

THE ASSET
MANAGEMENT
REVIEW

EIGHTH EDITION

Editor
Paul Dickson

THE LAWREVIEWS

THE ASSET MANAGEMENT REVIEW

EIGHTH EDITION

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PREFACE

Despite significant improvements in the global economic landscape in the years since the global financial crisis some ten years ago, the macroeconomic position is looking increasingly complex and global growth has been hampered by various geopolitical factors, including political uncertainty and the rise of populist movements in Europe. As the UK prepares for Brexit, absent any agreement to the contrary currently set to take place at the end of October 2019, political uncertainty remains around the form and extent of any UK–EU deal relating to financial services, and as to whether any transition period (during which UK firms would remain able to access to EU markets on current terms) will be agreed. This has had, and is likely to continue to have, a potentially destabilising effect on the UK asset management sector and its clients. The impact of the UK's decision to leave the EU is thus already being felt, not only in the UK and across the European continent, but also more widely.

Nevertheless, the importance of the asset management industry continues to grow. Nowhere is this truer than in the context of pensions, as the global population becomes larger, older and richer, and government initiatives to encourage independent pension provision continue. Both industry bodies and legislators are also increasingly interested in pursuing environmental, social and governance (ESG) goals through private sector finance. For example, the European Commission has proposed a package of measures seeking to introduce sustainable finance into current regulations to make it easier for investors to identify and invest in such projects.

This should not be a surprise: lack of shareholder engagement has been identified as one of the key issues contributing to the governance shortcomings during the financial crisis. Given the importance of the asset management industry in investing vast amounts on behalf of clients, the sector is the natural focus of regulatory and governmental initiatives to promote effective stewardship and take the lead in instilling a corporate cultural focus on sustainability and ESG initiatives.

The activities of the financial services industry remain squarely in the public and regulatory eye, and the consequences of this focus are manifest in ongoing regulatory attention around the globe. Regulators are continuing to seek to address perceived systemic risks and preserve market stability through regulation. In Europe, further significant changes to the regulatory landscape for investment services were introduced by the revised Markets in Financial Instruments Directive regime (known as MiFID II), which has applied since 3 January 2018. In the UK, the Financial Conduct Authority continues to focus on the asset management industry. In 2017, it published its asset management market study on the performance of the asset management market for retail and institutional investors, and is beginning to implement its findings during the course of 2018. In contrast, the Trump administration in the US has signalled a deregulatory agenda, which includes plans to

repeal the Wall Street Reform and Consumer Protection Act of 2010 (also known as the Dodd-Frank Act).

It is not only regulators who continue to place additional demands on the financial services industry in the wake of the financial crisis: the need to rebuild trust has led investors to call for greater transparency around investments and risk management from those managing their funds. Senior managers at investment firms are, through changes to regulatory requirements and expectations as to firm culture, increasingly being seen as individually accountable within their spheres of responsibility. Industry bodies have also noted further moves away from active management into passive strategies, illustrating the ongoing pressure on management costs. This may, in itself, be storing up issues for years to come.

The rise of fintech and other technological developments, including cryptocurrencies, data analytics and automated (or ‘robo’) advice services, is also starting to have an impact on the sector, with asset managers looking to invest in new technologies, seeking strategies to minimise disruption by new entrants, or both. While regulators are open to the development of fintech in the asset management sector, they also want to ensure that consumers do not suffer harm as a consequence of innovations. Regulators across various jurisdictions are working together to develop a global sandbox in which firms can test their new technologies.

This continues to be a period of change and uncertainty for the asset management industry, as funds and managers act to comply with regulatory developments and investor requirements, and adapt to the changing geopolitical landscape. Although the challenges of regulatory scrutiny and difficult market conditions remain, a return of risk appetite has also evidenced itself and the global value of assets under management continues to increase year on year. The industry is not in the clear but, prone as it is to innovation and ingenuity, it seems well placed to navigate this challenging and rapidly shifting environment.

The publication of the eighth edition of *The Asset Management Review* is a significant achievement, which would not have been possible without the involvement of the many lawyers and law firms who have contributed their time, knowledge and experience to the book. I would also like to thank the team at Law Business Research for all their efforts in bringing this edition into being.

The world of asset management is increasingly complex, but it is hoped that this edition of *The Asset Management Review* will be a useful and practical companion as we face the challenges and opportunities of the coming year.

