

Mutual funds system in Ukraine

JEL classification: G19

Keywords: collective investment institutions, investments, assets, investment funds, market transformations, mutual investment funds, corporate invest funds, shareholders, dividends

Słowa kluczowe: instytuty wspólnego inwestowania, inwestycje, aktywa, inwestycyjne fundusze, rynkowe, przekształcenia, udziałowe inwestycyjne fundusze, korporacyjne inwestycyjne fundusze, akcjonariusze, dywidendy

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Abstract: The question about trying to enrich and protect their own wealth, encourages everybody to find the best way to do that. And in search of the most effective and safest way there appeared collective investment institutions. Collective investment institutions (CII) collect investors' money for their future investments in securities and other assets; since 2002 it had become quite popular in Ukraine. However, even at the peak of its popularity in 2007–2008, CII failed to become a serious alternative for other profitable assets.

Abstrakt: Problem wzbogacenia i obrony własnego bogactwa pobudza do poszukiwań najlepszych ku temu sposobów. W poszukiwaniu bardzo efektywnego i najbezpieczniejszego sposobu pojawiają się instytuty wspólnego inwestowania. Instytuty wspólnego inwestowania załączają pieniądze inwestorów, inwestują je w papiery wartościowe i inne aktywa; od 2002 roku są one popularne na Ukrainie. Jednak nawet w szczytowym okresie swojej popularności w latach 2007–2008 nie były poważnym wariantem alternatywnym innych dochodowych aktywów.

Introduction

For many centuries people have tried to enrich and protect their own wealth. Finding the best way to do that became everybody's goal. And as a result of the search for the most effective and safest way there appeared collective investment institutions.

Back in 1774 the Dutch merchant and broker Adriaan van Ketwich established the first collective investment institution, Eendragt Maakt Magt (EMM) in the Netherlands. This fund had a lot in common with modern mutual funds.¹

Later, in August 1822, one more collective investment institution sprang out in Belgium, and in a few decades — in Switzerland and France. As a mass phenomenon, collective investment institutions began to develop only after World War II, gradually creating competition for banks and other financial institutions. The greatest expansion of investment funds took place in the UK and the U.S. Today, more than half of American households are investors of an investment fund.²

Ukraine joined the process rather late, since such market transactions became possible only after market transformations. There was no such idea of investment in the times of command economy.

Collective investment institutions (CIIs) are a new opportunity for Ukrainian investors to invest their savings so as to ensure their growth. CIIs are investment funds in which investors accumulate funds for future profit by investing in securities of other issuers, corporate rights and real estate.²

Classification

Economists noticed a long time ago that investments are a crucial force of progress. Over the time the problem of investment choice has arisen. Today, anyone can become an investor, forming an investment portfolio within his financial capabilities. Investment funds became the best alternative to a deposit.

CII is a form of collective investment that allows an investor to join the stock market even with a small amount of money. To invest means to put money into any enterprise business for a profit.

The purpose of investing is to maximize profits with a minimal risk.³ Investors who are not satisfied with the bank deposit's rate and, on the other hand, are not willing to take the risk of self investment, choose the alternative — CII, relying on the professional management of a specialized company.

CII reduces the risks inherent in any stock market, by diversifying, creating a portfolio of different classes, types and branches of stocks, bonds, deposits, as it possesses significant resources. The most interesting fact is that all the profits earned by CII, unlike bank deposits, are the income of investors, with the exception of expenses necessary for the CII managing.⁴

As regards their legal forms, collective investment institutions in Ukraine are divided into the so-called corporate and mutual funds. Corporate and mutual

¹ *Collective investment institutions*, <http://www.kinto.com/useful/9214.html>.

² *What are CII?*, http://www.uaib.com.ua/abcpeople/abetka_isi/5909.html.

