The Role of Mutual Funds and Non-Banking Financial Companies in Corporate Governance in Pakistan

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1. Introduction

Mutual funds are becoming vehicles of securities investments most favoured by the general public worldwide. Whereas, this trend is more pronounced in the developed securities markets of the United States of America and Europe, mutual funds are increasingly gaining the public attention in the developing economies as well. Pakistan is not an exception to this global trend and even though mutual funds form a comparatively small segment of the securities markets, they have grown phenomenally over the last few years. In recognition of their increasing importance as an investment vehicle, and their potential role in promoting better corporate governance, the Securities and Exchange Commission of Pakistan (SECP) has recently introduced a new framework for the regulation of mutual funds and their related Non-banking Financial Companies (‘NBFC’). What are the strengths and weaknesses of this regulatory framework? Which corporate law model is most suitable to the legal and economic environment in Pakistan? How mutual industry can play optimal role in promoting corporate governance in Pakistan? This paper attempts to address these and related questions.

This paper advances the argument that mutual funds and related institutional players can play a vital role in enhancing corporate governance in emerging economies. Regulatory frameworks need to be structured in a manner that would encourage the growth of the mutual fund industry and enable it to play a proactive role in corporate governance. The paper reviews and evaluates the regulation of mutual funds in Pakistan in the light of the above propositions.

Section 2 outlines various models of corporate law that may be followed by the regulators in an emerging economy, identifying the model, which we believe is most suitable for the particular legal, and economic environment prevailing in Pakistan. Section 3 explores the role that institutional investors, generally, and mutual funds, particularly, can play towards the development of appropriate framework for corporate governance and the establishment of vibrant capital and securities markets. Section 4 reviews the present state of the mutual fund industry in Pakistan while section 5 identifies key issues, which need to be addressed if mutual funds are to play an optimal role in promoting corporate governance and public participation in the securities markets.

2. Corporate Governance in Emerging Economies

Developing economies like Pakistan have had a tendency to import the corporate laws and replicate the corporate regulatory frameworks prevalent in developed economies.

*Financial support for this study was provided by LUMS-Citigroup Corporate Governance Initiative at Centre for Management and Economic Research, Lahore University of Management Sciences. Taimur Adil and Nadia Sattar provided excellent research assistance on the study.
in the hope of achieving similar results\(^1\) and to attract foreign capital.\(^2\) More recently, this propensity appears to have acquired an even more distinct shape, i.e., the replication of the corporate laws of the most successful developed economy, namely the United States of America.\(^3\) Correspondingly, Pakistan has recently adopted a corporate regulatory structure, which appears to mimic that of the U.S. with the establishment of the Securities and Exchange Commission of Pakistan (‘SECP’). Our present discussion is in the context of the Code of Corporate Governance (‘CCG’) imbued with the spirit of the Cadbury Report and which, as variously pointed out, conforms to the fundamental precepts of corporate governance as presently practiced in the U.S.A. including for example, the enhanced role of independent directors, committees, audits and quarterly reporting.

In order to develop a more distinctive approach towards adopting a corporate governance regime that works in Pakistan, it must be realized that developed economies, like those of the United States of America or the United Kingdom, follow what has been termed as an ‘enabling’ model of corporate law.\(^4\) In this model, the company laws themselves play a relatively minor, background and mostly facilitative role in corporate governance. There are very few mandatory or prohibitive rules and a majority of the major provisions are in the form of default rules. In order to achieve a balance between the competing needs of maintaining management control and discretion and the protection of outside minority investors, corporate law combines with other legal, market and cultural constraints on the actions of corporate management and the controlling shareholders. These extraneous control mechanisms include, for example, a reasonably efficient capital market, an active market for corporate control and incentive compensation for management. The existence of sophisticated professional accountants and securities’ lawyers, detailed scrutiny of financial disclosure, active financial media and press, competent judiciary, sophisticated and powerful administrative agencies such as the U.S. Securities and Exchange Commission (SEC), and self-regulatory organizations, such as the National Association of Securities Dealers (NASD) and the New York Stock Exchange (NYSE), provide significant protection to outside public shareholders. Corporate law, therefore, is left with the task of providing the management with appropriate mechanisms to exercise the necessary discretion and to facilitate corporate decision-making free from unnecessary legal and procedural constraints.

\(^{1}\) It has been argued that a ‘simple adoption’ of the successful corporate governance framework of other jurisdictions may not lead to the desired results unless the adopted framework is tailored to the specific needs and conditions of the local environment [see Pistor et al. (2003) as cited in Mumtaz (2005)].

\(^{2}\) This is an avowed motivation for the adoption of recent corporate reforms in Pakistan [see SECP-UNDP (2003)].

\(^{3}\) See Cunningham (1999), Cheffins (2000), and Fanto (1998). Such developments have partially been motivated by the need of foreign corporations to raise funds in U.S. capital markets [see Coffee, Jr. (1999)]. For the most forceful assertion of the convergence thesis, i.e., worldwide convergence on the U.S. corporate governance model, see Kraakman & Hansmann (2003). By contrast, however, Bebchuk & Roe (1999) assert that corporate governance framework continues to differ around the world despite globalisation and pressure for convergence, and predict that this will continue to be the case. Also see Branson (2001), Licht, Goldschmidt & Schwartz (2004), Roe (2002, 2003), and Palepu, Khanna & Kogan (2002).

\(^{4}\) The discussion in this section concerning the ‘Enabling’ and the ‘Self-enforcing’ models of company laws is largely based on the work of Black and Kraakman (1996) and Black, Kraakman & Hay (1996).
In emerging economies like that of Pakistan, where there is a prevalence of family or group-owned companies, and which generally lack the extra-legal constraints on management and insider action mentioned above, it is inappropriate to import wholesale enabling company laws crafted in developed economies. The assumptions that underlie the enabling laws of developed economies are absent in emerging economies: there are severe informational asymmetries, markets are relatively inefficient, contracting costs are high, investors and other market players are less sophisticated and financial intermediary services are either unreliable or too expensive. Family or group-controlled companies, which are the classic ownership structure in Pakistan, require especially robust minority protection rules. Otherwise, corporate scandals materialize resulting in a decline in public confidence in securities’ markets: the markets develop notoriety for high-risk and speculative trading. Outside investors, anticipating higher risks of looting and abuse tend to demand higher rates of return on their investment. Consequently, honest management is less inclined to seek public investment at such high costs and prefer loans from banking institutions over equity infusion. Therefore, generally speaking, the company laws of emerging economies must provide much greater and more effective protection for outside minority investors than the enabling company laws of developed economies.

However, even if the corporate laws depart from the ‘enabling model’ and provide enhanced protection to outside minority shareholders, much like the ‘prohibitive’ corporate and securities laws adopted by the U.S. in the 1930’s, that begets a new set of problems.

