



Chairman Review

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Industry Review

The mutual fund industry closed the financial at PKR 622.35 billion up 27% over last year. The equity fund category (both conventional and Shariah compliant) constituted of PKR 270.69 billion up 37% from last year followed by income fund category at PKR 101.46 billion (down 20%) and money market category at PKR 77.88 billion up 40% from the previous year. The asset under management (AUM) under Asset Allocation and Fund of Funds categories were PKR 46.58 billion and PKR 65.58 billion respectively. The Fund of Funds category had grown in AUMs from PKR 25.41 billion on June 30, 2016. Of the total AUM in Fund of Funds category PKR 23.67 billion was held under Shariah compliant category.

The Shariah compliant fund category continued growing faster, particularly due to contribution by Fund of Funds category, than the conventional category and closed the year at PKR 237.82 billion, recording the growth of 51% over the previous year. A variety of mutual funds are being offered in this category to suit the varied needs of investors by asset management companies.

Board Review

The Board of MUFAP started its term on October 1, 2016. The Board in its 2nd meeting held on November 4, 2016 had constituted the following objectives for the term 2016-2017:

1. Completion of Change in Accounting Treatment of the Element of Income issue

Pursuant to the amendments that were brought in through the Finance Act 2014, mutual funds are now mandatorily required to make cash distribution to achieve the tax free status. Due to this change, those investors who are investing later in the year are subjected to tax also on the portion of dividend that pertains to the portion of capital being returned to them (i.e. element of income received from them at the time of investment to equalize the dividend distribution). An investor who invests nearer to June/dividend distribution date may only receive his capital back (his dividend would comprise only of the element of income he brought in), which should not be taxed, but at time of distribution since the dividend is distributed equally for all investors as cash on which tax is required by law to be withheld, resultantly their capital portion also gets taxed. To come up for a solution for this matter so that the investors are not taxed unjustly, the MUFAP had formed a Committee to study the different jurisdictions and make recommendations accordingly to resolve this issue. Internationally in most jurisdictions including the USA, varying dividends are paid to the investors based on the period of their investment and proposed that this should be the way forward for Pakistan as well.

In this regards, MUFAP held extensive discussions during the year with the Securities and Exchange Commission of Pakistan (SECP), Institute of Chartered Accountants of Pakistan ("ICAP") and leading firms of Chartered Accountants on the subject matter. ICAP itself has been pursuing the matter with SECP vide its letter No. CA/DTs/TAC-2011-2210 dated June 9, 2011 that as per International Financial Reporting Standards (IFRS), the element of income, being in the nature of "equalization account" does not qualify for recognition as either income or expense and hence the treatment of recognition of element of income in the "Income Statement" (as per the requirement of the Schedule V to the Non - Banking Finance Companies and Notified Entities Regulations, 2008) should be discontinued and instead the net balance of element of income at the end of the reporting period should be recognized in the "Distribution Statement".

The SECP notified the amendments in Non-Banking Finance Companies and Notified Entities Regulations 2008 pertaining to change in accounting treatment of element of income vide S.R.O. 354 (1)/2017 dated August 3, 2017. The amendment includes insertion of a new clause defining the 'Element of Income' as the difference between net asset value on the issuance date and the net asset value at the beginning of relevant accounting period, a definition of income which was absent in NBFC regulations earlier and has also prescribed the disclosure requirements for element of income. The notification has removed a major anomaly in accounting of open-end funds, whereby for maintaining "dividend equalization" part of "capital" contributed on incoming units was recognized in the income statement. As a result, the Fund Accounting will undergo major changes. The financial statements for the quarter ended September 30, 2017 will now be prepared as per the revised accounting treatment.

MUFAP is in the process of issuing an operational circular to standardize the procedure to be followed by AMCs for accounting, financial and tax treatment of element of income for which a draft has already been shared with SECP for approval.