³ *Ibid.*

⁴ *Collective investment institutions...*

funds, depending on the order of activities, are divided into open, closed and interval funds. Open-end and interval funds, depending on the period for which they are created, are divided into urgent open and perpetual open. Closed-end investment funds, in turn, are divided into diversified closed-end investment funds and closed-end non-diversified funds. Non-diversified funds may be venture and non-venture.⁵

So what is a mutual fund? According to the Law of Ukraine on Collective Investment Institutions, mutual investment funds (MIF) are the assets belonging to investors in common partial ownership, which are managed by the asset management company (AMC) and are accounted separately from their operating results, but do not appear as a legal entity.

The best understanding of MIF comes from comparison with corporate investment funds (CIF). Having examined certain characteristics of these funds, we get a clear picture of common and distinctive features.

Therefore CIF:

- is a legal entity, created in the form of public joint-stock company, where more than 70% of average assets are securities;
- it provides the ability to receive dividends;
- investors may participate in the management, governing body is the General Meeting of Shareholders and Supervisory Board;
- participants of such fund may be individuals or legal entities, whereas in the venture one — only legal entities;
- CIF has a contracting relationships with the asset management company;
- CIF emits ordinary registered shares;
- Commission on Securities and Stock Market may initiate judicial liquidation procedure, the decision to replace AMC is adopted by the General Meeting of Shareholders;
- in the event of liquidation the requirements of investors who are not founders are primarily satisfied.

Conversely, MIF:

- is not a legal entity and assets belong to investors in the form of jointly shared ownership;
- investors are not able to participate in the managing of the fund, but if funds work through initial public offering, the investors can create a Supervisory Board;
- the participants of the investment fund may be individuals or legal entities, whereas in the venture one — only legal entities;
- it creates asset management companies;
- it emits investment certificates;

⁵ *Ukrainian investment funds: comparative analysis of mutual and corporative funds*, http://ua.prostobank.ua/finansoviy_gid/investitsiyi/statti/investitsiyi_fondi_ukrayini_porivnyalniy_analiz_payovih_ta_korporativnih_fondiv.

- possibility to receive dividends exists only in closed MIFs;
- Commission on Securities and Stock Market may decide to replace AMC or to liquidate the fund. The allocation and issuing of investment certificates ends with the decision to liquidate;
- in the event of liquidation the requirements of investors who have applied for redemption of investment certificates at the time of the decision to liquidate are primarily satisfied, other investors possess only a quarter turn.

Thus, investment funds propose a mechanism by which individuals transmit money or assets to the hands of professional managers for their managing. Consequently, the sum of contributions of investors is managed as a single portfolio, where each investor's share is proportional to his investment. Investors that buy shares in the investment fund are its shareholders. The property in MIF is a common property and belongs to its shareholders on the basis of common partial ownership. If a shareholder owns one share out of a thousand, and the property of MIF is invested, for example, in a thousand shares of a company, it does not mean that the shareholder owns one share of the company.⁶

Revenue that is received through investment fund consists of dividend and interest payments, and also of the increase in securities value that make up the fund's assets. However, the fund's assets may either rise or fall. The value of shares may either rise or fall. Revenue position of a fund in the past does not guarantee future income. Neither the management of a company nor the state can guarantee the return on investing in MIFs and CIFs.

Legal framework

The Ukrainian history of the collective investment market began with the adoption of the Law of Ukraine on Collective Investment Institutions (mutual and corporate funds) No 2299 dated March 15, 2001. Mutual investment has become a very promising segment of the financial market, therefore its state regulation had several reasons, the main one of which was the protection of financial relationships between investors and investment funds.

This law defines the legal and organizational basis for the creation, operation and responsibility of subjects of mutual investments, peculiarities of their assets management, establishes requirements for the composition, structure and assets storage, peculiarities of placement and circulation of securities of MIFs and CIFs, procedures and scope of the disclosure of information by investment funds in order to attract investment and allocate financial resources of investors efficiently.⁶

⁶ *The essence of mutual funds*, http://www.creditcoop.ru/index.php?option=com_content&view=article&id=244:pifs-about&catid=31:pifs&directory=57.

