Law is to gain for the fund investors the benefits of the management company's motivation to provide services as cost effectively as possible. The management company's prospects of retaining investors and attracting fresh investment are enhanced to the extent fund overhead expense is reduced. In North American markets, a closely watched measure is called a fund MER -- management expense ratio – the measure of the total operational charges levied against a fund. The calculation includes not merely the management fee but as well costs and charges of all kinds. The MER is in effect the net total charge made to the fund and thus equal to the amount an investor's return on his or her investment is less than had the individual made a direct investment in an identical portfolio of stocks. .

Fees and Recoupable Expenses

In view the non-arm's length relationship between funds and the management company, it is necessary to relatively precisely delineate the fees and expense the management company is permitted to charge to investment fund.

Article 48(3) provides a management company may receive a compensation fee for expenses incurred in conducting activities on behalf of funds for which it functions as a management company. Article 51(1) lists 8 heads of expenses which "may be claimed against the fund assets".

The relationship between the Articles 48 and 51 is not entirely clear; however, the implication is that the Article 51(1) expenses are paid direct to entities providing the services out of fund assets, whereas the Article 48(3) expenses are paid by way of a compensation fee. It is difficult to know what expense these would be, particularly since Article 51(1)2 refers to depository bank fees and possibly other fees. The uncertainly would appear to grant unwarranted latitude in determining the quantum of costs to be paid from fund assets.

An important expense that does not appear in the Article 51 list and which might well appear in the list is legal, audit and accounting fees and charges. These are major expense items for which specific provision should be made.

The amount of the management fee, by far the most important fee charged to the fund, is dealt with in Article 51(2). It provides the management fee shall not exceed 2% of fund assets. A fee of this amount is relatively consistent with management fees charged to equity funds generally. However, to determine reasonableness of any fee, it is necessary to consider several important collateral circumstances.

The first is the type of fund. A 2% charge may be reasonable for an equity fund, but may not be reasonable for a bond fund, and is certainly not reasonable for a money market fund. The second factor is the extent to which the management company undertakes activities and absorbs costs associated with the activities. For example, if a management company were to calculate fund NAVs, process subscriptions and redemptions and keep investor records generally, a 2% fee is reasonable. To the extent, however, the management company does not itself undertaken these activities, and consequently the fund assets are debited for them (through a depository fee), a 2% management company is certainly too large. An additional key factor is the size of the fund. A fee of 2% of fund of modest size produces a great deal less revenue to a management company than a fund of substantial size.

Open-end Fund
Withdrawal and Liquidation

The Article 41 provisions respecting the entitlement of a management company to withdraw its services are similar to the provisions in Article 27 respecting a company's entitlement to withdraw management of an open-end fund. In both cases, the management company is permitted to terminate the relationship on six months notice.

Express provision is made for the entitlement of the Assembly of the fund on six month's notice to terminate the management engagement and assign the management right to another management company. This is a useful lever to hold over the head of the management company. Having said that, it is very unusual for shareholders to take the trouble to initiative such a change. The more usual response to negative performance is to sell the shares in the company and move on to another investment.

Management Company

The Law provides a management company is a commercial enterprise established as a joint stock company in accordance with the commercial law. Its sole purpose is the establishment and management of investment funds and investing money on behalf of investors in open-end and closed-end funds. This Article 42 provision, apparently confined the management company's activities strictly to investing on behalf of funds, does not seem to square with Article 43 which provides the Charter of a management company shall also contain:

> "Establishment and management of funds, or investing money in its own name and on behalf of an open-end fund or in the name and on behalf of the closed-end fund."

This suggests or at least leaves open the possibility the words may be interpreted to permit the management company to invest on its own behalf at the same time it is investing on behalf of managed funds. Or perhaps the reference to its own name in intended to reflect the entitlement of the management company to utilize its own name when make investments for the fund.

(Is there a clear reason the management company must use its own name when investing for an open-end fund? It is preferable investments be made in the name of the fund.)

The policy underlying the provision confining the activities of the management company to managing investment funds is open to question. Until relatively recently, a prohibition on activities other than such management has been relatively standard provision in fund regulation. However, it is notable that a 2001 EU Directive has adopted a more flexibility attitude and granted management companies significant latitude in the scope of their activities.

The rationale underlying the change is that the function of a management company is to selecting investments for purchase and sale, and such a capacity logically is capable of deployment on behalf of almost any pool of funds .In a sense the pool is neutral; in terms of making investment decisions other than confirming to pool investment objectives, the manager's stock picking function is identical no matter what client pool is involved.

