Civic Review, Vol. 14, Special Issue, 2018, 114-124, DOI: 10.24307/psz.2018.0408

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Investing Safely and Lucratively: What is New in Hungarian Investment Law?[1]

Summary
The aim of the article is to give an overview of the development of laws on investments in Hungary. The paper aims to establish the concept of investment in Hungarian law. A key finding is that there is no general, all-encompassing investor concept in Hungarian law, as the definition may vary depending on the act reviewed. The paper outlines the changing role of the central bank in Hungary. As hedge funds have an important role in the financial sector, a brief overview is given of the regulatory changes relating to them. The conclusion of the paper is that the Hungarian trends in investments follows the general worldwide trends.

Journal of Economic Literature (JEL) codes: K2, K12, G30, G33
Keywords: investment, investor, sovereign fund, hedge fund, Hungary

Introduction

The past few years can be considered quite turbulent in Hungarian legislation. A new Civil Code came into force in 2014[2] and required numerous changes in investment-related Hungarian regulations. One such development was the incorporation of company law provisions in the code. However, changes in the European Union's regulatory framework also necessitated revisions in other statutes related to investments, such as the Capital Markets Act. Another interesting trend in the field of Hungarian

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investments was the new role of the National Bank of Hungary. Due to the success of the applied monetary policies, the central bank amassed considerable reserves, which were then used for investment. This behaviour of the bank is reminiscent of sovereign fund management, and it is even more interesting if we remember that there is no definite legal or institutional framework.

This paper gives an overview of the recent trends. The first part showcases definitions of investment in different Hungarian statutes. The second part explores the different definitions of investors in Hungarian laws and regulations. Creditors and creditor protection are concepts so intertwined with investment that their overview is of the utmost importance. The third part briefly describes interrelationships with investments, investment and creditor protection according to Act XLIX of 1991 on Bankruptcy Proceedings and Liquidation Proceedings. Once the conceptual framework has been established, the fourth and fifth parts tackle the new investment trends. The quasi-sovereign fund operation of the central bank, and the new Hungarian hedge fund regulations suggest changes in the investment landscape.

Developments in the theoretical background

The investor in Hungarian law

The concept of an "investor" is defined in Section 5 (1) 20 of Act CXX of 2001 on the Capital Market as follows: "investor shall mean any person who has entered into a contract with an investment fund management company or another investor to invest and risk his own money and/or other assets, or that of others, for the purpose of making a profit subject to developments in the financial market, regulated market or the stock exchange". This definition is confined within a narrow compass. The relevant commentaries, however, extend it to persons who undertake capital market risks based on contracts concluded with the issuer of securities or with investment firms (Farkas et. al., 2014; p. 43).

In addition to the *investor*, the Capital Market Act also defines the concept of an *institutional investor* as a credit institution, investment enterprise, investment fund, investment fund manager, venture capital company, venture capital fund, insurance institution, a voluntary mutual insurance fund, a private pension fund, the National Health Insurance Fund *(Nemzeti Egészségbiztosítási Alapkezelő)*, or the Central Administration of National Pension Insurance *(Országos nyugdíjbiztosítási Főigazgatóság)*.

Other Hungarian regulations defining the term "investor" include Act XVI of 2014 on Collective Investment Trusts and Their Managers, and on the Amendment of Financial Regulations, which stipulates in Section 4 (1) 24 that an investor is the holder of collective investment instruments.

A comparison of the above concepts with the definition of the term in economics reveals no overlap between the legal and the economic concepts in an economical sense. This means that no general concept exists for the term "investor" in Hungarian law, each regulation only defines it according to its respective legal policy.