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5 It has been argued that listed companies in Pakistan exhibit a significant disjuncture between ownership and control, such that one study revealed that whereas the top 5 shareholders own on average 37% of the outstanding shares, the controlling families held a higher percentage of the seats on the board of directors: 32.3% in textiles and 53.4% in other companies [Cheema (2003), Bari and Cheema (2003)]. This leads to the enjoyment of private benefits for the controllers, and hence direct transfers from the outside shareholders to them. This trend is further strengthened by the prevalence of pyramiding in Pakistan, which is much more pervasive than in some of the leading East Asian markets, such as Indonesia, Malaysia, Korea, Philippines and Thailand. Other consequences of disproportionate control enjoyed by family-dominated boards include opposition to reforms that may challenge such entrenchment and limited trading in the securities of these listed companies.

6 A pathological study of privatisation in Russia highlighted the absence of a robust legal system, the predominance of insider self-dealing, undue concentration of ownership and conglomerate as the main reasons for the failure of corporate reforms [see Black, Kraakman & Tarassova (2000), Fox & Heller (2000)].


8 A prohibitive model is characterized by rules out-rightly prohibiting all kinds of corporate actions that are susceptible to abuse, such as self-dealing transactions and cash out mergers. Such rules were widely adopted in the United States and Britain the first part of the last Century, in similar market conditions as currently experienced by the developing economies. For further discussion on prohibitive models, see Black et al. (1996).

9 However, Cheema (2003) argues that ownership structures characterized by disproportionate control vis a vis ownership and family-dominated boards do create incentives for the management to maximize profits since they are likely to receive a disproportionately large share. Therefore, he argues that if the control of family groups is to be diluted through enhanced regulatory protections for minority shareholders, ensuring effective monitoring by outside shareholders should offset this phenomenon.
First, the enforcement of such protective rules is problematic due to weak legal systems. The judiciary is generally believed to be corrupt and/or incompetent, especially as regards complex financial arrangements, which require substantial understanding of economic and financial concepts. Second, the judicial system suffers from inordinate delays and in corporate transactions time literally translates into money. Third, if investor-protection is made the primary focus of corporate law, managers of private companies that may be suitable entrants into the securities markets are reluctant to invite public investors for the fear that they may have to give up too much power and control over to the minority investors disproportionate to the value of funds that they bring in to the company. This leads to a situation where good companies avoid raising equity funds in public securities markets leaving fewer good options for the public to invest in.

The multi-billion dollar question that emerges is that: how can corporate laws balance the divergent requirements of investor-protection and the managers’ need for flexibility in decision-making such that sound private companies are encouraged to enter into and raise funds in public securities markets and the general public is persuaded to invest in their securities rather than in the relatively less productive sectors of the economy, such as real estate. In response to this query, professors Black and Kraakmaan have proposed the so-called ‘self-enforcing’ model of corporate law. This model advocates the structuring of corporate decision-making in such a manner that large outside shareholders may protect their interests and act as a check on the insiders’ misappropriation. This will solve collective action problems, which severely restrict the small shareholders’ ability to protect their interests since the large minority shareholders will be protecting all minority interests.

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10Black et al. (2000) argue that similar, insider-dominated, boards in post-privatisation Russia dealt with the strategic choice between looting (short term gain) or maximizing long term profits based essentially upon the likelihood, threshold and severity of legal sanctions. In simple words, the choices they faced were to either loot and run, or indulge in self-dealing and enjoy private profits but at a level below the threshold inviting serious legal liability. According to these scholars, Russia possessed a weak legal infrastructure with the result that the threshold of legal sanctions was very high. This encouraged the insiders to indulge in large scale self-dealing over an extended period without fear of negative consequences. The overall business environment, corruption, red tape, organized crime and other macroeconomic factors left long-term profits uncertain, thereby motivating the management to loot rather than invest for growth.

11Porta, Silanes & Shleifer (2003) relying on data collected from securities attorneys in forty-nine countries (available at http://post.economis.harvard.edu/faculty/shleifer/papers/securities_data.xls) rank these countries’ securities laws in terms of investor protection. Pakistan’s securities laws appear to provide significant public enforcement by the regulators (7.56 on a scale of 1-10) but limited private enforcement (6.67 on the same scale). This difference is significant since, as the authors conclude, private enforcement is far more important than public enforcement. Furthermore, the existence of appropriate laws is one thing; adequate enforcement of these is an altogether different issue [Also see Licht et al. (2004)].

12For an overview of the conflicting position of the regulators, the Securities and Exchange Commission of Pakistan (SECP), and many listed companies over the adoption of the Code of Corporate Governance, [see Rais & Saeed (2005)].

13Williamson (1988) explored similar issues, concerning the appropriate balance between rules and discretion in corporate governance.

14See Black et al. (1996).
Now, if these larger minority shareholders are institutional investors, it is quite likely that the management of the company will feel comfortable dealing with them at a professional level without the fear of being squeezed out since such investors are unlikely to be interested in taking over the management themselves.

There are two main aspects of the self-enforcing model: (1) Structural constraints, and (2) Simple ‘bright line rules’ coupled with pre-determined remedies. Structural constraints, such as minimum board size, cumulative voting for directors, provision for the appointment of independent directors, staggered board terms, supermajority shareholder approval for suspect categories of transactions such as mergers, insider dealings, etc., mandatory disclosure rules, mandatory seats for independent directors on the board, independent directors’ representation on executive compensation and audit committees are optional in an ‘enabling’ corporate law regime but should be mandatory in the ‘self-enforcing’ corporate laws of a developing economy. The second requirement of this model is that corporate laws should be framed in such a clear and precise manner that, to put it bluntly, an unsophisticated lawyer, judge or regulator may have little difficulty in understanding it and a corrupt judge, regulator or other public official has little opportunity to depart from the intention of the statute/rule. For example, whereas a statute in an enabling corporate law might require shareholder approval of a sale transaction where “substantially all” assets are being disposed of, a bright-line rule in a self-enforcing corporate law will set an objectively verifiable threshold such as 50% of book value.

Upon reviewing Pakistan’s corporate law, it appears that the Companies Ordinance, 1984 does depart from the enabling model to some extent and attempts to redress the balance in favour of outside investors along the lines of the self-enforcing model. For example, the requirement of minimum board size for public companies (7 directors) and mandatory cumulative voting is designed to ensure that outside minority shareholders may be given the opportunity to achieve representation on the board of directors. Similarly, other provisions try to ensure that the creditors of a public company may also be able to play an enhanced role in corporate governance. The Code of Corporate Governance also goes some way towards implementing the structural constraints proposed by the self-enforcing model including the provision for independent directors, audit committees, more elaborate disclosure, etc. Furthermore, the broader aims of the Code include development of the necessary corporate culture not only in the public-listed companies that it applies to but also by strengthening the role of other market

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15 It should be mentioned that the use of book value might be under-inclusive or over-inclusive of transactions, primarily due to its limitation in measuring the importance of a transaction. See Black et al. (1996).