Following this approach to a logical conclusion, there is no reason why a management company should not offer management services to any number of client pools including pension funds and private accounts as well as investment funds. The logic is supported by the business rationale that permitting the management company to expand its client base would enable it to deploy its research resources over a larger client base, thereby reducing unit costs and in other ways achieving economies of scale. The result is to lower the costs investment management thereby encouraging investment fund and capital market development.

Prior to following the EU lead and relaxing the prohibition on management company's offering services to non-investment fund, it is important to consider any negative implications in granting such flexibility. The first point is whether the management company should be permitted to establish itself as a client. To some eyes, it may seem unreasonable to prevent the management company from making investments as principal. After all, it seems a basic right for a person to make investments. However, the caveat arises as to which pool the management company will select to make available a highly desirable investment.

No doubt, should the management company come to be permitted to manage investment funds in addition to the closed-end fund and open-end fund constituency, it will be required to establish policies and procedures designed to ensure fairness in the allocation amongst client accounts of trades in securities. Such policies may be regarded as sufficient in relation to a range of client accounts, in none of which does the management company or its principals have a personal financial interest; however where such interest does exist, it is difficult to place full confidence in the internal policy. The logic of this reasoning is that the current prohibition on management company personal investment should be sustained.

This discussion is not complete without reference to a question that may be regarded as technical but which has important substantive implications. That is whether the various provisions in the Law relating to the activities of the management company, are to be read as applicable to the management company alone or, more broadly, are to be regarded as also applicable to its affiliates.

All of the provisions in Section V. titled Fund Management Companies are made applicable to management companies. Nowhere in the text are the prohibitions or restrictions said to apply to a company directly or indirectly, nor are any prohibitions made applicable to affiliates or parent or sister companies.

On the face of it, the principals of a management company are at liberty to organize another joint stock company that would offer investment management services to any number of clients and to manage the investment funds of the principals themselves. The company would require registration with the Commission as an Investment Advising Company in accordance with the Securities Law; presumably the principals could satisfy the requirements.

The Commission may determine as a matter of policy to either permit multiple registration of an investment advising company and a management company by the same person or group of persons or to deny such dual registration. The policy conclusion the Commission might draw is not so clear cut that applicant would necessarily know in advance the conclusion the Commission would draw. In such ambiguous circumstances, it is desirable the Law provide guidance as to the entitlement.

In the course of crafting its policies in this area, there are several conclusions the Commission could reach. It might permit a management company to obtain dual registration as an investment advising company or it might expand the management company entitlement to include advising for a range of clients to a greater extent than currently permitted but not to the unlimited extent permitted to an investment advising company.

The question of capital adequacy is addressed in Article 44. It provides a management company must have a minimum capital of DM500,000 in the event it manages a single fund and an additional DM250.000 for each additional fund.

Provisions are contained in Article 45 to ensure confidentiality of fund information including keeping private specific enumerated information. The Article provides:

> (3) The data about the owners of unit certificates and stock, about the payments and disbursements, are business secrets and may only be announced with a court order.

A degree of clarification is in order. The Law must reconcile the need to keep information confidential and the need to disseminate relevant information to investors. Unit holders are entitled to access a listing of units for purposes of calling unit holder and shareholder meetings. As a joint stock company, a shareholder is entitled to inspect the records of the company. He may utilize the list for company purposes such as soliciting votes or calling a special meeting of shareholders.

The reference to stocks in the Article is not clear. If the stocks referred to are the stocks forming the investment portfolio, it is expected a stock listing would be disclosed from time to time in accordance with information disclosure requirements.

Generally, there is some question whether special confidentially rules are necessary. Perhaps, it is sufficient that information disclosure rules applicable to public companies generally are made applicable to investment funds.

The final subarticle of Article 45 provides the prohibitions on disclosure contained in the Article do not refer to the obligation of the management company to provide information to the Commission and to the depository. This seems sensible enough; however, surprisingly, the Article does not make reference to the obligations of the management company to provide information to unit holders or to shareholders.

The disclosure requirements of the Law generally are weak and, in fact, virtually non-existent. This is an area of the Law requiring substantial strengthening. It is interesting that Article 46, titled, Maintaining and Reporting of company's Assets, does not impose reporting requirements on a management company but merely provides the company’s asset\s are to be reported separately form the company’s own assets. It would be expected that this goes without saying.

Comment is made elsewhere that the Law insufficiently takes into account that as a joint stock company the closed-end fund is likely to be listed on the stock exchange and subject to stock exchange listing obligations. There is a need to reconcile the Law expectation that a management company will run the affairs of a closed-end fund company and the obligations imposed by stock exchange rules on listed issuers.

