

U-I-77/96  
May 16, 1996

## DECISION

At a session held on May 16, 1996 in a procedure to review constitutionality begun at the initiative of the company Proficia Dadas, družba za upravljanje investicijskih skladov, d.o.o., Maribor, the Constitutional Court

decided:

The resolution setting an upper limit to the value of funds in a unit trust that may be managed by an individual fund management company (Official Gazette of the Republic of Slovenia, no. 17/96) is contrary to the statute inasmuch as it does not contain a provision on a time restriction on the prescribed measure.

The Securities Market Agency must, within 30 days of the publication of this Resolution in the Official Gazette of the Republic of Slovenia, remove the established illegality.

Reasoning:

A.-I.

1. In its application of April 3, 1996 the initiator contests the decree setting an upper limit to the value of funds in a unit trust that may be managed by an individual fund management company (hereinafter: the Decree), passed on March 20, 1996 by the Securities Market Agency (hereinafter: the Agency), which came into effect on March 30, 1996.

2. The initiator believes that the Resolution is contrary to the Investment Funds and Management Companies Act (Official Gazette of the Republic of Slovenia, no. 6/94 - hereinafter: ZISDU), as at the time of its adoption there were no reasons for it pertaining under Paragraph 3 of Article 112 of the ZISDU, which was the basis on which the Agency adopted the contested resolution. With the adoption of the Resolution the Agency allegedly transgressed its authority, as the adoption of a resolution setting an upper limit to the value of funds held in unit trusts that may be managed by a single management company has no legal basis in the provision contained in Paragraph 3 of Article 112 of the ZISDU. The initiator also believes that with the adoption of the Resolution investors were put in an unequal position because they were banned from making payments into a freely chosen investment fund.

3. In the opinion of the initiator, the Resolution passed by the Agency will lead to a high degree of uncertainty on the securities market, which could result in a number of investors cashing in their coupons. This in turn, it is claimed, would lead to large-scale sell-off of securities and a fall in their value. This type of chain reaction would in the initiator's opinion cause a financial loss for investors, while the upsetting of the balance between supply and demand on the securities market could lead to a capital market crash.

4. In the opinion of the initiator, by adopting a resolution that would introduce uncertainty on the Slovene Stock Exchange, the Agency acted contrary to Article 147 of the Securities Market Act (Official Gazette of the Republic of Slovenia, no. 6/94 - hereinafter: the ZTVP), which sets out the basic purpose of its operations: the protection of investors and the development of the securities market in the public interest.

With the adoption of the contested Resolution, the Agency allegedly intentionally obstructed the operations of those management companies in which the amount of money invested exceeded SIT 3,500,000,000. It would appear that Proficia Dadas is the only fund management company in Slovenia at the moment to have funds exceeding this amount.

5. On April 19, 1996 the initiator submitted a reply to the Agency's statements of April 10, 1996. In the reply it states that prior to the adoption of the contested Resolution there were no extraordinary circumstances on the securities market.

The high concentration of cash within a single management company in the initiator's opinion cannot be the basis for the adoption of a resolution on the basis of Paragraph 3 of Article 112 of the ZISDU. Without making any specific statements, the Agency asserts that there was a discrepancy between supply and demand for securities on the securities market, but ignored the fact, which it knew of, that new shares were about to arrive on the market (Mercator, Tovarna sladkorja Ormož, Grosist Gorica, Droga, Sava and others).

6. The initiator also states that no financial institution is in a position to reduce its balance-sheet total by half and, until it does so, only pay money out. Therefore the Agency's Resolution is completely illogical, and at the same time not in compliance with its basic functions as set out in Article 147 of the ZISDU. Increased sales would destabilize the securities market which would result in a drop in unit values. This situation would lead the initiator into insolvency which would, pursuant to the ZISDU, mean the liquidation of its funds.

7. The Agency's decision allegedly caused a fall in the SBI, Slovenia's stock market index, which on March 15, 1996 stood at 1566. On the day the Resolution was published it fell to 1461.93, and on April 16, 1996 to 1146.91. So from the time the Agency published the first notice the SBI fell 418.09 points, some 26.7 per cent.