16 §174 of the Companies Ordinance, 1984, as amended by the Companies (Amendment) Ordinance, 2002.

17 §178 of the Companies Ordinance, 1984.

18 Black et al. (1996) proposed in the context of law reform in Russia, ‘Self-Enforcing’ model, for which some of the pillars are minimum board size, mandatory cumulative voting and the opportunity to elect independent directors.

19 For example, as per §182 of the Companies Ordinance, 1984, creditors may nominate directors by virtue of contractual arrangements.

participants such as their creditors, outside directors, accountants, lawyers, the regulators and the public investors [Cheema (2003)].

Nonetheless, it must be realized that as regards the public investors, in order for them to play a meaningful role in corporate governance a shareholder needs to hold a substantial minority holding in a company. Small and independent shareholders cannot exercise effective control on management; cannot elect independent directors through cumulative voting or effectively review the financial information now disclosed on a quarterly basis. Small shareholders have neither the resources nor the motivation to play too meaningful a role. In such an environment, for the Companies Ordinance, 1984, and the Code of Corporate Governance to really achieve their objectives, the market must rely on large outside shareholders, especially institutional shareholders, to step up to the plate and take advantage of the minority protection provisions of the Companies Ordinance and the Code. Mutual funds and related Non-Banking Financial Companies (‘NBFCs’) that hold substantial minority positions in public-listed companies can fill the gap and provide the necessary expertise and the scrutiny that would make corporate governance more efficient. Hence, there is a need for regulation of mutual funds and NBFCs in such a manner as to encourage and enable them to play an enhanced role in corporate governance.

3. The Role of Mutual Funds in Corporate Governance

In their study of the role of institutional investors in Pakistan, Shahnawaz Mahmood and Haroon Sharif have pointed out that these investors can play a vital role in corporate governance since they own substantial holdings, have significant incentive to ensure that the companies invested in are managed properly, have negotiating power as well as the expertise to safeguard the interests of minority shareholders and the company on the whole.

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21 See Cheema (2003) and Black et al. (2000). The analysis of Russian failure leaves little room for optimism if one is hoping that the adoption of good corporate laws will automatically generate a culture of transparency and good corporate governance. In fact, as Cheema points out, the enforcement of minority protection rules is likely to backfire rather than turn out to be beneficial. This paper essentially argues that the only viable solution is to find means of creating a culture of corporate governance simultaneously and independently of the adoption of good rules, through the strengthening of extra-legal market constraints before legal enforcement is strengthened. This is an endorsement of the policy adopted by the SECP, which has brought in the Code of Corporate Governance as part of the listing requirements without the attachment of serious legal sanctions for failure to comply with the Code. The legal sanctions are likely to follow at a later stage when the SECP reaches a determination that compliance with the Code has become the norm.

22 For a review of the primary arguments and academic literature supporting the assertion that institutional investors have a very important role in promoting corporate governance, see Gillan & Starks (2003), Bhattacharyya & Rao (2005).

23 Compare with the corporate law reform implemented in Italy in 1998, the purpose of which was to spur institutional investors, especially mutual funds, to play a more active role in monitoring of listed companies. The new rules have dramatically improved disclosure, including quarterly reporting and minority protection rules along the lines of the Code of Corporate Governance adopted in Pakistan [see Bianchi & Enriques (2001)].

Most importantly, such investors have the ability to appoint truly independent directors to the board. However, they also noted that it is not possible to verify the extent to which institutional shareholders and their nominee directors do in fact participate in the Annual General Meetings and the board of directors’ meetings since sufficient data is not available. Furthermore, as depicted in Table 1, below, the authors have argued that there is evidence that the performance of a company, in terms of return on equity (‘ROE’) and return on asset (‘ROA’) ratios, is directly proportional to the size of the institutions investors’ shareholding in it:

Table 1: Performance Indicators

<table>
<thead>
<tr>
<th>ROE (%)</th>
<th>ROA (%)</th>
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<tbody>
<tr>
<td>Less than 1%</td>
<td>13.17</td>
</tr>
<tr>
<td>Less than 10%</td>
<td>19.28</td>
</tr>
<tr>
<td>Less than 20%</td>
<td>45.39</td>
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<tr>
<td>Less than 30%</td>
<td>45.43</td>
</tr>
<tr>
<td>Less than 50%</td>
<td>68.54</td>
</tr>
<tr>
<td>More than 50%</td>
<td>98.93</td>
</tr>
</tbody>
</table>

These findings may not be entirely reliable since the causal connection between the performance and institutional shareholding has not been credibly established. Is it that these companies perform well because of the role that institutional investors play in corporate governance, or is it that institutional investors tend to invest so heavily only in those companies, which are already established, and performing well? Given the small number of actively traded ‘blue chip’ companies on Pakistan’s stock exchanges, it is more likely that the latter of the answers suggested above is more plausible. Since mutual fund investors tend to own relatively smaller blocks as compared to other institutional investors, especially as compared to the equity holdings of banks, it may be argued that their direct role in corporate governance is diminished. It is indeed pertinent that individual mutual fund may not be able to appoint independent directors given limitations on their share ownership in individual companies in Pakistan, but this problem can be by-passed with two or more mutual funds acting in concert, especially when the same Asset Management Company or Investment Advisory group manages these funds. Furthermore, it is even questionable whether mutual funds should appoint directors to the board since that would tie a fund to a particular company in an undesirable fashion and may impact the fund’s ability or desire to withdraw its investment if the company is not performing at par. Arguably, the Mutual Funds Association of Pakistan (‘MUFAP’) should perhaps look into devising mechanisms for recommending and appointing independent directors on behalf of all mutual funds.