Operational Prohibitions

Articles 47 and 48 impose restrictions on the management company in its dealing with fund assets and in relation to the fund’s affairs. None of these appear controversial and most would appear to conform to the relationship between the management company and the funds it manages. Probably, a number of the provisions although not mistaken may be regarded as not necessary, strictly speaking. Even if the Law did not include the prohibitions, it is reasonably certain that it was understood the relationship between a management company and fund would not permit the management company to deal with fund affairs in a manner that offended any of the provisions.

An interesting exception to suggestion the provisions of Article 47 are somewhat redundant is Article 47(3). This is a conflict of interest provision that states

> (3) Persons described in Article 45(2) shall neither buy nor sell assets owned by the fund to the fund management company on behalf of the fund.

Persons mentioned in Article 45 include

> “The founders of the company, the members of the managing board and supervisory board, and all persons employed in it or carrying out some pe3rmanent or temporary activities under a separate contract…

The terminology in Article 47(3) is not entirely clear; however, it can be presumed the Article is intended to prohibit any trading between the fund and the management company and persons associated with it. This is an important and entirely appropriate provision, and is a core conflict of interest rule.

Depository

Part VI, Articles 52 to 54 deal with appointment and activities of the depository bank. Only a Macedonian bank or branch of foreign bank may function as a depository. It may be appropriate that only a bank function as a depository; however, in time other entities may achieve status to be regarded as capable of discharging depository functions. For clarity, it is preferable to identify the depository role and the tasks associated with functioning as a depository, and then to provide that only banks are eligible to function as depositories.

The Article 52 (1) definition of depository's activities might better provide that the depository is engaged by a management company by contract to undertake the activities described in Article 53 and such other activities as the contract may prescribe. This drafting would ensure the contract include the Article 53 responsibilities.

The requirement the Commission approve the depository and approve the contract, by which the depository is engaged, is appropriate.

The core depository responsibilities are set out in Article 53. The prime responsibilities are to safe guard the fund assets. In addition, the depository is to undertake activities enumerated in the Article. Generically speaking the matters may be identified as:

- Responsibility for dealing with fund monies in all respecting including subscriptions and redemptions and buying and selling of securities;
- Determining the value of fund assets and calculating the fund net asset values;
- Providing instructions to brokers to buying and sell securities on the markets based on management company requests;
- Administering the fund including issuing unit certificates and processing redemptions;
- Manage the liquidation of the fund on winding up.

Certain of the matters are referred in the Law explicitly; others are inferred from the Law. For example, the Law does not say directly that the depository is to administer the fund, however, since the depository process subscriptions and redemptions and issues certificates, it follows it must keep tract of investor records.

The Law does not distinguish between open-end funds and closed-end funds in its allocation of responsibilities. This is perhaps unfortunate as it is far easier for a closed-end fund to keep track of investor records than is the case with open-end funds. The point is made above that control of costs of administration are a key factor in the success of an investment fund from the fund sponsor perspective. Based in experience in other jurisdictions, depositories have a tendency to charge amounts for services that prevent funds achieving economic returns. This is a difficult trade off between investor protection and enterprise economic viability that Macedonia as is the case in other smaller markets, must acknowledge and face.

SECTION THREE

ANALYSIS AND COMMENT ON LAW REGULATIONS

The Law contains substantive provisions regulating the parameters within which fund operations may be conducted, particularly investment criteria applicable to fund investment portfolios. It also defines the respective roles of fund management companies and depositories in undertaking a fund's activities.

However, the Law also usefully recognizes that in addition to setting these substantive parameters, fund regulation that adequately protects investor interests must also ensue a fund's day to day activities are conducted in a manner that is fair to investors. Particularly in the operation of an open-end fund, there are a range of investor interfaces in relation to which experience has demonstrated there are risks of improper conduct by management companies. These include the process of subscribing for and redemption of fund units, the establishment of fund NAVs and the conformity of portfolio investment to fund investment objectives and diversification regulation. In the circumstances, the Law makes provision for issue of detailed regulation governing these fund activities and contemplates ongoing reporting by fund registrations as to the conduct of its activities.