The objective of this law is to regulate social relations that arise in collective investment concerning the creation and activities of collective investment, guaranteeing ownership of securities and protection of the stock market.⁷

The mentioned law defines all possible concepts that operate in collective investment and disclose their contents. It provides the classification of investment funds on various grounds and characterizes them. It also describes the principles of operation, principles of registration and liquidation, constructively and meaningfully explains the essence of corporate and mutual funds and describes their operating procedures.

In addition to the Law of Ukraine on Collective Investment Institutions, relations in collective investment are governed by other regulations on the stock market matters and on the matters of joint stock companies activities.

For example, these may be legislation on financial markets matters (approximately 100 amendments, decisions, regulations and interpretations), corporate governance (40 decisions, regulations and interpretations), on innovations, financial monitoring, antitrust legislation, independent regulation in the stock market, project legislation on financial market matters.

Dynamics

After the adoption by the Supreme Council of Ukraine the mentioned law, investment funds were set up in this country in 2003.

MIFs and CIFs play an important role in the development of the stock market. At the expense of small investors' resources who invest in these financial institutions, incredibly large cash flows into stock markets are made. Gradually this process infused the citizens of Ukraine, who came to the stock market independently to buy and sell stocks, bonds or place cash. In modern conditions, collective investment institutions can become an effective accumulation of capital the circulation of which ensures harmonious development of economy, development of financial and productive sectors of the national economy. Development of collective investment is one of the indirect incentives for the development of the stock market, in particular.

It happens that MIFs are the most common form of CII in Ukraine. This situation is legitimate: the existence of low-income population is the main reason for the lack of savings, and therefore of investment. Mutual investment fund has become, so to speak, a breakthrough in the field of investment for the public. The opportunity for small individual investors to accumulate funds has allowed them to enter the stock market. Therefore, let us have a closer look at the dynamics of this particular structure in Ukraine.

⁷ *The Law of Ukraine on Collective Investment Institutions (mutual and corporate funds) No 2299 from 15.03.2001*, <http://zakon2.rada.gov.ua/laws/show/2299-14>.

After the adoption of the already mentioned law in April 2001, the Commission on Securities and Stock Market and the Ukrainian Association of Investment Business (UAIB) signed a memorandum of cooperation, which included their joint efforts to develop collective investment institutions, that was the development of legislation and consideration of the possibility to transfer certain powers to regulate activities of professional stock market participants from the Commission to UAIB. MIFs began to operate just after the collaboration and adoption of numerous regulations which were necessary for the creation and further operation of MIFs by the Commission.⁸

During 2001–2005 increase in the number of MIFs was hardly observed. For instance, in 2003 the Commission issued only 27 licenses for professional activity at securities market, namely one asset management, and 28 mutual funds were registered. When it comes to MIFs only, the following were registered: “Dostatok,” “Trident-Capital,” “Halytski Investytsii,” “Capital-Fund,” “Novi Tekhnolohii,” “Avtoalians Portfolio,” among others.

The positive dynamics of mutual funds became prominent only since the beginning of 2006: increased profitability, number of employees at MIFs, assets that were under their control. Therefore, there was an urgent need to reform the stock market, which would provide the necessary legal regulation of economic relationships. The development of MIFs was prevented by outdated legal background, in particular, the Law of Ukraine on Securities and Stock Exchange No 1201-XII, which was adopted back in 1991 by the Supreme Council of the USSR.⁹ On November 23, 2006 the Supreme Council of Ukraine adopts the Law of Ukraine on Securities and the Stock Market dated February 23, 2006 No 3480-IV, which ordered and legislatively defined the functioning of MIFs and other aspects of stock markets.¹⁰

The year 2007 became a breakthrough for the Ukrainian mutual fund industry. The main indicator of the stock market — the PFTS index for 2007 increased by more than 130%, which in turn had a positive impact on the activities of mutual funds. Another advantage was the favorable macroeconomic situation, which caused revenue growth for businesses and individuals. Investors were able to invest surplus funds in mutual funds.