Paul Dickson

Slaughter and May

London

August 2019

PAKISTAN

*Haroon Jan Baryalay*¹

I OVERVIEW OF RECENT ACTIVITY

The asset management industry in Pakistan is dominated by open-ended retail mutual funds, which account for over 66 per cent of the total assets under management (AUM). Other asset management categories such as discretionary and non-discretionary portfolio management (20.5 per cent), real estate investment trusts (5 per cent), *modarabas* (5.5 per cent), private equity funds (0.5 per cent) and pension funds (2.5 per cent) make up the remainder.

The asset management industry in Pakistan has been able to make only limited inroads in mobilising investments and generally has low penetration levels in the economy. The total AUM account for only around 5 per cent of the total banking sector deposits of the country. This represents a significant potential for growth in the industry. Pakistan also has a low savings to GDP ratio of less than 10 per cent, with investors preferring to invest in real estate assets over financial products. In order to encourage investment in equities and fixed income products, Pakistan's tax laws provide various incentives for investors to invest in mutual funds (as further discussed below).

Between July 2016 and July 2017, the asset management industry in Pakistan grew by around 30 per cent. However, between July 2017 and May 2018, the sector saw a much more modest increase of 5 per cent, primarily on account of the prevailing political uncertainty and resultant decline in the value listed equities on the Pakistani Stock Exchange. Over the last eight years starting from the beginning of this decade, the asset management industry has experienced an average annual growth rate of around 16 per cent per year. From June 2010 to May 2018 the total assets of non-banking finance companies (NBFC) grew by over 220 per cent. The largest increase was seen in shariah-compliant funds, which experienced growth of 720 per cent, whereas conventional funds saw growth of over 150 per cent.² However, between June 2018 and May 2019, the sector saw a downward trend and there was negative growth of 4.61 per cent primarily on account of the general economic slowdown, monetary tightening by the State Bank of Pakistan, sharp currency devaluation and the resultant decline in the value listed equities on the Pakistani Stock Exchange.

Although Pakistan's stock market has for most of past decade been among the world's best performing stock markets delivering returns of around 26 per cent per year in US dollar terms between 2009 and 2015, the recent economic slowdown has dampened market sentiment despite Pakistan being upgraded as an emerging market to the MSCI Emerging Markets Index in 2017. Pakistan has also experienced a sizeable currency devaluation of

1 Haroon Jan Baryalay

2 Source: SECP Monthly Sector Summary May 2018 and May 2019.

around 60 per cent over the past two years which has further reduced the value of listed securities, in US dollar terms, on the stock market. The Pakistan Stock Exchange experienced a decline in market capitalisation from a peak of 10 trillion rupees (US\$100 billion) in May 2017 to 7 trillion rupees (US\$41 billion) in June 2019.

As at May 2019, there are 23 asset management companies or investment advisory companies licensed by the SECP which manage over 202 mutual funds. Of these, 10 asset managers are also licensed to manage pension funds. There is a total of 28 *modarabas*, four REIT management companies and four domestically licensed private equity firms. The total size of the asset management industry in Pakistan is around 945 billion rupees (US\$6 billion). Given the size of Pakistan's economy (around US\$300 billion), the asset management sector is quite small in relative terms, showing low penetration levels of asset management companies in the economy.

II GENERAL INTRODUCTION TO THE REGULATORY FRAMEWORK

Asset managers in Pakistan are regulated by the Securities and Exchange Commission of Pakistan (SECP), a statutory independent body formed under the Securities and Exchange Commission of Pakistan Act, 1997.

The Securities Act, 2015 (Securities Act) regulates the provision of financial services such as acting as a securities manager or securities adviser, and the entities that provide such services. Under the Securities Act, the services provided by the 'securities manager' and 'securities adviser' constitute regulated activities and entities providing such financial services are required to be licensed by the SECP. A 'securities manager' is defined as a person who manages a portfolio of securities belonging to another person, whether on a discretionary or non-discretionary basis. A 'securities adviser' is defined as a person who provides, inter alia, advice on investing and managing a portfolio of securities for another person without holding the property of that person.

In Pakistan, asset management companies fall within a broader category of financial institutions generally known as 'non-banking finance companies'.³

Section 282 (A to N)⁴ of the repealed Companies Ordinance, 1984⁵ continues to govern NBFCs in Pakistan.

Modaraba companies are similar to investment funds but they must invest their capital in a shariah-compliant manner. *Modarabas* are regulated under a separate law known as the Modaraba Companies and Modaraba (Floatation and Control) Ordinance, 1980 (the Modaraba Ordinance).