In any case, mutual funds can play a more important role in the endorsement of adequate corporate governance mechanisms and the growth of the securities markets by enabling the development of those very extra-legal market mechanisms the absence of which has constrained corporate activity in Pakistan. Firstly, mutual fund managers
have the expertise to review and evaluate financial reports (like other institutional shareholders); more importantly (and unlike other institutional investors) mutual funds can pass on the pertinent information to individual investors in a comprehensible form, thus achieving a more effective dissemination of financial information than the mere formality of periodic reporting.\(^{25}\) Secondly, mutual funds act directly on behalf of the minority shareholders and are more important than banks and other creditors since these institutions only incidentally benefit outside small shareholders while safeguarding their own interests qua creditors. In fact, banks and other lenders who also own shares may suffer from serious conflicts of interest and may tend to prefer their interests as lenders on top of their interests qua shareholders. Third, by indulging in active trading in substantial blocks of securities, mutual funds can establish significant pressures on corporate managers to act on behalf of all the shareholders and also help create a culture of securities trading related to long-term performance of companies.\(^{26}\)

Mutual funds may be regarded as one of the best avenues for investment available to small retail investors on account of the lower transaction costs, diversification, liquidity, especially in the case of open-end funds.\(^{27}\) According to the Mutual Fund Association of Pakistan (MUFAP), both open-end and closed-end funds are incorporated in the definition of mutual funds. For further discussion, see MUFAP (2005), available at http://mufap.com/mufap/informations.htm.\(^{28}\) Whereas mutual funds may not shield investors from the risks associated with overall market failure, the ability to diversify that they provide may reassure public investors as regards the failure of individual companies and hence make them less wary of insider opportunism in any given corporation. In Pakistan’s relatively small securities markets, lack of liquidity may be a major concern since there are only a few listed companies whose shares are actively traded. With the recent rise to prominence of open-end funds in the mutual fund industry, liquidity ceases to be a concern since the units may be redeemed at any time. Closed-end funds may not provide this satisfaction since their shares have to be disposed of in secondary trading in the market and that too usually at a discount on the net asset value (NAV). Hence, mutual funds alleviate some of the biggest concerns that the public may have regarding investment in the securities markets. Mutual funds can thus play a vital role in attracting the general public to the securities markets and engendering public confidence in them.

\(^{25}\)See Dong (2003).

\(^{26}\)The expansion of the capital markets has created an environment favourable for the growth of investment funds in China. In return, the funds industry is playing a significant role in creating a ‘stable and mature’ capital market [see Tao (1999)].

\(^{27}\)According to the Mutual Fund Association of Pakistan (MUFAP), both open-end and closed-end funds are incorporated in the definition of mutual funds. For further discussion, see MUFAP (2005), available at http://mufap.com/mufap/informations.htm.

\(^{28}\)For benefits of investment through mutual funds, see Wang (1994).
4. The State of the Mutual Funds Industry in Pakistan

The mutual fund industry in Pakistan has experienced significant growth in recent years: the combined net asset value of all funds has increased from approximately Rs. 21 billion on June 30, 2001 to approximately Rs. 129 billion as of March 31, 2005 [Beg (2004)]. Viewed historically, as shown in Figure 1, mutual funds had earlier flourished during the stock market boom of 1994-96 after which the industry withered during the prolonged recession of the late 90’s. The stock market and the mutual funds industry have resurfaced in recent years, especially during the period of 2002-05.29

![Figure 1: Growth in Net Assets](image)

However, as depicted in Figure II, if viewed in terms of the ratio of NAV of funds to the GDP, mutual funds have still not reached the same levels as they had in 1994.

![Figure 2: Growth in Ratio of Net Assets to GDP](image)

Furthermore, when compared to the mutual fund industry worldwide, the mutual fund industry in Pakistan is miniscule in size. According to Khorana, Servaes and

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This indicates that the Mutual Fund industry has significant room to grow in Pakistan vis a vis other financial institutions. Furthermore, the mutual fund industry has generally failed to attract individual retail investors to the securities markets. According to the Mutual Funds Association of Pakistan (‘MUFAP’) Country Report, 2004, there were only 138,643 individual investors of mutual funds as of December 31, 2003 and 155,192 as of December 31, 2004. This data does not indicate whether any investors who have bought into more than one mutual fund are included only once. Secondly, the unit/share ownership of institutional investors vis a vis individual investors is also not indicated.

5. The Regulation of Mutual Funds and Related Non-Banking Finance Companies in Pakistan

In Pakistan, there are two types of mutual funds: open-end and closed-end. Closed-end funds include either an investment company or a closed-end scheme.

<table>
<thead>
<tr>
<th>Table 2: Pattern of ownership in Pakistan</th>
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<tbody>
<tr>
<td>Bank</td>
</tr>
<tr>
<td>------</td>
</tr>
<tr>
<td>Domestic</td>
</tr>
<tr>
<td>Foreign</td>
</tr>
<tr>
<td>Total</td>
</tr>
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\[\text{Source: Khorana, Servaes and Tufano (2004).}\]

\[\text{Source: Mahmood et al. (2003).}\]

\[\text{This is in contrast to the popularity of mutual funds amongst individual retail investors in the U.S.A for example Hunt, Jr. (1997) notes that: ‘Americans today have more wealth invested in funds than in real estate. A few years ago this would have been unthinkable. Millions of fund investors across the country read magazines and watch television programs that are devoted to personal finance topics such as mutual funds. And, billions of dollars in retirement savings are invested in mutual funds.’}\]

\[\text{Source: MUFAP Country Report, 2004.}\]

\[\text{For a brief explanation of the difference between the two types of funds in the U.S., see Symposium (2001b).}\]
An investment company is one that is registered with the SECP for the purposes of trading in the securities of other companies; its shares are listed on the securities markets and are traded just like that of any other company. A closed-end scheme is one where the investors do not have the option to withdraw their investment at any given time and may only trade in their units/shares in public securities markets. An Investment Advisor licensed under the Non-Banking Finance Companies (Establishment and Regulation) Rules, 2003 (NBFC Rules) notified on April 1, 2003 by the Securities and Exchange Commission of Pakistan (SECP), assists the fund manager in management of a closed-end fund. A trustee is also appointed to supervise the management of the company.\textsuperscript{35}

An open-end fund is one, which gives the participants the opportunity to withdraw their investment from the fund at any given time (redemption).\textsuperscript{36} An open-end fund is created as a trust under the Trusts Act, 1882.\textsuperscript{37} The Trust Deed is registered with the SECP under the NBFC Rules, 2003. An Asset Management Company approved by the SECP is appointed as the manager of the fund. Historically, the mutual fund industry in Pakistan has been dominated by closed-end funds. During the latest boom in the mutual funds industry open-end funds have proliferated and are increasingly rising to prominence in the industry. This trend reflects the evolution of mutual funds in other emerging economies, including China [Dong (2003)].

The State Bank of Pakistan regulated the non-banking financial institutions (‘NBFIs’) prior to the NBFC rules mentioned above. In December 2002 the responsibilities for the regulation of NBFIs was transferred from the State Bank to the SECP as per the recommendations of the joint committee for reconstruction of NBFIs. The Banking Companies Ordinance, 1962 and the Companies Ordinance 1984 were amended in order to achieve this reconstruction. The SECP, in promulgating the NBFC Rules, gave life to the concept of the non-banking finance companies, which brought together and under one regulatory framework all non-banking services including investment banking, venture capital, asset management, investment and advisory services. The NBFC Rules consolidated and substituted the Investment Companies and Investment Advisors Rules, 1971; Asset Management Companies Rules, 1995; Venture Capital Companies and Venture Capital Rules, 2001; and Investment Finance Companies SRO 585(1)/87, amongst others.