The situation on the stock market in 2008 negatively affected the investment funds. With some delay there was adopted the Law of Ukraine on Amendments to the Law of Ukraine on Collective Investment Institutions (mutual and

⁸ O.A. Slobodyan, *Historical and legal aspects of mutual funds*, http://www.nbu.gov.ua/e-journals/prtup/2011_3/pdf/11coapif.pdf.

⁹ *The Law of Ukraine on Securities and Stock Exchange No 1201-XII, from 18.06.1991*, <http://zakon3.rada.gov.ua/laws/show/1201-12>.

¹⁰ *The Law of Ukraine on Securities and the Stock Market No 3480-IV from 23.02.2006*, <http://zakon3.rada.gov.ua/laws/show/3480-15>.

investment funds) No 693-VI dated December 18, 2008, in order to somehow solve problems.¹¹

This diagram clearly presents the situation in the period of 2006–2012 for MIF “Platinum” (Платинум). We can observe the upward trend from August 2006 till February 2008 and from March 2009 till March 2010 on average.

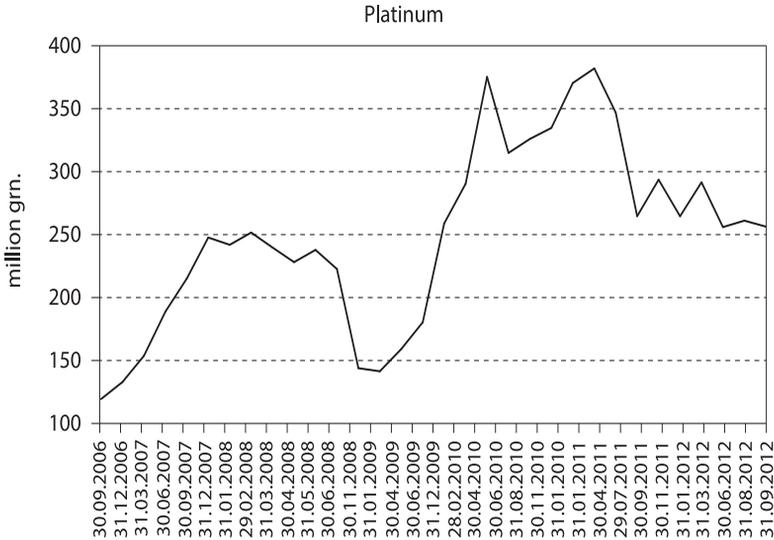


Figure 1. Investment situation at MIF “Platinum”

Source: <http://dragon-am.com/platinumreporting3/?L=1>.

To date, during the period 2002–2011 we may observe the vast AMC’s quantity dynamics and impressive growth of financial assets under management. In 2002, when first CII were set up, the quantity of AMC equaled 5. In two years, when the financial market was filled with 88 AMCs, financial assets under management increased to 1938 million gryvnas (grn). In 2005–2008 investment market was presented with 159, 228, 334, 409 AMCs and assets under management — 6904, 17145, 40780 and 63259 million grn, respectively. After stagnation in 2008, the number of AMCs dropped to 380, and further to 341 in 2011.¹²

¹¹ *The Law of Ukraine on Amendments to the Law of Ukraine on Collective Investment Institutions (mutual and investment funds) No 693-VI from 18.12.2008*, <http://zakon2.rada.gov.ua/laws/show/693-17>.

¹² *AMC’s quantity and financial assets under management*, <http://www.uaib.com.ua:88/analitu-aib.html>.

Problemes and perspectives

Economic activity has always been associated with numerous risks. For Ukraine, one of the pressing issues was and remains the creation of appropriate organizational and legal protection of property and other assets.