The SECP has issued further detailed rules and regulations pursuant to Section 282 (A to N), which set out regulatory requirements for NBFCs. These additional rules and regulations include the following:

- a* NBFC (Establishment and Regulation) Rules 2003 (the NBFC Rules);
- b* Non-Banking Finance Companies and Notified Entities Regulations, 2008 (the NBFC Regulations);
- c* Private Funds Regulations, 2015 (the Private Funds Regulations);

3 In addition to asset management companies etc., NBFCs also include investment banks and investment finance companies, leasing companies and microfinance banks.

4 This section remains in force despite repeal of the remaining provisions of the Companies Ordinance, 1984.

5 The Companies Ordinance, 1984 has been repealed by the Companies Act, 2017 (Act XIX of 1997).

- d* Real Estate Investment Trust Regulations, 2015 (the REIT Regulations); and
- e* Voluntary Pension System Rules, 2005 (the VPF Rules).

Furthermore, where a fund is established as a unit trust, the declaration of trust and appointment of trustee is governed by the Trust Act 1882.

The NBFC Rules divide NBFC's into two categories: (1) fund management NBFCs; and (2) lending NBFCs.⁶ A fund management NBFC means an NBFC licensed by the SECP to undertake asset management services or REIT management services or pension fund scheme business or private equity and venture capital fund management services or investment advisory services.

i Establishment and regulation of NBFCs

The NBFC Rules prescribe the manner of setting up an NBFC and set out their reporting and compliance requirements. An NBFC is licensed by the SECP and is required to renew its licence every three years. A company cannot be issued an NBFC licence if a similar category of licence is held by another group company. An NBFC may not alter its constitutional documents without approval of the SECP (an NBFC may, however, increase its authorised share capital without permission from the SECP).

ii Management

The promoters, directors and chief executive of a proposed NBFC must also fulfil the fit and proper criteria laid out by the SECP. The promoters must be issued at least 25 per cent of the paid-up share capital. The shares held by the promoters or majority shareholders and the directors must be deposited in a blocked account with the Central Depository Company and such shares cannot be transferred without the approval of the SECP. The NBFC's chief executive cannot hold a similar position in any other company, except an investment company managed by the NBFC, and any change in the chief executive or the board must be approved by the SECP.

iii Reporting and accounting

An NBFC is required to maintain an accurate and up-to-date accounts book, which shall represent a true and fair view of its affairs and must be prepared in accordance with International Accounting Standards (IAS) and audited by an auditing firm licensed by the SECP. The NBFC must also adhere to the requirement of submitting quarterly unaudited and annually audited financial statements to the SECP. The asset management company must also appoint an internal auditor, compliance officer and a chief accounting officer having the minimum prescribed experience and qualifications. Furthermore, an NBFC is prohibited from removing any of its records or documents from Pakistan without prior permission of the SECP.

⁶ A lending NBFC is one that is to undertake leasing or housing finance services or investment finance services or discounting services.

iv Rating

An NBFC is required to obtain an annual rating from a credit rating agency registered with the SECP and publish such rating in its annual report and quarterly reports, as well as the annual and quarterly reports of any funds managed by it.⁷

v Change of control

A sale of a strategic investment, a sale of shares of a subsidiary or associated company, or any merger or acquisition of an NBFC requires prior approval of the SECP.

vi Other

An NBFC must also comply with the applicable laws and directions relating to money laundering, terrorist financing and other unlawful activities.

The applicable rules and regulations regulate not only the asset manager but also require the fund vehicle itself to be registered with the SECP as a 'notified entity', which is thereafter regulated under the applicable regulatory regime.

III COMMON ASSET MANAGEMENT STRUCTURES

Under the NBFC Rules, a fund management NBFC can be licensed by the SECP to undertake any of the following activities:

- a* asset management company services;
- b* real estate investment trust (REIT) management services;
- c* pension fund scheme business;
- d* private equity and venture capital fund management services; and
- e* investment advisory services.

These licensed activities are not categorised in any order of hierarchy and a licensee must obtain a separate licence or approval in order to undertake each particular category of regulated activity.

Asset management services are defined as the business of providing services for management of collective investment schemes. Investment advisory services mean the services provided for, managing discretionary or non-discretionary portfolios for both individual and institutional clients and include the business of advising others as to the value of securities or as to the advisability of investing in, purchasing or selling of securities, for remuneration. The other regulated activities listed above relate to each type of licence granted by the SECP and are further discussed below.