The difficult questions that arise relate to the manner of regulation that needs to be devised in order to promote the mutual fund industry [Wang (1994)]. A number of factors need to be looked at, which are discussed in detail below.

A. Barriers to Entry: Regulatory Approval

What are the requirements for and how long does it take to obtain approval for starting a new fund? If the time and groundwork necessary for obtaining regulatory

\textsuperscript{35}In a comparative study of the American and European mutual funds Wang (1994) has outlined the differences between the ‘corporate’ and ‘contractual’ models of fund governance.

\textsuperscript{36}In the U.S. the term mutual fund is largely reserved for open-end funds. See, for example, Wang (1994).

\textsuperscript{37}Also, see Wang (1994) for a description of open-end funds in U.K.
approval are high it is logical to expect that mutual fund sponsors will be deterred from introducing a diversification of funds; large consolidated funds will dominate the market. Such funds tend to be conservative in their investment approach and avoid ‘high risk high return’ investments. This will result in a number of funds very similar in their portfolios and returns and providing fewer genuine options for the public to invest in. As a result, the competition between mutual funds will be reduced offering fewer incentives for the funds to invest in research in order to out-perform each other.

Under Rule 5(1) of the NBFC Rules, separate applications have to be filed for licences to conduct any of the specified NBFC businesses. However, the SECP may issue a single licence for both investment advisory (for closed-end funds) and asset management services (for open-end funds). This enables a group to launch both open-end and closed-end type funds and reduces the time and efforts for obtaining the necessary licences. Both closed-end and open-end funds must be authorized by the SECP. Further, a closed-end fund in the form of an investment company must register with the SECP prior to commencing business. If the SECP is satisfied that the company is eligible and ‘it would be in the interest of the capital market’ it will register the closed-end company.

It has been reported by some sponsors of existing funds that the SECP takes considerable time in approving the establishment of new funds. However, according to SECP officials, any delay that exists may be attributed not only to weighty paperwork and approval requirements, but also to the inexperience of the sponsors of funds who fail to submit the necessary paperwork at the first instance. It is beyond the scope of this paper to conduct a detailed study of the average timeline taken to obtain approval for establishing funds and the specific reasons for delays, if any. As indicated already, the longer it takes to obtain approval the lesser the number of diverse funds in the market and the SECP should look into various possible methods of removing bureaucratic hurdles and granting timely approval to new funds. One proposal is to fix deadlines for the various stages in the approval process thereby requiring the regulators as well as the sponsor NBFCs to speed up their part of the work. Furthermore, an advisory body consisting of SECP officials and industry experts may be set up to review the applications and advise the SECP whether or not to approve a new fund.

B. Barriers to Entry: Capitalization Requirements

Open-end funds have significant liquidity requirements since a number of investors may chose to redeem their units on any give day. Hence, in order to ensure that such funds may not fail, the regulators may require significant capitalization requirements;

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38See R. 41 and R. 67 respectively of the Non-Banking Financial Companies (Establishment and Regulations) Rules, 2003, hereinafter referred to as the NBFC Rules.
39R. 36 of NBFC Rules.
40See R. 38 of NBFC Rules.
however, the greater the capitalization requirements the higher the barrier to entry and greater the dead weight that a fund has to carry. On the other hand, closed-end companies do not have to deal with similar liquidity issues since their shares are traded in the secondary securities’ markets. In addition, it is necessary to require the sponsors of funds, both open-end and closed-end, to maintain ownership interest in the funds in order to ensure responsible decision-making.

R. 5(2) (b) specifies Rs. 30 million as the minimum capital required to initiate investment advisory services. The NBFC rules have substantially increased the capitalization requirements for setting up an investment advisory business. As per R. 33(a), an Investment Advisor of a closed-end investment company must retain liquid capital equal to 1 • % of the paid up capital of the fund. Furthermore, the Investment Advisor must maintain beneficial ownership of 10-20% of the equity securities of a closed-end fund.\textsuperscript{44} The closed-end fund must have a minimum equity of Rs. 100 million. The capitalization requirements for initiating and operating a closed-end fund are thus minimal. However, by insisting on the Investment Advisor maintaining a substantial ownership interest (10-20%), the rules seek to ensure that the management of the company’s investments is conducted in responsible and efficient manner. The Asset Management Company of an open-end fund must give an undertaking that it will invest or arrange the investment of Rs. 250 million for a minimum period of two (2) years.\textsuperscript{42} The capitalization requirements for initiating and operating an open-end fund must, of necessity, be higher than those of a closed-end fund. These requirements do not appear to cater for funds of different sizes. Furthermore, the Asset Management Company is required to maintain its contribution in the fund for a limited period only. Arguably, asset management companies ought to be required to maintain a 10-20% ownership of open-end funds as well, in order to ensure responsible decision-making.

C. Internal Corporate Governance of Mutual Funds: Avoiding Conflicts of Interest

Mutual funds are sponsored and managed by entities and individuals that are invariably related to other market participants, including banks, brokers, etc. Furthermore, the industry is dominated by a handful of sponsors that manage not just individual funds but fund complexes [see Bogle (2004)]. It is, therefore, necessary to ensure that any conflicts of interest are minimized. Otherwise, the risks of mismanagement, insider-dealing and looting are likely to be high. If mutual funds are to play an important role in corporate governance, it is imperative to ensure that there are no scandals regarding mismanagement of assets by the funds themselves. In this regard, it is necessary to structure funds in such a manner that there are inbuilt checks and balances so that the possibilities of self-dealing and/or mismanagement are curtailed.\textsuperscript{43}

\textsuperscript{41}R. 33(a) and (b) of the NBFC Rules.
\textsuperscript{42}R. 67(2)(f) of the NBFC Rules.
\textsuperscript{43}It is necessary to put in place a system for monitoring the behaviour of the fund manager (the investment advisor or the asset management company). The difficulty for the investors is essentially that, given the large number and relatively small state of individual investors, they face a collective action problem. See Wang (1994).
This renders the role of the fund trustee exceedingly important. As per the ‘Contractual Fund Model’ followed in Pakistan, every fund is required to have a trustee with the SECP’s approval,\(^44\) who ensures that the fund manager complies with the requirements of the rules and the constitutive documents.\(^45\) An Investment Advisor or an Asset Management Company must report and account to the trustee for any loss caused by its negligence.\(^46\) The trustee must be independent of the Investment Advisor or the Asset Management Company.\(^47\) Ensuring the genuine independence of the trustee is vital to the internal corporate governance of mutual funds.

