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New law on investment funds

a breath of hope for struggling financial markets

Historically, access to finance has been a major challenge for businesses in Georgia.

In spite of several waves of reform and the declared policy of the Georgian government to develop capital markets, these remain at an inception stage. Although the Georgian banking sector is rather strong, a predominant part of businesses are not bankable. In addition, absence of competition among funding sources impedes product development and the financial institutions, while advanced technologically, remain conservative in product development.

In response to the above problem, in recent years the National Bank of Georgia (NBG) has championed a number of reforms to strengthen capital markets in the country and create alternative sources of funds. Setting up a functional legislative framework for investment funds has long been declared part of this agenda. Although the previous law was around for almost 7 years, it fell short of any modern standard,

regulatory depth, and predictability and proved to be a non-starter – over the course of its existence, no single investment fund was registered.

Largely modeled around the experience and directives of the European Union, the new Law on Investment Funds was drafted by the NBG, with the involvement of private sector representatives. We are privileged that two partners of BLC – Tamta Ivanishvili and Giorgi Batlidze were actively involved in the process and even provided technical assistance to the regulator.

The Law on Investment Funds was published on 14 July 2020 and enters into force on 12 October 2020. It establishes a transitional period of 12 months. Every entity engaged with the investment activities characteristic to an investment fund has the obligation to obtain registration or authorization with the NBG throughout this transitional period.

It is now prohibited to use the phrase 'investment fund' in a company legal name unless the relevant entity can qualify as such and is duly registered by the NBG. This limitation is inapplicable to companies registered prior to enactment of the new law.

The law provides a regulatory framework for investment funds established or operating in Georgia, asset management companies, foreign investment funds and other players similar to special depository, auditors and other actors.

Herewith, the law defines investment fund as a collective investment vehicle, the primary objective of which is to attract funds with the purpose of their further investment. As of the enactment, it becomes prohibited to carry out activities characteristic for

investment funds without first obtaining authorization or registration with the NBG.

From the standpoint of a target investor base, the new law differentiates between authorized investment funds (which have the authority to raise funds from retail investors through public offerings) and registered funds (aimed primarily at qualified investors and authorized to raise funds through private offerings only). Following best international practice, the registration requirements, as well as the scrutiny of regulation, is much more extensive for authorized funds since retail investors are considered more vulnerable due to the lack of experience and funds required to bear risks associated with investment activities.

The law defines public offering as an offering of securities to more than 20 retail investors. It is worth noting that this is a stricter standard since, under general circumstances, the Law on Securities Market considers offering of securities as public if the offering is made to more than 100 persons or unidentified pool of addressees.

When it comes to legal form, an investment fund can be registered in the form of an incorporated entity such as a limited liability company, a joint stock company or a limited partnership (investment company) or a contractual scheme (common fund). Investment companies are not obliged to contract an asset manager, while common funds have such obligation. Both investment companies and common funds can obtain the status of registered fund or an authorized fund and thus, they will be subject to the relevant level of regulatory oversight. Regardless of the opted legal form, the law provides for limitation of liability of the investors for the activities of the investment fund and vice versa.

The law also differentiates open and closed funds. Investors in open funds have the ability to exit the fund any time through exercising their redemption rights, while no such right exists in close funds until the latter is liquidated. The valuation and financial reporting requirements are thus different for open and closed funds. As a mixture of these two sub-categories, the law also regulates interval funds, which periodically offer investors the possibility to buy back a percentage of outstanding shares at net asset value.

A special procedure is introduced for the recognition of foreign investment funds. For such recognition to be obtained, the following conditions must be satisfied: the country of origin must allow public offering of units; it must not be categorized as non-cooperative by the FATF (Financial Action Task Force), and it must have a legislative framework comparable to the one established for authorized funds in Georgia.

As mentioned above, among other actors, the new law sets regulatory requirements for two entities instrumental to the functioning of the investment fund: (1) asset manager companies, which are entrusted with the competence to manage the fund's portfolio and risks; and (2) special depository, which has the obligation of safekeeping the fund's assets and exercising oversight over the asset manager's activities. To exclude any potential conflict of interest, asset manager and special depository cannot be the same person. Only the authorized funds have the obligation to contract special depository.

Certainly, the structure of investment funds cannot be functional without a proper tax framework.

This is why related amendments were also introduced to the Tax Code of Georgia. According to these amendments, activities related to the management and administration of investment funds is categorized as financial services and thus, exempt from VAT. As regards corporate income tax, the tax code attempts to treat an investment fund as a pass through entity to ensure that the tax burden of the investors is not increased due to involvement of intermediary into the structure rather than investing directly.

The sophistication of the Law on Investment Funds creates high hopes for the sector, while it is also understood that much will be dependent on how the law is administered, interpreted and enforced. Meanwhile, we remain hopeful that it will prove to be what every enthusiast of the field hopes for – a new breath for development and innovation of otherwise quite stagnant financial markets of Georgia.



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Please apply for the professional advice prior to relying on the information given in this article. BLC and its team shall be ready and pleased to provide any information, legal advice and specific recommendations regarding the issues covered herein.

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