A collective investment scheme can either be a closed-end scheme or an open-ended scheme. A closed-end scheme is required to specify its maturity period and must not continuously offer its units or certificates to investors. The holder of a certificate is entitled to receive a proportionate share of the net assets of the closed-end scheme. An open-ended scheme, on the other hand, can offer units based on net asset value on continuous basis

⁷ At present, there are two rating agencies licensed by the SECP, namely the JCR-VIS and Pakistan Credit Rating Agency (PACRA).

without specifying any duration for redemption. The certificate entitles the holder of such units on demand to receive its proportionate share of the net assets of the scheme less any applicable charges on redemption or revocation.

Under the NBFC Regulations, an open-ended scheme can only be established as a unit trust whereas a closed-end scheme can be established as an investment company as well as a unit trust. Private equity and venture capital funds, pension funds and REITs are required to be structured as unit trusts. Unlike some other jurisdictions, Pakistan does not have a limited partnership law and accordingly it is not possible to establish a private equity or other fund using the typical limited partnership structure.

In unit trust structures, the appointment of a trustee requires SECP's prior approval. The trustee and the asset management company are required to be independent entities. A trustee can only be a bank licensed in Pakistan that has at least an AA- rating, a subsidiary of a scheduled bank, a foreign bank operating in Pakistan and operating as trustee internationally, a central depository company registered with the SECP, an investment finance company that has at least an AA- rating, or such other company as the SECP may specify.

Where a closed-end fund is set up as an investment company, it must take the corporate form of a public limited company. In this case, the investment company must appoint an independent custodian to hold legal title to the fund assets and enter into an investment management agreement (IMA) with the asset management company. The IMA shall be valid for a period not exceeding 10 years unless its renewal is approved by the shareholders of the investment company at a general meeting.

IV MAIN SOURCES OF INVESTMENT

The SECP's website only makes sources of investment available for certain categories of funds. As noted above, mutual funds, and in particular open-ended funds, are the dominant category of funds operating in Pakistan.

Local investors are by far the largest source of investment into domestic mutual funds, with only 0.29 per cent of investment coming from foreign sources. Institutional investors dominate the investment side and contribute around 65 per cent of the overall investment capital whereas individual retail investors collectively contribute around 35 per cent of investments. Among the institutional investors, domestic corporates account for around 26 per cent, followed by retirement funds (14.5 per cent) and funds of funds (5.5 per cent). The remainder is contributed by insurance companies (4 per cent), associated banks and development financial institutions (5.5 per cent) and other institutional investors.

There are only four domestic private equity funds licensed by the SECP (Ijara Capital, PNO Capital, JS Investments and Lakson Investments), which manage three private equity funds currently licensed by the SECP. There are also a few foreign private equity and venture capital players active in the Pakistani market. The prominent foreign funds include the Abraaj Pakistan Fund (established in collaboration with the now insolvent Abraaj), Pakistan Catalyst Fund (with JS Group) and Baltoro Growth Fund (with Baltoro Capital) in collaboration with the United States Agency for International Development (USAID), which had contributed 50 per cent of their initial US\$50 million seed capital under its Private Public Investment Initiative in 2016/17. Although these funds are mandated to invest only in Pakistan, the funds have been established offshore in Mauritius, which has a more well regarded regulatory framework regulating private equity funds. An offshore-based venture capital fund Sarmayacar, which recently received a US\$2.5 million investment from IFC, has been active

in the domestic market having made a number of seed capital or Series A round investments in start-ups focusing primarily on the technology and IT space. However, despite the tax incentives for domestic private equity and venture capital funds, the bulk of private equity investments tend to be made via offshore fund structures or by high net worth individuals and family groups as direct investments in the target entities.

Investment by foreign investors is also affected by Pakistan's restrictive foreign exchange regime. Domestic securities can be issued, transferred and exported on a repatriable basis to the foreign investors provided the investment falls within one of the general exemptions under the State Bank's Foreign Exchange Manual. The general exemption requires that the purchase price of the securities being purchased by the foreign investor should not be less than the market value for listed securities and not less than the break-up value for unlisted securities. Pakistan's foreign exchange regime allows for repatriation of dividends and divestment proceeds provided the initial investment is routed through banking channels and is registered with the State Bank via authorised dealers. On a sale of the securities, the sale price cannot exceed the market value for listed securities or the break-up value for unlisted securities.