FBR is now required to amend Income Tax Rules 2002 pursuant to changes in NBFC Regulations in order to adjust cost of acquisition post distribution for the purposes of computation of capital gain tax. MUFAP has taken up the matter with National Clearing Company of Pakistan Ltd. (NCCPL), the agents for CGT computation for Mutual Funds, in order to have the Income Tax Rules amended accordingly. We have also shared with them a draft of changes to be made in the Income tax rules along with a detailed example elaborating such change.

2. Taxation issues

Mutual Fund Industry has faced a host of taxation problems involving costly litigations since 2010. In the recent years, the past assessments of mutual funds were reopened, discarding bonus issues from qualifying as distribution for tax exemption. The mutual funds were also issued notices to pay super tax. These issues were ultimately resolved as Appellate Tribunal Inland Revenue which decided both the cases in favor of



mutual funds. The cases relating to Workers' Welfare Funds and Federal Excise Duty, which have also been subject to lengthy legislation were decided in Court of Laws in favor of mutual funds and Federal Government has gone for review/ appeal with Honorable Supreme Court of Pakistan.

The outstanding tax issues are as under:

Minimum Tax

This point was included in taxation proposals that were sent to FBR for inclusion in the Finance Act 2017-18 and MUFAP had also raised this concern separately through numerous letters and meetings with FBR. 8% is an exorbitantly high rate of withholding tax for AMC, particularly as the tax is final and nonadjustable. The mutual fund industry is working at a low margin and for majority of AMC it tantamounts to very high rate of tax and for those AMCs which are in losses, it results in extreme financial difficulties. The Federal Government has reduced minimum tax on service provider companies for many corporate service providers to 2% while for AMCs it still remains at 8% despite many follow-ups. This is really hampering majority of the AMCs capacity to operate as it massively affects their profitability. AMCs should be included in the same list of companies exempted from applicability of minimum tax at rate of 8%. The Board has now decided to appoint a tax consultant to plea this case to FBR on AMCs behalf.

Withholding Tax Exemption Certificate Requirement

Mutual Funds are exempt from income tax and thereby through Clause 47B of Part IV of Second Schedule of the Income Tax Ordinance 2001 funds are exempt from withholding tax. FBR in May 2015 introduced the requirement to obtain an exemption certificate even for exempt entities. This has made things operationally difficult as it's an extremely cumbersome task to obtain these certificates and in the interim tax is withheld and funds end up having refunds which are equally, if not more difficult to obtain from FBR. Exempt entities should not have the requirement to obtain income tax exemption certificates, as it is an operationally cumbersome process. The matter is pending in the Honorable Supreme Court.

Federal Excise Duty (FED)

In July 2016, the Honorable Sindh High Court had struck down the Federal FED component, which was the same as the Provincial law. The FBR has challenged the same in the Supreme Court, even though the Federal Government's position on the same is also clear with the removal of the FED on services, which are subject to provincial sales tax. Therefore although the funds have stopped further provisioning from July 1, 2016, they will be unable to take a decision on the reversal before Supreme Court's decision in the matter.

Workers Welfare Fund (WWF)

The Supreme Court has decided that levy of WWF on service sector through Finance Bill was illegal and accordingly struck it down. Federal Government has filed a review petition.

I hope the new Board under the chairmanship of Mr. Yasir Qadri and the Taxation Committee of the Board under the chairmanship of Mr. Razi ur Rahman Khan will actively pursue the tax cases with FBR.

3. Conversion of MUFAP to SRO particularly arrangement of funding

In September 2015, SECP shared a concept paper wherein it has proposed that MUFAP may be converted from trade organization to SRO, which will enhance the integrity and growth of industry. The Proposed SRO will play proactive role for the development of Mutual Funds and for the protection of Investors.