"Investment" in Hungarian law

Although the term "investment" is frequently used in commentaries and legal regulations, there is no definition for its general concept in Hungarian law. Investment is only defined for the purposes of specific legal regulations. It is defined, for example, in Section 3 (4) 7 of Act C of 2000 on Accounting as the purchase, establishment and production of tangible assets within the scope of business activity and the commissioning of purchased tangible assets or activities conducted before the commencement of the designated use. Transportation, customs clearance, intermediation, groundworks and other activities are listed here, as they are related to the purchase of tangible assets, including the design, preparation, performance, borrowing and insurance. Moreover, activities resulting in the expansion, change of designated use, transformation, direct increase in the efficiency and duration of the already existing tangible assets should also be mentioned here.

There is an interesting discrepancy between the Hungarian and the English versions of the Accounting Act. The common English term "equity securities" is used in the Hungarian text as "*tulajdoni részesedést jelentő befektetés*" (investment representing ownership interest). The act otherwise uses a standard definition for equity shares, stipulating that all printed or dematerialized securities, or instruments deemed as securities by law, carry certain rights and represent the issuer's acknowledgement that a certain amount of money, or non-financial assets with a value determined in monetary terms, has been placed at its disposal and its commitment to transfer predetermined financial and other rights to the holder of such securities. The Accounting Act lists in particular, stocks, partnership shares, shares in cooperatives, share notes, other partnership shares, investment units issued by unlimited term investment funds, venture capital notes and venture capital shares. Another interesting inconsistency is that Section 3:11 of the Civil Code prohibits, except for private and public companies limited by shares, the issue of securities for membership rights.

Interrelationship between creditors and investors

As the concept of investor has features similar to that of a "creditor", it is also worth examining the latter. The term "creditor" has numerous definitions in law. In the generally accepted meaning, a "creditor" is an entity entitled to demand services from a "debtor". Creditors have the right to enforce the service in the case of non-performance, or, if performance is impossible, to receive damages. However, this general concept of creditor does not bring us closer to understanding investor and creditor protection.

In business law, however, the concept of creditor is considerably narrower. The Hungarian Civil Code, for example, applies this term to one of the parties of a loan agreement. In this case, the creditor is obliged to pay a specified amount of money (or substitute), and the debtor is obliged to repay this amount (or assets of the same type, quantity and quality as the lent assets) and any interest accrued.[3] In the case of credit agreements, the creditor is obliged to make the specified credit facility available, and to conclude a loan, suretyship, guarantee or other agreement for the performance of the credit transaction. In return, apart from claiming the principal amount, it is entitled to demand the payment of interest.[4]

In Hungarian business law, the term "creditor" is given a different definition in Act XLIX of 1991 on Bankruptcy Proceedings and Liquidation Proceedings. For the purpose of this act, the concept of "creditor" has four different interpretations:

1) in bankruptcy and liquidation proceedings, up to the time of the opening of liquidation, a creditor is a person an overdue claim, whether in money or in kind expressed in monetary terms, against the debtor based on a final and executable court ruling, administrative decision or other enforcement order that is uncontested or recognized;

2) in bankruptcy proceedings, in addition to what is contained in the paragraph cited above, a creditor is a person who has a claim, whether in money or in kind expressed in monetary terms, falling due during the bankruptcy proceedings, and registered by the administrator;

3) in bankruptcy proceedings, in addition to what is contained in the paragraphs cited above, a creditor is a person who has a claim, whether in money or in kind expressed in monetary terms, with a future due date, lawfully arising from various supply, work, service and other contracts related to the supply of products and services, the sale of debt securities and equity securities, lending arrangements or advance payments, which have already been performed by the creditor and have been registered by the administrator;

4) based on the provisions of the Bankruptcy Act, after the time of the opening of liquidation proceedings, any person who has a claim, whether in money or in kind expressed in monetary terms, against the debtor is treated as a creditor, if such a claim has been registered by the liquidator.

Thus, the definition of a creditor clearly varies according to the act using the term. Nevertheless, in practice it does not cause any confusion, as in each separate field the concept of creditor is well-understood. It also needs to be pointed out that in many cases a creditor may be synonymous with the generally understood concept of an "investor", as in many cases its position is established by investing resources in a given business venture.