A closed-end fund must appoint an Investment Advisor pursuant to a contract of a maximum duration of ten years, which sets out the duties and rights of the parties.\(^48\) R. 39 of the NBFC Rules. The contract must provide that the Investment Advisor shall bear all management and secretarial expenses. A copy of the contract must be submitted to the SECP for approval.\(^49\) No more than fifty percent (50\%) of the directors of a closed-end company may be affiliated with an Investment Advisor. A closed-end fund shall not enter into any transaction with an insider or an affiliate of itself, its Investment Advisor or any person who owns more than 10\% of the closed-end fund.\(^50\)

An Investment Advisor or an Asset Management Company must act in “good faith and to the best of its ability and without gaining any undue advantage for itself or for any of its related party.”\(^51\) The Asset Management Company of an open-end fund cannot employ an insider as a broker, or enter into transactions with any connected broker, which shall equal or exceed ten percent (10\%) of the total transactions in any one accounting year without the SECP’s approval.\(^52\) A mutual fund shall not invest in any company if any insider owns more than five percent (5\%), or collectively the directors own more than ten percent (10\%), of that company.\(^53\)

It is also pertinent to ensure that the managers of funds possess the necessary skills and competence. Thus, an Investment Advisor or an Asset Management Company to furnish an undertaking to the SECP that the executive officers, researchers, and other key personnel have the requisite qualifications and professional experience.\(^54\) These include, inter alia:

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\(^{44}\)R. 43 and R. 74 of the NBFC Rules.
\(^{45}\)R. 45 and R. 76 of the NBFC Rules.
\(^{46}\)R. 34(b) and R. 65(b) respectively, of the NBFC Rules.
\(^{47}\)R. 47 and R. 78 of the NBFC Rules.
\(^{48}\)R. 39 of the NBFC Rules.
\(^{49}\)R. 39 (1) of the NBFC Rules. Compare with the situation in the U.S. where it is amongst the "special responsibilities" of the independent directors of the corporate funds, also referred to as trustees, to review and approve the investment advisory agreement [see Fernandez (1997)].
\(^{50}\)R. 52(1) of the NBFC Rules.
\(^{51}\)R. 34(a) and R. 65(a) of the NBFC Rules, respectively.
\(^{52}\)R. 64(1)(h) of the NBFC Rules.
\(^{53}\)See R. 51(n) and R. 73(3) of the NBFC Rules.
\(^{54}\)Rule 5(2)(h) of the NBFC Rules.
• At least one Director having senior management level experience of five years;\(^{55}\) and
• CFO to be a chartered or cost and management accountant having senior management level experience of five years.\(^{56}\)

An Investment Advisor or an Asset Management Company shall not elect more than twenty-five (25\%) of its directors from the same family without the prior approval of the SECP.\(^{57}\) For a critique of independent director requirements, see footnote 61. An Investment Advisor or an Asset Management Company may not remove the CEO or any director, other than nominee directors of creditors or of a sponsoring financial institution, without SECP approval. Mergers, takeovers and other such transactions also require SECP approval.\(^{58}\)

The above rules are designed to ensure that the risks of self-dealing transactions at the expense of public interest are minimized. This is done first through defining bright line rules for the interaction of various parties involved with the management of the funds so that certain structural checks and balances are created without inhibiting the discretion available to the investment advisors or asset managers of the funds. Second, the impartiality of the decision-makers is being sought through prohibiting the domination of the boards of various parties by the same people. Third, the supervisory role of the SECP has been strengthened compared to that of regulators in developed economies. However, the role of the independent trustee needs to be further strengthened and the SECP should look into imposing serious obligations for breach of fiduciary duties on the trustees and the fund managers.

**D. Primary and Secondary Disclosure**

It is imperative that mutual fund managers make ‘primary disclosure’ regarding their own operations to reassure the public that they are being properly managed. This goes hand in hand with the internal corporate governance requirements discussed above. A review of the new disclosure rules applicable to mutual funds in Pakistan indicates that Investment Advisors and Asset Management Companies are required to make quarterly disclosure to the SECP, to the certificate holders and the stock exchanges of un-audited balance sheet and changes in equity,\(^{59}\) as well as audited annual reports.\(^{60}\) Close-end companies have to follow similar reporting requirements under the Code of Corporate Governance. Generally, as a condition for granting authorization to an open-end fund, the SECP requires regular reporting from them as well.\(^{61}\)

\(^{55}\) R. 7(1)(f) of the NBFC Rules.
\(^{56}\) R. 7 (1)(c) of the NBFC Rules.
\(^{57}\) R. 7(2)(a) of the NBFC Rules. For a critique of independent director requirements, see footnote 61.
\(^{58}\) R. 7(2)(c) of the NBFC Rules.
\(^{59}\) R. 34(b)(f) and R. 65(f), respectively of the NBFC Rules.
\(^{60}\) R. 34(e) and R. 65(e), respectively of the NBFC Rules.
\(^{61}\) Mutual fund shares are subject to disclosure requirements under the Securities Act of 1933.
With regard to fund disclosures, the important issue is whether they disclose information that an average public investor may use or do they provide information that shields them from potential liability. In the U.S., for example, disclosure has historically been targeted at the shareholders’ lawyers. However, in 1990’s the S.E.C. initiated the ‘plain English’ movement in an attempt to make the disclosure understandable by the average investor. Investors in mutual funds need more information than the names of the officers and directors of the fund managers, or the bare financial information; they need to know the investment policy, what investment decisions are being made, what securities are being bought and sold, and how this fund differs from the others in the market. Furthermore, if mutual funds are to play a key role in corporate governance, it is imperative that they digest information regarding the companies they invest or disinvest in, and pass this on to their unit-holders/shareholders in a comprehensible form. This will help educate the investors regarding the securities markets, lower psychological barriers to investing in corporate securities and reassure investors that the mutual fund managers are doing their job. On the flip side, if mutual funds are required to disclose too much of their confidential information that they may have obtained after incurring costs on research, this will result in free-rider problems and de-motivate funds from conducting such research.

Details regarding disclosure of information to shareholders by a close-end company have been laid down in R. 58: the companies are required to disclose their annual audited reports, quarterly reports, statement of securities owned at the beginning and end of each reporting period, statement of transactions in securities during each reporting period including the sale and/or purchase prices, details of directors’ and officers’ security holdings, amongst other things. There are no similar requirements for open-end funds, although most as a matter of prudent business practice make similar disclosure.

62 In China, there are serious civil and criminal liabilities for the use of false information to induce securities transactions: imprisonment for up to five years and fines ranging from 10,000 to 100,000 Yuan [Dong (2003)]. In Pakistan, the new legal regime applicable to listed securities, the Code of Corporate Governance, does not provide for legal liabilities for failure to disclose vital information: the Code merely adds to the listing requirements of stock exchanges and the most serious penalty for failure to provide adequate disclosure is the threat of de-listing.