8. Furthermore, the initiator claims that the contested Resolution, despite being of a general nature, is aimed solely at Dadas Proficia[1]. The Agency has inspected the operations of the unit trusts of Proficia Dadas several times and has issued a resolution with which it called upon the company to remove certain irregularities. The initiator has always abided by these instructions. In any case, deficiencies or irregularities in the management of a single unit trust of an investment management company cannot be cause for the adoption of a "resolution with statutory power" that applies to all participants on the market. In order to achieve the removal of such irregularities the Agency is able, pursuant to the ZISDU, to take measures against an individual violator, but the Agency so far has not begun a procedure to revoke Proficia Dadas' operating licence. The initiator rejects all allegations of irregular operation and maintains that Proficia Dadas' unit trusts operate in accordance with the legislation. It also rejects the criticism that Proficia Dadas is the cause of inflated prices on the securities market. In the period between January 15, 1996 and March 12, 1996 other shares[2] without any capital or managerial connection to Dadas increased significantly.

9. The initiator also maintains that the calculation of the upper limit (market capitalization of the shares listed on the Stock Exchange divided by the number of management companies) is at odds with economic, legal and financial logic because it means that certain management companies are prevented from becoming more successful than others.

10. The initiator proposed to the Constitutional Court to abrogate ab initio the Resolution because it has no basis in the statute it refers to. The enforcement of the statute had harmful consequences on the securities market, and consequently investors who placed money in these funds suffered serious damage. It proposes that a temporary resolution be issued and requests priority treatment.

#### A-II.

11. On April 10, 1996 the Agency submitted a reply in which it stated that the initiative is unjustified. Paragraph 3 of Article 112 of the ZISDU gives the Agency the authority to order unit trusts to cease operating in cases of serious disturbance in securities transactions or similar serious disturbances. The purpose of this provision is for the Agency to stop (or restrict) the operations of unit trusts when, as a result of conditions on the capital market, the unit trusts are unable to manage their investments in accordance with the principles of limitation and diversification.

12. The fundamental reason that led the professional council of the Agency to adopt the contested Resolution was protection of investors in unit trusts from a risk clearly different to the normal

investment risk. This situation was created by the so-called "spiral effect". This phenomenon began to develop as a result of the significantly increased inflow of cash into the unit trusts, encouraged by the high rate of return of the unit trusts managed by Proficia Dadas. Because of large increases in investments in the unit trusts and because in the period between January 1, 1996 and March 18, 1996 no new shares were listed on the exchange, with the number of listed securities remaining the same the demand for securities increased, which led to an artificial inflation of prices on the exchange. Increased securities prices had a reverse effect on the return of the unit trusts, which can lead to multiplication at an ever higher level.

13. Further support for the conclusion that serious disturbances were created on the official securities market came from the unusual investment policy of Proficia Dadas' unit trusts. In the period between January 1 and March 7 they did not invest net monetary inflows in the purchase of new securities; instead, Proficia Dadas on behalf of the unit trusts illegally approved loans to Priom, a company solely owned by Mr Davorin Sadar.

14. The investment structure in the unit trusts managed by Proficia Dadas has visibly deteriorated, at the same time as a significant growth of new monetary inflow has taken place, which is why Proficia Dadas cannot follow an investment policy that permits normal diversification and limitation of investment risks.

15. At the moment there are 17 unit trusts in Slovenia, managed by 11 management companies. On July 31, 1995 the total balance of funds in the unit trusts stood at SIT 4,626 million, of which 44.7 per cent, or SIT 2,070 million, was in unit trusts belonging to Proficia Dadas. By February 29, 1996 the volume had increased by 82 per cent and peaked at SIT 8,433 million. The majority of the new money was attracted by Proficia Dadas' unit trusts (90 per cent of the growth in the unit trusts was directed into the following funds: Diver - 109 per cent increase in funds; Neli - 135 per cent increase and Herman Celjski - 9600 per cent increase). Between July 1995 and January 1996, net inflows reveal that money was pouring into Proficia Dadas' unit trusts while other funds suffered net cash outflows.

16. The above-average growth in funds in the unit trusts this year was the result of a coinciding of a deterioration in investment opportunities due to falling deposit rates and the falling exchange rate for the German mark. Certain high-yield unit trusts offered an alternative to these trends.

17. The Agency says that it established irregularities indicating a great probability that the assets value of Proficia Dadas' unit trusts (unit yield) had been manipulated. In an inspection of documents carried out in the period between January 3, 1996 and March 18, 1996, the Agency established that Proficia Dadas included Priom d.o.o. as the buyer or seller in almost all (99 per cent) of its transactions in non-tradable securities. These transactions involved fake deals where the capital profits shown by the capital funds involved in the transactions directly affected the growth of the unit value.