Recent developments in the field of investments in Hungary

New regulatory framework for hedge funds in Hungary and Europe

Europe chose a different path in the regulation of hedge funds than the United States. In 2010, the legislators of the European Union realized that controlling the growing number of hedge funds is an impossible mission, and the only way to successfully regulate their functioning is through the implementation of certain rules applied to fund managers. For this purpose, Directive 2011/61/EU on Alternative Investment Fund Managers (AIFM Directive) was adopted. The AIFM Directive also contains certain exemptions: alternative investment funds[5] managing a capital below EUR 100 million and funds managing unleveraged capital below EUR 500 million and not granting redemption rights to investors for 5 years are exempted from certain provisions of the AIFM Directive. Fund managers may choose either of two different methods of functioning: the traditional one described in Directive 2009/65/EC on Undertakings for the Collective Investment in Transferable Securities (UCITS), or the one compliant with the AIFM Directive.

In March 2009 the AIFM Directive set forth certain targets with respect to the alternative investment fund industry (EC, 2012, p. 8). The first and most important is the management of macroprudential risks. In the context of alternative investment funds, macroprudential risks are systemic risks requiring the coordinated collection of macroprudential data in accordance with the legislator's intent, with data processed in a cross-border framework of prudential authorities.[6]

Furthermore, the management of microprudential risks is among the targets of the AIFM Directive. Microprudential risks are risks which appear in the context of specific services and service providers. The management of microprudential risks proved to be important for the European Union, since previously there were no appropriate methods for the supervision of the risk management practices of alternative investment funds. Weak risk management practices endanger investors (Zéman, 2016, p. 364), contractual partners and the market as a whole, while consistent regulation mitigates that risk, and cross-border regulations can reduce the possibility of supervisory authorities engaging in regulatory arbitrage.[7]

The 2007-2009 financial crisis repeatedly confirmed the need for intervention to protect investors (Lentner and Zéman, 2017, p. 8). Even though the clients of alternative investment funds are usually professional investors, they require reliable and comprehensive information. Previously, legislations in the Member States applied a different approach than the EU with respect to corporate governance and disclosure obligations, and thus they were unable to provide a consistent legal basis for the reliable functioning of alternative investment funds.

In the context of alternative investment fund management, the standardization of market rules can increase financial stability and the integrity and efficiency of the markets, irrespective of their location.

The Hungarian legislation transposed the AIFM Directive by Act XVI of 2014 and with Government Decree No. 78/2014. (III.14.).[8] In addition, the Hungarian regulatory regime applies the framework conditions of the AIFM Directive, has also adopted concepts such as a prime dealer[9] and determines feeder funds and master funds. The act uses the term "feeder fund" for funds investing in other funds, while funds being the subject of investments are determined as "master funds" (a type of umbrella funds).

Similarly to the AIFM Directive, Act XVI of 2014 grants exemption from certain obligations to funds which manage a capital below EUR 100 million and funds which manage an unleveraged capital below EUR 500 million and do not grant redemption rights to investors for 5 years.[10]

Contrary to the EU's regulatory framework, the Hungarian legislation applies to funds with the above-mentioned characteristics, but exempts them in four different areas: remuneration, risk and liquidity management, redemption policy and consistency between the latter two systems.[11]

The Hungarian regulation implements the policy of variable remuneration, including deferred portions, as minimum 40% of the performance-based remuneration must be deferred over a period of 3 to 5 years.[12]

Despite the differences in the approach to hedge funds in the legislation of the EU and the United States, it seems that the Hungarian regulatory framework gives them a wider room to manoeuvre. Section 23 (2) of Government Decree 78/2014 exempts hedge funds from certain stricter rules by including the term "derivative investment fund" in their name, and requiring them to meet one of two criteria: firstly, the initial investment made by an investor in the fund must be at least HUF 10 million, secondly, the shares of the fund can only be marketed to professional investors. In case the conditions mentioned above are fulfilled, the overall risk exposure rate of certain positions in derivatives transactions can be specifically determined. Through this method an alternative fund may be established which incorporates two basic characteristics of hedge funds, i.e. large-scale investors and high leverage. Performance-based remuneration is partly deferred. The fund manager and the investors may only make and manage investments in the same fund with the involvement of a third person.