64 After U.S. investors who had invested in offshore securities in Asia suffered huge losses in the Asian crisis, attention was directed to the disclosure provided by the funds in Asian countries. Analysis revealed that these funds made minimal disclosure concerning the companies they were invested in using boilerplate language. Compared to mutual funds in the U.S., that disclose enough information to the shareholders about their portfolio companies so that the shareholders may be able to make an independent assessment of the fund’s investment decisions, mutual funds in Asia generally require the investor to put blind faith in them [Krider (1998)].

65 Different jurisdictions use different terms to denote investors of mutual funds. They include, for example, shareholders (in the U.S.), unit holders (in the United Kingdom) and beneficiaries (in Japan).

66 It has been argued that the disclosure obligations of mutual funds should be further enhanced. The Sarbanes-Oxley Act of 2002, which imposed new regulatory responsibilities on public companies, has been criticized for failing to enhance the responsibility of institutional investors to their shareholders [Karmel (2005)].

67 See R. 58(1), (2), and (4) of the NBFC Rules.
It is recommended that open-end funds should be required to make disclosure to shareholders similar to that required of close-end companies by R. 58. Furthermore, all mutual funds should be required to submit directors’ reports along with the periodic reports which should state briefly the funds’ investment policy and rationales for the sale and purchase decisions undertaken during the reporting period.68

E. Risk Management

If some mutual funds are to differentiate themselves from others,69 and invest in high growth and high risk sectors sufficient risk management practices have to be put in place to ensure that the risks undertaken are not disproportionate to the expected rewards. Moreover, there is a need to ensure that mutual funds in a developing low immature, market like Pakistan do not indulge in speculative transactions.

As per R. 49(1), a close-end company shall clearly state its investment policy in its constituent documents and prospectus. A close-end company may only invest in listed securities or up to twenty percent (20%) in government securities or investment grade debt securities.70 A close-end company’s investment in a security shall not exceed 10% of the paid-up capital of the close-end company or ten percent (10%) of the listed securities of the listed company, whichever is lower. A close-end company may not invest more than twenty-five percent (25%) of its net asset value in any one sector.71 The SECP may relax any of these conditions if it deems fit.72

Open-end fund are also required to clearly state their investment policies in their offering documents.73 Equity open-end funds are required to invest at least fifty percent (50%) of their assets in listed securities.74 An open-end fund’s investment in any one security shall not exceed ten percent (10%) of the paid-up capital of the fund or ten percent (10%) of the total securities of the listed company, whichever is lower.75 An OEF shall not invest more than twenty-five percent (25%) of its net asset value in any one sector.76

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68 In the U.S., the quarterly and annual shareholder reports contain a mandatory management’s discussion on the fund’s performance (‘MDFP’). The MDFP is the mutual fund’s version of the management’s discussion and analysis (‘MD&A’) section of a listed company’s shareholder reports. In this section the management is required to discuss, in plain English, their evaluation of the fund’s performance, reasons for any successes or failures and common sense analysis of future prospects. See Longstreth (1998).

69 It has been claimed that the funds industry in China, just like Pakistan, is characterized by the existence of funds that have very similar investment strategies, which prevents investors from distinguishing between them [Dong, (2003)].

70 R. 49(2) of the NBFC Rules. In comparison, if a U.S. investment company advertises itself as a ‘diversified’ fund, it must invest seventy-five percent (75%) of its assets in cash or cash items, government securities, securities of other investment companies, and other securities. However, it may not invest more than five percent (5%) of the fund’s assets or more than ten percent (10%) of the portfolio company’s securities. See Karmel (2005).

71 R. 49(4) of the NBFC Rules.

72 R. 49(5) of the NBFC Rules.

73 R. 71(1) of the NBFC Rules.

74 R. 71(2) of the NBFC Rules.

75 R. 71(3) of the NBFC Rules.

76 R. 71(4) of the NBFC Rules.
The SECP may relax any of these conditions if it deems fit. The diversification requirements for close-end companies seek to ensure that the shares of such companies, which are only traded in secondary markets, may be clearly valued. If close-end companies were to invest heavily in un-listed securities, their own shares are likely to be under-priced in the market. In contrast, since open-end funds’ units may be readily redeemed, such funds may be granted greater latitude to invest in un-listed securities at their own peril. As regards, the requirements ensuring that all mutual funds invest in diverse sectors, the SECP has relaxed these diversification requirements if a suitable case is presented, as for example with the Meezan Islamic Fund.

F. Expense and Fee Structures

Mutual fund fees and expenses may have a direct bearing on the income and profits that the funds generate and whether investors find them to be valuable intermediaries. Accordingly, there may be a case for imposing limitations on or standardizing fees and certain expenses. The application fee for the authorization of a close-end company is twenty-five thousand Rupees (Rs. 25,000) while that for an open-end fund is Rupees one million. A mutual fund is required to pay an annual fee equal to 0.1% the average annual net asset value to the SECP. An Investment Advisor of a close-end fund or an Asset Management Company of an open-end fund may be paid an annual remuneration of an amount not exceeding three percent (3%) of the average annual net asset value of the fund for the first five years, and two percent (2%) thereafter. A close-end fund is required to distribute to its shareholders at least ninety percent (90%) of any income it has received. An open-end fund must redeem its units within six (6) working days of the request for redemption. The fund may charge such redemption fees as have been disclosed in the offering documents.

77 R. 71(5) of the NBFC Rules.
78 Consistent with the enabling model and assumption of efficient markets the Investment Company Act in the U.S. does not impose such diversification requirements. Investment companies are free to decide upon their investment strategies so long as shareholders ratify significant changes in that strategy. For a criticism of such free reign given to mutual funds, see Karmel (2005).
79 R. 41(f) and R. 67(e) of the NBFC Rules, respectively.
80 R. 54e and R. 79 of the NBFC Rules, respectively.
81 R. 53 and R. 66 of the NBFC Rules, respectively. Contrast this bright line rule from the ‘enabling’ standard in U.S. law. According to 15 U.S.C. sec. 80a-35(b), both the independent directors and the investment adviser owe a fiduciary duty to the shareholders with respect to the fees. In Krinsk v. Fund Asset Management, Inc. the Appeals Court held that the test for determining if fiduciary duty is satisfied is ‘whether the fee schedule represents a charge within the range of what would have been negotiated at arm’s length in light of all the surrounding circumstances.’ See Krinsk v. Fund Asset Management, Inc. (2nd Cir. 1989), 875 F.2d 404 at 409. Comparing with China, management fees for the first funds (RMB 2 billion) were originally set at 2.5% per but were criticized by investors as being excessive. For the second group of funds (offered at RMB 3 billion each) the fees were reduced to 1.5% per annum. However, performance fees were made payable to the fund managers if a funds generated net profits exceeding the one-year fixed deposit rate by 20% and the growth rate of the fund’s net asset value exceeded the average return on A shares in the stock markets [see Dong (2003)].
82 R. 55 of the NBFC Rules.
83 R. 80(6) of the NBFC Rules.
G. Dispute Resolution Mechanisms

As Khorana, Servaes and Tufano concluded, a strong regulatory and judicial framework appears to lead to the development of the mutual fund industry.\textsuperscript{84} In case of mismanagement of assets and investments, what recourse do investors have against a mutual fund? If an investor feels aggrieved by the management of a mutual fund, the only option or that investor is to complain to the SECP or file a lawsuit. In most cases, a lawsuit is not a viable option especially if the investment is a small one. Furthermore, given the weaknesses of the judicial system, especially the likely delay, the investors are unlikely to sue if they feel aggrieved. Hence, there is less pressure on fund managers to perform their fiduciary duties.