The enactment of the Investment Fund Law in early 2000 was followed by the issue on October 16, 2000, pursuant to authority granted the Commission in Articles 5, 7, 16, 53, 55 and 57 of the Law, of implementing regulations dealing with the following subjects:

- Information to be Delivered to the Commission by the Fund Management Company (Management Report Regulation) ;
- Content of the Public Offer Inviting Subscription of Units In Open-end Fund and Shares in Closed-end Fund (Public Subscription Regulation);
- Method of Conducting Control over the Operations of the Investment Funds, the Fund Management Companies and the Depository Banks (Supervision Regulation)
- Amount and Method of Payment of Shares of Closed-end Fund Management Company (Management Company Subscription Regulation);
- Content of Prospectus by type of Investment Fund (Prospectus Content Regulation);

- Computing the Net Value of the Fund's Assets (NAV Calculation Regulation); and
- Documentation for Staff, Technical and Organizational Qualification for establishment of an Investment Fund (Qualification Regulation).

In fact, day to day operational services are furnished a fund by the investment fund management company or by third party suppliers, particularly the depository. Of the group of regulations, the following deal with operational activities: The Task Order directs attention to regulation of investment fund management and custodian services. However, rather than confining focus to those regulations that could be regarded as dealing with day to day activities as opposed to one-off events such as the management company subscription for capital in a fund, all of the above regulations were reviewed individually and as a group.

The conclusion was reached that the regulations are adequate in the context of their preparation. The caveat is of course the conclusion reached elsewhere in this Report as to the inadequacies of the Law generally. Obviously, the regulations implement Law provisions that may be regarded or come to be regarded as inappropriate. Should the recommended Law changes come to be undertaken, of necessity consequential changes to the regulation would need to be undertaken.

The *Public Subscription Regulation* mandates information to be furnished to prospective fund subscribers in addition to information furnished in the fund prospectus. The subjects dealt with include information on open-end fund unit certificates, closed-end fund share certificates and the management company.

The *Management Report Regulation* requires delivery of a fund annual report including financial statements prepared to an international standard, and quarterly financial reports within two months of quarter end. Special reports are required in the event of material changes in the business and affairs of the management company. Other reporting obligations in the Management Report are keyed to regulatory requirements contained the Law.

The *NAV Calculation Regulation* provides a highly detailed (24 Articles and Appendixes) code for calculating open-end fund unit values, closed-end fund share values and calculation of subscription and redemption prices. There are no substantial problems with the approach taken which appear to conform to conventional procedures.

Closed-end fund NAVs are to be calculated every business day. It is perhaps representative of the unfortunate but understandable somewhat academic environment in which the regulation is prepared that it was not recognized that preparing NAVs every single working day is by no means the practice in developed markets. Such a calculation is an expensive process; every day calculations involve unnecessary costs.

There is a similar lack of familiarity with appropriate practice displayed in the requirement for calculation of open-end fund NAVs only at the time “the annual and periodic balance sheets are being prepared.” Calculation of closed-end fund NAVs is essential market information. Investment in such funds is made by share purchase, however, investors determine the share price as a function of the price premium or discount to fund NAV. Absent periodic NAV calculation and publication of the calculation, essential investment information is lacking.

Whether it is constructive at this time to amend regulation in this and other respects is doubtful. As reflected elsewhere, the priority is change the Law to better accommodate the launching of investment funds.

The *Investment Company Subscription Regulation* deals with the initial subscription by a management company in a closed-end fund. For reasons that are obscure the Law limits the investment of 20% of the initial offering and does not permit the management company to participate in subsequent offerings.

However, the Law and Regulation are silent as to the entitlement of the management company to buy shares in the fund on the open market. This is presumably an oversight. However, it is a significant gap in regulation. Here again, it is doubtful whether there is much point in plugging the gap unless accompanied or more accurately preceded by a wholesale revision of the Law.

As would be anticipated, the *Prospectus Content Regulation* outlines the information and the format in which the information is to be presented, to be included in fund prospectus. The information is detailed and is broken out by investment fund type.

Deficiencies in the regulation follow from deficiencies in the Law. There is no requirement for certification of the information contained in the prospectus, nor provision for civil liability. There is not yet a sense of the special quality of information in a prospectus distinct from information furnished respecting a fund or security generally.

The *Management Report Regulation* details periodic information to be furnished the Commission by fund management companies in connection with the day to day operation and activities of a fund.

Requirements are imposed for delivery of quarterly and annual specialized Commission reports and provision of fund reports to unit holders and shareholders as the case may be. Quite properly, reporting requirements are focused on the business and affairs of the management company as opposed to the activities of the fund itself. A special obligation is imposed to enable the

Commission to keep abreast of capital problems experienced by the management company. In summary, an omnibus obligation is articulated for the management company to report any and all material changes in is business and affairs to the Commission forthwith.