Quasi-sovereign fund operation by the central bank

To date there have been no sovereign funds in Hungary or any piece of legislation which regulates the establishment or internal functioning of an organisation operated as a sovereign fund. Nonetheless, in practice new asset management forms have emerged which, in spite of all the differences, show similarities to sovereign wealth funds.

In Hungary it is difficult to properly outline the interrelationships between the central bank, the state and the government merely on the basis of legal provisions. The National Bank of Hungary is a stock corporation with shares owned by the state, as stipulated by Act CXXXIX of 2013, Section 5 (1), and thus the state exercises its right as a shareholder. According to Section 1 (1) of this act, the government and other bodies are not given power to interfere with the activities of the National Bank of Hungary. Nevertheless, the state as the owner is represented by the minister responsible for the budget, who happens to be a member of the government. Thus, the government, albeit indirectly, exerts a significant influence over the central bank. Regardless of this, certain bodies of the National Bank of Hungary cannot be instructed directly. Under Section 6 (1) of the mentioned act, significant decisions, such as ones relating to the alteration of articles of association, or other important matters, may be made in the name of the shareholders. Additionally, the governor of the National

Bank of Hungary is nominated by the Prime Minister, as stipulated by Section 10 (1) of the act.

The governor of the National Bank of Hungary reports both orally and in writing to the National Assembly, pursuant to Act CXXXIX of 2013, Section 2 and Section 131 (1-2), while Section 9 (4) c assigns the appointment of members to the Monetary Council to the competence of the National Assembly.

It is particularly interesting that, unlike in many other countries, sovereign wealth funds are not regulated in Hungary. Thus, Hungarian sovereign wealth funds to be founded in the future may only operate within the bounds of public law and capital markets regulations on fund management, but there is no specific legislation for their special legal status or other legal criteria of their activities.

Additionally, attempts were made in Hungary at clarifying whether the state ownership of sovereign wealth funds can be attuned to their institutional investor role, if the different interests of the individual nation states, in relation to both investors and the target countries, can be harmonised, and if yes, which instrument is best to use.

These attempts included the setting up of organisations for privatising state owned assets in the 1990s (e.g. *Állami Vagyonügynökség, ÁVÜ* [Hungarian State Holding Agency]*; Állami Privatizációs és Vagyonkezelő Rt., ÁPV Rt.* [Hungarian Privatisation and State Holding Company]*)*, investment funds (e.g. OTP EMDA Derivative Fund and the OTP Supra Derivative Funds), alternative investment fund manager companies (e.g. Plotinus Nyrt.), and companies specialised in fiduciary asset management (e.g. Concorde Zrt.). In the aforementioned institutions one may find the characteristics of sovereign funds.

Act LIV of 1992 on the Sale, Utilization and Protection of Assets Temporarily owned by the State contained provisions on the sale, utilisation and maintenance of assets in the temporary ownership of the state. The main aim of the act was to regulate the sale of state assets. For this purpose, the act established the State Holding Agency.[13] The Agency, as a financial body, exercised the ownership right of the state.[14] The actual asset management activities of the Agency were outlined by the State Holding Policy,[15] in the framework of a National Assembly Resolution adopted in 1992 in Section 18 (1) of Act LIV of 1992. Interestingly, pursuant to Section 3.2 of the Policy, the Agency was allowed to assign the assets[16] in temporary state ownership to investment funds or portfolio packages, however, such activity was only allowed in the case of privatisation. Although only assets in temporary state ownership were subject to asset management activities, an example was set for an asset management through financial bodies. This activity was linked to the annual budget via further regulations, and this served as a reason for the joint discussion of both matters.