In case of a complaint to the SECP, the NBFC rules do not provide for compensation of the investor, an omission which needs to be addressed. Additionally, it may be advisable for the rules to incorporate arbitration under the umbrella of the SECP or a self-regulatory authority. The MUFAP has not been granted self-regulatory status yet. Perhaps it is time to do that and provide a platform for arbitration, similar to that offered by the National Association of Securities Dealers (NASD) in the U.S.A.\textsuperscript{85}

H. Advertisement

The public in Pakistan is generally unaware of mutual funds and their capacity as investment vehicles. If mutual funds are to attract individual investors, they need to actively advertise their services. Here, we also need to ensure that there is no false advertising and the general public is not misled for that will erode public confidence in mutual funds and the securities markets in the long run.

The offering documents of close-end funds must meet the requirements of the Companies Ordinance, 1984, as well as provide certain information set out in the Schedule-III of the NBFC Rules, 2003.\textsuperscript{86} The offering documents of open-end funds must meet the requirements of Schedule-IV of the Rules.\textsuperscript{87} Advertisements of all mutual funds must be approved by the SECP in advance.\textsuperscript{88}

I. Preferential Treatment and Tax Incentives

We have advanced the argument that mutual funds play a more vital role in corporate governance than banks and other financial intermediaries since they attract the general public to the securities markets and may help improve the public’s perceptions of these markets. Accordingly, it may further be argued that mutual funds should be favoured over banks as regards the opportunities to invest in equity securities.

\textsuperscript{84} See Khorana et al. (2004).
\textsuperscript{85} A similar argument for has been made for a self-regulating organization in China. [Dong (2003)].
\textsuperscript{86} R. 48 of the NBFC Rules.
\textsuperscript{87} R. 70 of the NBFC Rules.
\textsuperscript{88} R. 48 and 70 of the NBFC Rules for close-end companies and open-end funds, respectively.
Likewise, it may be argued that tax incentives should be structured in such a way that the general public is encouraged to invest through mutual funds rather than on their own. At present, investments through mutual funds are treated at par with direct investments by individuals, as regards the structuring of tax incentives. Both manners of investment are exempted from capital gains while the withholding taxes on dividend incomes are set at ten percent (10%) regardless whether the dividends are received directly from a listed company or passed through to the unit/shareholders by a mutual fund. However, accounting for the fees and expenses deducted by a fund, an investor stands to gain more in pure financial terms by investing directly rather than through a fund. Therefore, it may be argued that dividend income received through mutual funds should be exempted from withholding tax in order to motivate individuals to invest through mutual funds.

J. The Role of the Regulator

In The U.S. the S.E.C. acts primarily as a rule making, investigation and enforcement agency. The S.E.C. is not known to be proactive in enforcement and industry supervision: its primary role is to ensure that corporate criminals are prosecuted and prospective wrongdoers thereby deterred. However, the S.E.C. is dealing with an enormous corporate and securities jurisdiction and can rely on courts, civil suits, state regulators and self-regulatory organizations to back it up and reduce its workload. In the absence of such support, and given its comparatively smaller workload, the SECP should not conduct passive oversight of the market and its participants but arguably should play a more proactive role in managing the securities industry. The performance of a proactive and aggressive role in securities regulation would require significant increase in the capacity of the SECP. Given the resource constraints, it is unlikely that the SECP will be able to develop the capacity to perform such proactive oversight across the board in the near future. However, through active oversight of financial intermediaries, including mutual funds, and by ensuring that such intermediaries’ transactions are above-board, the SECP can indirectly develop a very positive governance environment. Accordingly, the NBFC Rules, 2003, have significantly expanded the SECP’s jurisdiction by giving it authority over the non-banking financial sector in addition to that over the securities markets and listed companies. The SECP should exercise its new regulatory powers with diligence and ensure that the right governance culture is developed first in the financial intermediaries who may then insist on similar practices being followed by the listed companies they invest in.

89 Similarly, in China, there is also no capital gains tax on investment in stocks or stock funds and tax incentives play a small role in the development of the fund industry. See Dong (2003). In the U.S., it has been argued that the capital gains tax creates a disincentive for MF. For the effect of capital gains on US MF investments see Krishna (1996). It is also argued that capital gains tax creates incentive for investors to invest in funds that don’t trade actively. See Kertz & Simko (2001).

90 The State Bank of Pakistan previously regulated non-banking finance companies.
6. Conclusions

We have advanced the argument in this paper that the development of an appropriate corporate governance culture is contingent upon the adoption of a regulatory framework based upon clear bright line rules tailored to the particular legal and economic environment prevalent in Pakistan. The regulation of the securities markets should seek to ensure, as its primary aims, that minority investors are afforded sufficient protection without unduly and bureaucratically restricting the discretion managements of listed companies need to possess in making business decisions. This difficult balance may only be achieved if institutional investors generally, and mutual funds particularly, are encouraged to play a significant role in corporate governance.

A review of the NBFC Rules, 2003, indicates that the new regulatory framework put in place for mutual funds is based upon the right premises and will facilitate mutual funds to develop in such a way that they may become significant market participants. The implementation of the rules and their further development should be considered in the light of the specific regulatory concerns highlighted in the last part of the paper. Furthermore, it is imperative that the SECP should recognize the significance of mutual funds and related NBFCs for corporate governance and the role they can play in developing the public’s confidence in the securities markets. Therefore, the SECP should exercise its new jurisdiction in such a manner as to facilitate the growth of mutual funds while at the same time ensuring that the internal corporate governance of these funds is flawless. This would require a strong and symbiotic partnership between the regulator and the regulated.
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Abstract

This paper advances the argument that institutional investors, particularly mutual funds can play a vital role in enhancing corporate governance in emerging economies. Accordingly, regulatory framework need to be structured in a manner that would encourage the growth of the mutual fund industry and enable it to play a proactive role in corporate governance. The paper reviews and evaluates the regulation of mutual funds in Pakistan in the light of the above propositions. The Role of Mutual Funds and Non-Banking Financial Companies in Corporate Governance in Pakistan.