With tradable securities too there is a clear increase in prices, mainly in those which are affiliated in the Dadas system. In formal terms the connected entities are individuals linked to each other through management or capital (husband and wife, Mr and Mrs Sadar are the managing directors, or direct or indirect majority shareholders). Because of these links, the Agency claims, the Sadar partners determine the nature of business in these affiliated entities, and hence they operate as one person.

18. Furthermore, the Agency stated that an inspection of the operations of Proficia Dadas has shown that as at March 7, 1996 Priom d.o.o. had been approved SIT 1,306 million in short-term loans in the name and on behalf of the unit trusts. Such investments are not permissible per se, as they are very risky and completely unsecured. Thus, on the basis of Paragraph 1 of Article 112, the Agency ordered Proficia Dadas to cancel the loans within 8 days. Priom d.o.o did not return the loans it had received in cash, and the initiator explained that the claims of the unit trusts on Priom were reconciled with Priom's counterclaims on the funds. It was not possible to verify whether these claims really existed.

19. According to the Agency, the irregularities in the operations of Proficia Dadas are reflected in the investment structure of the unit trusts. Unit trusts must have at least 75 per cent of funds invested in securities listed on the stock exchange, which reduces the risk (Paragraph 1 of Article 94 of the ZISDU). In January and February 1996 none of Proficia Dadas' four funds satisfied this statutory

criterion. Compulsory diversification and liquidity of a portfolio is dictated by the provision contained in Paragraph 1 of Article 95 of the ZISDU.

In order to achieve further spreading of the risk, the securities of an individual issuer may amount to no more than 5 per cent of investments. Proficia Dadas' unit trusts do not adhere to this rule; the Herman Celjski unit trust had 23.7 per cent of all its funds in investments that were not permitted.

And this rule is broken to an even greater degree by those companies which are considered to be affiliated in the Dadas system.

20. The arguments cited above were the reasons why the Agency adopted the contested Resolution. In the opinion of the Agency, the authorization (under Paragraph 3 of Article 112 of the ZISDU) to stop operations following the rule argumentum a majori as minus encompasses authorization to temporarily suspend operations. The Agency objects to the proposal for a temporary resolution to be issued because in its opinion there was no damage caused that would be difficult to rectify, and because the initiator itself caused the circumstances that it refers to. A violation of the initiator's equality was not proven. The contested Resolution was adopted with exactly the opposite intention, i.e. to ensure that all unit trusts operate in accordance with the provisions of the statute. The high degree of uncertainty on the market was not caused by the contested Resolution but by the initiator itself upsetting investors with public notices. The ban on new payments does not destroy the balance between rational management of funds and the sources of their funding. Therefore, the alleged harmful consequences were not created by the implementation of the contested Resolution.

The Agency also warns that if the enactment of the contested Resolution were to be suspended the manner in which Proficia Dadas operates its unit trusts, as described earlier, would have further harmful consequences for the securities markets as well as for investors. And therefore the Agency proposed that the Constitutional Court reject the initiative as unfounded.

## B.

21. In view of the fact that the initiator is an investment fund management company and the contested Resolution directly interferes with its rights, legal interest and status, it satisfies the requirement of standing as demanded by Article 24 of the Constitutional Court Act (Official Gazette of the Republic of Slovenia no. 15/94 - hereinafter: the ZUstS). The amount of money in the unit trusts managed by the initiator, some SIT 5.7 billion, exceeds the amount determined in the contested Resolution. Therefore the Resolution directly interferes with its rights, legal interest and status.

22. Given that the condition set out in Paragraph 4 of Article 26 of the ZUstS is satisfied, the Constitutional Court accepted the initiative and immediately proceeded to decide on the matter itself and for this reason did not adjudicate separately on the proposal to suspend the enactment of the Resolution.

23. The Agency adopted the contested Resolution on the basis Paragraph 3 of Article 112 of the ZISDU, which prescribes: "In the event of natural catastrophe, war, civil unrest, bank or stock exchange closure or severe obstruction to foreign exchange or securities transactions, the Agency shall issue a decree on the complete or partial temporary suspension of the operations of investment funds."

24. Article 1 of the Resolution adopted by the Agency provides that the "total value of all unit trusts managed by an individual management company may not exceed SIT 3,500,000,000"; in Article 2, that "management companies which at the time this Resolution comes into force manage unit trusts whose total value exceeds the value under Article 1 of this Resolution may not receive new payments of investment coupons until the total value of the unit trusts falls below the value stated in Article 1 of this Resolution."