Most private equity funds raise capital through their association with a local business group. Where they raise capital through direct contributions from high net worth individuals, this is usually due to close business or familial relations with the business group operating the private equity fund. Pension funds, provident funds and insurance companies are restricted from investing in private equity and venture capital funds in Pakistan as the regulator considers private equity funds to be risky investments which pension funds, etc. should not be exposed to.

For foreign investors, the UAE and Mauritius tend to be the preferred jurisdictions for setting up offshore funds due to the double tax treaties Pakistan has with these countries.

V KEY TRENDS

The first set of reforms in Pakistan's asset management industry took place in the first decade of this millennium as the SECP introduced a number of new rules and regulations to modernise and regulate the sector. This included the introduction of NBFC Rules, VPF Rules and NBFC Regulations. In addition, in order to promote the development of private equity and venture capital funds, new regulations were introduced in 2008 which have now been replaced by the Private Funds Regulations of 2015. Also in 2015, the SECP introduced the REIT Regulations. The SECP has also recently proposed certain amendments to the regulatory regime governing NBFCs and has published them on its website for public comment. The amendments primarily relate to requirements for promoters at the time of incorporating NBFCs. In addition, in 2018 the SECP amended the regulations governing REITs. Under the recent amendments, a REIT is no longer limited to making investments in a single real estate project and is now required to pay dividends only through cash and not via issuance of bonus units. REITs are also permitted to invest surplus funds in money market funds in addition to depositing such funds with banks.

Pakistan's asset management industry is primarily inward looking with virtually no significant investments made by domestic asset managers outside the country, for which State Bank of Pakistan approval is required in order to remit foreign exchange outside the country.

Investments made by mutual funds in Pakistan can be broken down into: term deposits (42.39 per cent); equities (35.64 per cent); government securities (6.30 per cent); debt securities (6.92 per cent); and others (8.76 per cent).

Over the past year, with the UAE-based Abraaj Capital going into provisional liquidation and restructuring in the Cayman Islands, a number of domestic and foreign investors have shown a keen interest in acquiring their Pakistan assets. While the sale of K-Electric to Shanghai Electric awaits regulatory approvals, certain other assets have been acquired or are in the process of being acquired by domestic and foreign investors. However, the decline in the value of Pakistan's currency has dampened interest from foreign investors who have seen the value of repatriated profits decline in US dollar terms (with profits repatriated declining by 40 per cent year on year). Similarly, the value of foreign direct investment in the country has experienced a decline of around 50 per cent⁸ year on year up to June 2019. Activity on the domestic front has also slowed, with institutional investors preferring to invest in short-term government debt (T-bills), which were recently issued at attractive interest rates of around 14 per cent. Further, increased rates of taxation have eroded returns thus making it harder for investors to find attractive investment avenues on the equity side or in the private sector that can offer comparable returns.

VI SECTORAL REGULATION

i Asset management companies

An asset management licence entitles the manager to manage a collective investment scheme, which can be a closed-end fund or open-end scheme. The NBFC Regulations define a 'collective investment scheme' as a vehicle that enables investors' funds to be pooled together for investment in a 'portfolio of securities, or other financial assets for profits, income or other returns', and where the investors do not have day to day management control.

Funds that have been set up under the NBFC Rules as 'collective investment schemes' are typically retail mutual funds. Such funds are required to comply with the prospectus and disclosure requirements under the NBFC Rules, NBFC Regulations and the Securities Act.

The vast majority of collective investment schemes in Pakistan are open-ended mutual funds that are set up as unit trusts. There are only four listed closed-end mutual funds currently established as investment companies.

Marketing and fundraising

The units or shares of a collective investment scheme may be offered for investment to the public and listed on a stock exchange in Pakistan. The shares of a closed-end fund that has been established as an investment company can also be listed (but not if it is established as a unit trust).

A public offer of securities is subject to the provisions of the Securities Act and the NBFC Regulations. These regulations specify the required disclosures that must be made in the prospectus, which require the SECP's prior approval. The Securities Act contains

⁸ Foreign direct investment in the country has also declined significantly from US\$3.16 billion in the financial year ending June 2018 to US\$1.6 billion during the financial year ending June 2019.

provisions barring certain types of ‘bad actors’ from making a public offer of securities, which includes any person that has been declared a defaulter or who has been delisted for violating listing regulations.

The NBFC Regulations set out detailed requirements and the information that is required to be disclosed in the prospectus or offering document. The prospectus must be signed by the fund’s promoters.