Act XXXIX of 1995 on the Sale of State-Owned Business Assets did not only cover assets in temporary state ownership.[17] This act established the Hungarian Privatisation and State Holding Company, which exercised the state's ownership rights during the sale of assets in temporary state ownership and during the management of assets in permanent state ownership. [18]

Act CVI of 2007 on State Assets is interesting for two reasons. On the one hand, the act put an end to institutional privatisation,[19] and thus the main goal was to regulate the management of permanently owned assets. That served as the reason for redefining national assets, which limited the scope of the act to assets in permanent state management. On the other hand, the act also established another asset management corporation, the Hungarian National Asset Management Ltd *(Magyar Nemzeti Vagyonkezelő Zrt.)*.[20]

This act was aimed at establishing a new, contemporary framework for managing state-owned assets. Within this framework, the act defined the Hungarian National Asset Management Ltd as a private limited company wholly owned by the state[21] and it stipulated detailed organisational and operational regulations. While technically the act prescribed the management of state-owned assets, and specified shares as concrete financial instruments in the ownership of the state,[22] judging by the content of the act's provision, they were more about operating state-owned assets rather than management in the narrow sense of the word.[23]

A novelty of Act CXCVI of 2011 on National Assets was the stated purpose of "providing for the needs of future generations". The act specifies numerous asset management organisations.[24] However, almost without an exception previously they had been managing state-owned assets, as the list included state- or council-owned companies, financial bodies or companies wholly owned by either of them. The only exception to that rule was the new asset management form established by the newly defined asset manager. As pursuant to Section 3 (1) 19 *ag)* of the act allows the individual appointment of an asset managing legal person by authorisation of a statute, the opportunity is given for mandating a partially state-owned or privately-owned company for managing state assets. This in turn allows the practice of sovereign funds, namely by mandating higher independence to asset managers. The management and utilisation of state-owned assets emphasises the operation and preservation once again, however, the act makes no mention of financial instruments. Section 16 of the act specifies the utilisation and management of special assets governed by other acts for the benefit of future generations.

Further legal analysis of the activities of central banks and asset managers reveals even more opportunities. Section 4 (2) 53 of Act CXXXVIII of 2007 on Investment Firms and Commodity Dealers, and on Regulations Governing their Activities defines portfolio management with no regard to the type of client. Section 48 (3) specifies the National Bank of Hungary among the professional clients as a high-priority institution. Thus, the person authorised to manage portfolios can be instructed by the central bank pursuant to the provisions of this Act. On the other hand, it gives rise to a conflict of interest between the two institutions, as pursuant to Section 4 (9) of Act CXXXIX of 2013 the central bank also serves as the monitoring agency of financial intermediaries, which in turn results in paradoxical situation of not only being the principal financial institution, but also supervising the others as an authority. Act CXXXVIII of 2007 provides an example for the legislature by enabling the central bank to act as an authority for reorganisation[25] under the provisions of another act.

The overview of statutes on the management of state-owned assets clearly demonstrates that, although in a rather disorganised way, there is an opportunity for establishing sovereign wealth funds as legal entities for managing the financial instruments of the state. However, to improve consistency, the current statutes need to be systematically expanded and amended. While it is less of a pressing issue in terms of launching sovereign wealth funds, it becomes increasingly urgent when it comes to their activities, as the aforementioned clearly demonstrates the current state of the Hungarian legal system, leaving a lot to desire in this respect as most of the deficiencies arise in these matters.

The most important conclusion is that the aforementioned legal forms may be suitable, but they would in no way be ideal for serving as a framework for the activities of sovereign funds. In this respect it would be more appropriate to create a dedicated legal form. In these special issues, particular legal provisions would also be suitable even if the sovereign wealth fund was to be operated as company fully owned by the state. This solution would be an exception, in contrast to the practices of other countries, as it would be considerably more difficult to articulate the interests of the state, both in terms of control and monitoring.