25. In accordance with the provision of the ZISDU cited above, the Agency, which was founded by the Securities Market Act as an independent organization, was given public authorization on the basis of Article 121 of the Constitution to issue regulations (general acts) - decrees. The main characteristic of

this authorization is that special circumstances envisaged by statute must exist, that the measures it determines are only temporary, and that the operations of investment funds may be suspended completely or partly by decree.

26. The legal act passed by the Agency refers to the authorization contained in the above-mentioned article, but it is given the title "Resolution". Nevertheless, this legal act must be treated as a decree under Paragraph 3 of Article 112 of the ZISDU, which sets out measures of a general nature. The abstract general nature of the legal norms contained in the Resolution are shown by the determination of an upper limit of the value of a unit trust that may be managed by an individual management company, as well as in the fact that this provision applies to every management company that exists or will be founded during the validity of the Resolution. Therefore it is a general act, which is also clear from Paragraph 4 of Article 112, which for the same cases gives authorization to pass individual acts (decisions).

27. The Agency may issue a decree only if special circumstances exist as envisaged by statute. The ascertainment of the existence of these circumstances therefore applies to a certain situation on the securities market. The Agency demonstrated the existence of such special circumstances in its extensive reply to the initiative.

28. The resolution passed by the Agency in essence means a restriction on the operations of investment funds. Since, pursuant to the provision contained in Paragraph 3 of Article 112 of the ZISDU, the Agency is authorized to completely or partially temporarily suspend operations in cases of serious disturbances in foreign exchange or securities transactions or other similar disturbances, it may adopt within this authorization a milder measure and merely restrict the operations of investment funds. This is precisely what the Agency has done with the contested resolution, with which it set an upper limit on the amount of funds in the unit trusts managed by an individual management company. As has already been established, this measure is within its statutory authorization. 29. According to the provision contained in Paragraph 3 of Article 112 of the ZISDU, as a result of established irregularities the Agency may pass a decree (completely or partially) suspending the operations of investment funds but does not have authorization to adopt measures which would restrict the operations of investment funds permanently. The subject of the contested resolution is the setting of an upper limit to the value of funds which may be managed by an individual management company, which the resolution defined as a permanent measure. Investment management companies were banned from receiving new investment coupons until their funds were brought into line with the resolution. The restriction on the payment of new investment coupons is temporary, but the Agency's resolution permanently set an upper limit to the amount of money in all investment funds managed by a single management company.

By not setting a time-limit for the validity of the contested resolution, the Agency violated its authorization under Paragraph of Article 112 of the ZISDU. A decree as an executive act must be in accordance with the Constitution and the statute and may not contain provisions for which there is no basis in the statute (Paragraph 3 of Article 153 of the Constitution). A regulation as an executive act may therefore complement a statutory norm only as long as it does not regulate relationships independently (outside the statutory framework).

30. In view of this the Constitutional Court established that the Resolution is contrary to Paragraph 3 of Article 112 of the ZISDU and Article 153 of the Constitution. The Agency had the authority to issue the Resolution but, contrary to the statute, did not place a time restriction on the measure. This means it is not possible to remove or abrogate ab initio the contested Resolution; instead it calls for a decision under Paragraph 1 of Article 48 of the ZUstS and a determination of a period for the removal of the established illegality.

### C.

32. The Constitutional Court decided the case on the basis of Article 48 of the ZUstS, at a session composed as follows: chairman Dr. Tone Jerovšek and Judges: Matevž Krivic M.Law, Janez Snoj

M.Law, Dr. Janez Šinkovec, Dr. Lovro Šturm, Franc Testen, Dr. Lojze Ude and Dr. Boštjan M. Zupančič. The Decision was made by six votes to two. Judges Krivic and Šturm dissented.

President of the Constitutional Court:  
Dr. Tone Jerovšek

Note:

[1] According to its own statements, at the time the Resolution was adopted Proficia Dadas held SIT 5.7 billion in securities. On February 29, 1996, the second largest management company (LB MAKSIMA - PIRAMIDA unit trust) allegedly held SIT 1,020,438,604. 2.

[2] According to the initiator, Kolinska recorded 83.84 per cent growth, GEA 36.92 per cent in its ordinary share, Rogaška 77.14 per cent in its ordinary share and 53.77 per cent in its preference share, Intara 121.35 per cent, Dadas 71.6 per cent, Primofin 79.6 per cent and Finmedia 57.8 per cent.