In addition, prior to a public offer of the fund’s units or shares, the fund must be registered with the SECP as a notified entity and any public offer underwritten by an underwriter that is approved by the SECP.

Restrictions on investments

Generally, public funds are only entitled to invest in listed securities or tradeable debt instruments. A fund manager requires special permission to make overseas investments on behalf of the scheme.

Fund management NBFCs are restricted from undertaking activities permitted to lending NBFCs or to use the assets of a collective investment scheme to make a loan or advance money to any person. These prohibitions preclude mutual funds from undertaking direct lending activities, although are not prohibited from investing in debt securities.

An asset management company is prohibited from investing the funds of a collective investment scheme that will vest the management or control of the investee company in the asset management company.

An asset management company can only manage a maximum of three investment funds, but it may be eligible to manage more than three funds subject to fulfilment of certain conditions, including demonstrating a good track record such as maintaining a minimum rating (of the fund and for itself) and compliance with applicable laws.

Redemption, distribution and fees

The NBFC Regulations prescribe maximum limits on the management and other fees that a fund manager is entitled to charge. A collective investment scheme is mandated to distribute at least 90 per cent of its accounting income to the investors from sources other than capital gains and less any expenses. Where a collective investment scheme makes such distribution, it is exempt from any further corporate income tax.

ii Pensions

The VPF Rules regulate pension funds and pension fund managers. A pension fund manager under the VPF Rules must either be an asset management company or a life insurance company.

A pension fund scheme in Pakistan may only be structured as a unit trust, and must consist of an equity sub-fund, a debt sub-fund, a money market sub-fund, or any other sub-fund allowed by the SECP.

Under the VPF Rules only Pakistani nationals over 18 years of age are eligible to contribute to and participate in pension funds. The retirement age for participants in a pension fund is any age between 60 and 70 years, or 25 years since the age of first contribution to a pension fund, whichever is earlier. The age of retirement may be reached in the event the participant suffers serious physical debilitation or disabilities.

The VPF Rules specify the mandatory benefits that must be paid to participants on retirement. Pension fund managers are restricted from merging or acquiring management of another pension fund without prior approval from the SECP. Pension fund managers are also prohibited from accepting deposits from another pension fund.

iii Real property

Real estate management companies (RMCs) are regulated by the SECP pursuant to REIT Regulations. The REIT Regulations apply in addition to the NBFC Rules and NBFC Regulations. An RMC is authorised to undertake REIT management services, which are services for the management of a REIT scheme. A REIT scheme must be established as a closed-end fund registered under the REIT Regulations, and is permitted to invest in real estate projects. The REIT Regulations require a REIT scheme to be listed.

Under the REIT Regulations, there are two types of REIT funds that can be established to invest in real estate assets: a rental REIT scheme and a development REIT scheme. As the names suggest, a rental REIT is established to invest in industrial, commercial or residential real estate with the purpose of generating rental income. A development REIT is intended to invest in real estate to develop, construct or refurbish such real estate for industrial, commercial or residential purposes.

An RMC cannot offer units of a REIT scheme for subscription to the public unless it has obtained SECP approval. For such approval, an RMC is required, inter alia, to ensure that the real estate is free from all encumbrances including outstanding debts. The REIT Regulations require RMCs to pay dividends in cash.

An RMC requires prior approval of the SECP in order to transfer the proposed real estate under the REIT scheme under its management. Furthermore, the real estate must be located within the territorial limits of certain specified cities in Pakistan.⁹

Although the investment policy of a REIT scheme is restricted to real estate, a REIT scheme is allowed to invest any surplus funds in government securities or deposit such funds with a scheduled commercial bank or money market fund.

iv Private equity

Private funds are governed by the Private Funds Regulations, which subdivides private funds into two categories: private equity or venture capital funds, and alternative funds.

A private fund is only permitted to be established as a closed end-fund and structured as a unit trust.

In general, the requirements set out in the NBFC Rules and the NBFC Regulations would apply to private funds and alternative funds to the extent they are not in conflict with the Private Funds Regulations.

Marketing and fundraising

The Private Funds Regulations prohibit a private fund manager from soliciting investments from the public or listing the units of a private fund on a stock exchange. The investments in the private fund must be limited to a maximum of 30 investors who qualify as 'eligible investors'. In order to be an eligible investor, a person has to offer a minimum investment

⁹ So far, this is limited to Islamabad, Rawalpindi, Karachi, Lahore, Peshawar and Quetta, or any other city approved by the SECP.

of 3 million rupees (US\$20,000) and provide a written confirmation of their understanding of the investment risks. Other than the 'eligible investor' exemption, there are no other safe harbours pursuant to which funds can be offered to sophisticated or institutional investors.