The world tendency is that over the past 50 years there occurred the concentration of financial power in the hands of a relatively small number of organizations, called institutional investors. Today investments are related with the ability to earn profits. But such results are not always identical because the investor cannot always know in advance the results of his activities. Almost all investments are made with uncertainty. It is therefore not surprising that investments that promise high rates of return are associated with high risks. There is the question of balance between profitability and risk. Actually, the main reason for increased activity of institutional investors is that they provide this balance in the most optimal way.¹³

Mutual fund is a chance for those who do not have extensive knowledge about the market, but are willing to invest. MIF is the most affordable option for investing. However, there are both advantages and disadvantages of such form of investment.

The advantages of MIF are as follows:

- it gives significant tax benefits resulting in savings of investors. The investor pays only a one-time income tax when leaving the fund. MIF is a kind of “accounting entity” of AMC without corporate entity;¹⁴

- the managing company (AMC) can create and manage the assets of numerous MIFs;

- the mutual investment fund itself does not create a team of managers and employees, significantly reducing costs;

- there is no need to be an expert in financial area;

- the investor has a professional team of managers, analysts, traders;

- investor has an ability to sell a share at any time without losing earned money;

- return and risk are balanced;

- investor needs a minimal start-up capital.

However, when it comes to disadvantages the situation is less optimistic:

- it is impossible to gain profit in the mutual funds by investing a small amount of money;

- liquidity, guaranteed by such funds, has no foundation. Investment funds are the barometers for financial institutions;

- AMC may have vast opportunities to manipulate investment in their own interests;

¹³ Z.G. Vatamaniuk, T.M. Kushnir, *The development of institutional investment in Ukraine*, <http://efaculty.kiev.ua/analytics/trf/5/2.htm>.

¹⁴ *Who will pay VAT instead of MIF*, <http://www.dtk.com.ua/show/1cid02655.html>.

- the issue of VAT payment is ultimately ambiguous;
- it is typical for the public to be ignorant and distrustful to CII due to unclear situation on stock markets.

However, there is another negative aspect, namely the dynamics of development and future prospects. Having previously regarded the establishing of MIF and having illustrated the dynamics of individual funds, we can draw some conclusions regarding cyclical return, or rather, whether macroeconomic stability or instability is reflected in the stock markets. Economic growth of 2006–2007 allowed investors to receive up to 70% of profit, but with the advent of the crisis in Ukraine in 2008 the performance drastically changed. The essence of the problem is not the cyclical nature of economy, since the most practical economic phenomena are cyclical in nature, but the recovery from the last global crisis, which is much protracted. This tendency can cause adverse effects on collective investment institutions.

Conclusions

Summing up, we can note that collective investment institutions, namely mutual and corporate funds, propose excellent alternative for investors and for the whole financial system in general. Products of non-bank financial institutions successfully replaced traditional bank deposits. On the other hand, it is a real chance to accumulate significant amount of money and the appearance of new investors at the stock market.

However, there are significant drawbacks to the development of this system, which can lead to negative consequences. First of all, ignorance and distrust of retail investors (households) pose a real obstacle for future investment, and consequently — to the development.

Secondly, imperfect regulatory framework and features of a competition “who beats who”: the lack of transparency in the activities of CIF or MIF within the context of government attempts to fill state budget with the help of investor’s money.

Thirdly, the investment funds dynamic depends on cyclical dynamics of the economy. The world crisis of 2008–2009 negatively affected the performance of mutual funds. The worst is that delayed recovery from the crisis gives no positive predictions regarding continued existence of collective investment institutions.

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Who will pay VAT instead of MIF, <http://www.dtk.com.ua/show/1cid02655.html>.

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Summary

In people's search for the best way to enrich and protect wealth there appeared collective investment institutions. This is a good alternative for investors who are not satisfied with bank deposit's interest rates. **Collective investment institutions (CIIs)** are the new opportunity for Ukrainian investors to invest their savings so as to ensure their growth. The Ukrainian history of mutual funds began with the adoption of the appropriate law in 2001. Still, besides the real advantages of this kind of investing there are numerous disadvantages, especially in conditions of transition economy of Ukraine.