Conclusion

Clearly, the Hungarian framework for investments has been greatly influenced by the recent events. It must be emphasised that the lack of an all-encompassing definition for investment may be detrimental, however, in practice none of the problems associated with a "vague" terminology has arisen yet. The reason is that each respective statute and regulation defines investment within its respective scopes of application, thus making the issue more of a theoretical one. Regardless of this fact, Hungarian jurisprudence could benefit from a scientifically sound investment definition. A similar question may arise in relation to the concept of creditor, but such issues are not of practical importance, as the meaning of these words are well-understood within their scopes of application.

The activities of the central bank seem to follow the international trend that certain institutions in a state earmark funds from more prosperous times in order to ensure the prosperity of future generations (Lentner et al., 2017, p. 64). It would be more beneficial if this quasi-sovereign fund activity of the central bank would be performed by genuine sovereign funds instead. However, it would require the establishment of a legal framework for such an institution, as the current statutes and regulations are insufficient.

The Hungarian investment legal landscape has also been greatly influenced by the regulatory trends in the European Union. The new hedge fund regulation was adopted within the confines of Hungarian investment law, with numerous provisions transposed in the Capital Markets Act, or the new Act on Collective Investment Funds.

Overall, the Hungarian regulatory framework for investments is on par with the European requirements, and a new, worldwide phenomenon can be identified in investor activities.

Notes

1 With support from the New National Excellence Programme 17-4-IV of the Ministry of Human Resources.
2 Act V of 2013 on the Civil Code.
3 Hungarian Civil Code, 6:383.
4 Hungarian Civil Code, 6:382.
5 Alternative investment funds are different capital-raising organisations, thus they fall outside the scope of regulations applicable to traditional investment funds. Alternative investment funds do not emphasize the establishment of diversified portfolios, they rather apply large-scale leverage and engage in derivatives transactions.
6 Prudential regulatory authorities are the capital market authorities.
7 In the course of a regulatory arbitrage, as a place of their operations certain service providers select the country which is more favourable or less strict with regards to regulations. This decision may incur additional costs, however, the main goal is to reduce the burdens of functioning.
8 Government Decree 78/2014. (III. 14.) on the Rules of Collective Investment Forms and Borrowing
9 A prime dealer is a financial service provider that undertakes not only account management but also financing services. In the United States this role is usually played by investment banks, while in Europe commercial banks are more likely to act as prime dealers.
10 Section 2 (2) of Act XVI of 2014.
11 Act XVI of 2014 gives exemption from the provisions of Section 33, 35 (1), (3), (5) and Section 36.
12 Annex 13 of Act XVI of 2014.
13 Act LIV of 1992, Chapter II.
14 Act LIV of 1992, Section 5.
15 National Assembly Resolution 71 of 1992. (XI. 6.) on Asset Management Directives of 1992
16 Such instruments are state-owned shares in companies.
17 Act XXXIX of 1995, Section 7.
18 Act XXXIX of 1995, Section 1 (3).
19 Institutional privatisation took place in a large volume and at a planned pace, contrary to spontaneous privatisation, between 1989 and 1992, in an ad hoc manner, exploiting the loopholes in the contemporary regulatory framework.
20 Act CVI of 2007, Chapter III.
21 Act CVI of 2007, Section 18.
22 Act CVI of 2007, Section 1 (2) c and e.
23 The difference between operating and managing assets is significant. While both activities are carried out in a portfolio viewpoint, the former implies passive management, and the latter entails active participation, which includes the sale and purchase or swapping of certain elements of the asset with a tight deadline either as a sale or on other legal grounds.
24 Act CXCVI of 2011 Section 3 (1) 19.
25 An authority of reorganisation is a financial institution which disposes of appointing liquidators to companies of special importance for a national economy and decides on certain issues regarding the liquidation proceeding.

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