The category of eligible investors is intended to capture qualified institutional buyers (QIB), high net worth individuals (HNWI) or sophisticated investors, and exclude retail investors. The criteria for determining eligible investors requires the fund manager to obtain written confirmation from the investor that they understand the risks involved in investing in a private fund.

The Private Funds Regulations set out the minimum disclosures required to be made in the private placement memorandum for a private fund. This includes prescribed language for warnings, which must be clearly displayed in the private placement memorandum.

Management

The Private Funds Regulations do not prescribe any specific requirements relating to the management of a private fund. However, when granting approval to the fund manager and when registering the private fund, the SECP will ensure that the fund manager has adequate resources and qualified personnel to be able to undertake the regulated activity of managing a private fund.

Restrictions on investment

A private equity or venture capital fund is permitted to invest in securities only, limited to the following categories: (1) unlisted company; (2) listed company or a company listed on the SME board if the objective of the investment is to 'turn around' such company; or (3) unlisted company with the objective to expand its business or which is engaged in the business of investing in developing a new product or process.

Private fund managers are entitled to invest in securities outside Pakistan subject to compliance with applicable regulatory requirements, which would include obtaining permission from the State Bank of Pakistan to allow investment capital to be remitted abroad.

Any change in investment objectives of a private fund require supermajority approval from investors and an updated private placement memorandum must be submitted to the SECP. Investments with connected persons can only be made on an arm's-length basis and are subject to making adequate disclosures.

Foreign funds

There is no exemption under the Securities Act or other applicable regulations that allows a foreign sponsor or promoter to register itself, or a foreign offering of securities within Pakistan, with the SECP. The Private Funds Regulations permit only a fund manager licensed in Pakistan to manage a domestic licensed fund. The SECP has publicly expressed the view, through various newspaper advertisements, that foreign issuers and fund managers cannot offer securities in the domestic market to Pakistani investors and the regulatory regime does not contain any exemptions or safe harbours for foreign offerings within the domestic market.

Most foreign private equity fund managers prefer to invest into Pakistan through offshore funds based primarily in the UAE and Mauritius.

The rules and regulations governing NBFCs do not envisage a domestic fund manager managing or operating a foreign fund; nor is it possible for a foreign fund manager to operate and manage a domestic fund in Pakistan.

v Hedge funds

The Private Funds Regulations also regulate what are known as ‘alternative funds’. There are no alternative funds registered in Pakistan at present. An alternative fund is a fund other than a private equity or venture capital fund that is permitted to use leverage or invest in derivatives. This category of funds is intended to capture what are commonly known as hedge funds.

An alternative fund can be established in the form of a unit trust only.

Alternative funds are required to disclose in their offering documents details of the use of derivatives, leverage or other proprietary investment strategies used by them. Such funds are required to demonstrate to the SECP that they have the required expertise for the use of their specific investment strategies, including the use of derivatives.

vi Modaraba companies

In general, a *modaraba* is an arrangement in which the investor entrusts money to a financial manager, who invests the capital on behalf of the investor. Any profits or losses will be shared between them in an agreed manner, whereas the financial manager is also entitled to charge certain management fees for its services.

Under the Modaraba Ordinance, *modarabas* have separate legal personality and are entitled to sue and be sued in their own name through the *modaraba* company. The assets and liabilities of each *modaraba* must be separate and distinct from those of another *modaraba* and also from those of the *modaraba* company.

The Modaraba Ordinance envisions two types of *modarabas*: (1) specific purpose *modarabas*, and (2) multi-purpose *modarabas*. A *modaraba* can last either for a fixed period, or for an indefinite period. *Modaraba* businesses cannot operate in contravention of the injunctions of Islam, and for this purpose, every *modaraba* company has to be certified by the religious board constituted under the Modaraba Ordinance. The Modaraba Ordinance allows *modaraba* companies to receive remuneration in the form a fixed percentage of the net annual profits of the *modaraba*; however, such percentage is capped at a maximum of 10 per cent.

VII TAX LAW

Pakistan’s tax code contains several tax incentives to make investing in mutual funds and other collective investment schemes attractive for investors to encourage greater participation. Under Pakistan’s tax laws, the definition of securities includes shares and units of a collective investment scheme.

i Tax credits and exemptions for mutual funds

A resident individual investing in listed mutual funds is entitled to tax credit under the Income Tax Ordinance 2001; however, such tax credit is only allowed if the units are held for at least 24 months. The amount allowed for the tax credit will be lesser of the total cost of acquiring the units; 20 per cent of the individual’s taxable income for the year; or 2 million rupees.

Under the Income Tax Ordinance 2001, any income derived by any mutual fund, investment company, or a collective investment scheme or a REIT scheme or private equity and venture capital fund from any instrument of redeemable capital is exempt from taxation provided not less than 90 per cent of its income of that year is distributed among the unit holders.

ii Capital gains tax

Under the Income Tax Ordinance 2001, no capital gains tax applies on redemption of units of a mutual fund, a collective investment scheme or REIT scheme by domestic investors that are held for more than four years. However, if the holding period of such units is less than four years, then an individual or an association of persons would have to pay capital gains tax at the rate of 10 per cent and a company would have to pay capital gains tax at the rate of 10 per cent for stock funds¹⁰ and 25 per cent for other funds. Further, capital gains tax on sale of shares or assets to a private equity and venture capital fund is capped at 10 per cent. By comparison, on a sale of shares to a foreign private equity fund, the normal regime of capital gains tax applicable on the sale of securities would apply.

The tax incentive offered to domestic private equity funds at the time of acquisition could potentially be wiped out when the domestic fund liquidates its investment, at which time it would have to pay capital gains tax under the normal regime as compared to the 10 per cent capital gains tax applicable under the double tax treaties with countries such as Mauritius or the UAE.

iii Withholding tax on dividends

Varying rates of withholding tax ranging between 15 and 25 per cent apply to dividends paid out to investors by domestic mutual funds and private equity and venture capital funds. In contrast, withholding tax on dividends payable under the double tax treaty with Mauritius is capped at 10 per cent and generally ranges between 10 and 15 per cent under the double tax treaties with the UAE and other countries.

VIII OUTLOOK

Although the SECP has tried to jump-start the sector through legislative reforms, Pakistan's asset management industry remains relatively miniscule (at US\$6 billion) compared with the size of its own economy as well as in comparison with the global asset management industry (which is estimated to be around US\$100 trillion). Despite recent and past legislative enactments, the industry lacks depth due to lack of corporatisation and formalisation of the economy, which translates into a dearth of investible assets.

The past decade has witnessed consolidation in the asset management industry with large market players taking over smaller entities in order to increase their market share. According to the JCR-VIS sector update on the mutual fund industry, in 2007 there were only 76 mutual funds in Pakistan being managed by 29 asset managers, while at present 23 asset management companies are managing over 220 funds. According to the same report, the profile of investors is primarily composed of institutional investors; however, the share of retail investors has seen a gradual increase over a period of time. At the end of June 2017, retail investors accounted for 32 per cent of industry assets under management, whereas as of June 2019 their share has increased to 35 per cent. According to the JCR-VIS report, a lack of understanding of mutual funds has hindered the growth of the investor base but recent

¹⁰ Under the Income Tax Ordinance 2001, a stock fund is defined as a collective investment scheme or a mutual fund where more than 75 per cent of the investible funds are invested by way of equity shares in companies.

marketing initiatives undertaken by asset managers coupled with diversification in product portfolio and financial incentives (both tax and others) have helped to expand the investor base of the industry.

The SECP, however, remains committed to introducing further reforms with the assistance of international agencies such as USAID in order to improve its own understanding of the industry and to help further develop and grow the sector. The recent tax amnesty coupled with the government's push to widen the tax net and document the economy could act as a boon for the sector.

Over the short to medium term, given the headwinds currently being faced by the Pakistani economy, especially a sharp devaluation in the Pakistani rupee coupled with performance of the Pakistan Stock Exchange, the outlook for the asset management industry is expected to remain subdued for the foreseeable future.

The government of Pakistan has embarked on an aggressive economic stabilisation programme under a US\$6 billion IMF facility, which is expected to curb growth but also help the government manage its budget and current account deficits and lead to economic stabilisation. As these measures begin to have an effect, the asset management industry can expect to recover, although it may be a while before an economic recovery in the real sector trickles down to the domestic securities markets.

Despite challenges, the sector has seen double digit growth over the past decade and as the economy grows, the asset management industry is likely to experience further expansion and play an increasingly important role in channelling capital towards productive assets in the economy.



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