The said concept paper was discussed in great detail in various meetings at MUFAP's Board. The matter was also discussed in detail in the EOGM of MUFAP specifically held to discuss the proposal of SECP for SRO status for MUFAP on July 15, 2016. The Members of MUFAP in the said EOGM have in principle approved the proposal of SECP for an SRO status for MUFAP subject to following conditions:



1. The member Asset Management Companies will not share any additional financial burden.
2. The Membership of SRO should be limited to mutual funds industry and the majority representation on the Board should be from AMCs. Independent directors should not be more than one third of the total composition of the Board and should have requisite knowledge of the mutual fund industry.
3. The SRO should have very well defined Terms of Reference (TORs) to be mutually agreed between SECP and MUFAP with the roles and responsibilities of SRO as front line regulator of mutual fund industry very clearly defined to ensure sufficient autonomy with SRO as well as avoid duplication of work. The SRO should be evolved in a phased manner with the TORs containing the phase wise implementation steps along with pre-defined timelines of the various areas to be covered by the SRO.
4. Sufficient resources should be allocated to SRO so that it is financially and administratively viable while maintaining independence. Since SRO will assume some of the functions presently done by SECP, a portion of the fees generated by SECP from mutual fund industry should be allocated towards the SRO by amendments in the Regulations so that it has financial muscle for its capacity building and for meeting its expenditure. Initial funding is required at the time of setting up the SRO for its capacity building to be generated from sources other than asset management companies. Also the possibility of setting up an endowment fund initially through funding from SECP or international donor agencies should be considered.

MUFAP had shared a phase wise implementation road map along with funding proposal and projections with SECP on the same and had proposed that as the SRO will be assuming some of the functions presently done by SECP, therefore a certain portion of the fees generated by SECP from mutual fund industry should be allocated towards the SRO by amendments in the Regulations so that it has financial muscle for its capacity building and for meeting its day to day expenditure as the Asset Management Companies will not be able to share any additional financial burden that this SRO requires to function properly. It is imperative that sufficient resources should be allocated to SRO so that it is financially and administratively viable while maintaining independence without which the SRO would not be able to function. This matter is under discussion with SECP.

4. Development of Retail business

The SECP issued Circular 40 of 2016 on December 30, 2016 titled Conditions for Reimbursement of Selling and Marketing Expenses to Mutual Funds, which now allows open-end equity, asset allocation and index funds to charge up to a maximum of 0.4% per annum of net assets of fund or actual expenses whichever is lower as Selling and Marketing Expenses. These selling and marketing expenses are only allowed to those AMCs who open new branches in cities other than Karachi, Lahore, Islamabad and Rawalpindi as per the schedule mentioned in the same circular.

This is a positive move, as this will allow the AMCs to expand their outreach and distribution network to make it easily accessible to the general public. The drawback in this is that there are a few AMCs who have already taken the initiative before this circular to open branches in cities other than the four main cities and they are unable to charge selling and marketing expenses on those existing branches. We have taken up this with SECP to allow it on the existing branches as well so that the AMCs have ability to further expand their outreach.

Significant Developments during the Year

Exchange Traded Funds (ETF)

The SECP had formed an ETF committee during the year under the chairmanship of Mr. Shahid Ghaffar. The Committee developed a concept paper highlighting regulatory and operational issues and other impediments to be removed for successfully launching ETF in the market. Thereafter on the recommendation of SECP, a Committee was formed at MUFAP under the Chairmanship of Mr. Yasir Qadri which is now liaising with PSX, CDC, NCCPL and other stakeholders on the activities required to be undertaken by these institutions and



taking forward the required activities for implementation of the actionable items mentioned in the roadmap. The committee had several meetings with representatives from PSX, CDC & NCCPL and stockbrokers to discuss operational points more comprehensively with these stakeholders.

The Committee in its paper has identified the following matters need to be addressed for ETFs to be launched in Pakistan:

1. Regulatory Amendments (as proposed by the Committee formed by SECP)

- ✦ Allowing AMC to act as authorized participant as well as Market Maker for ETFs under management
- ✦ Allow AMCs to have investments in ETFs and constituent basket of securities
- ✦ Allow Collective Investment Schemes to invest in ETFs; Amendments in sector and scrip limits for ETFs
- ✦ To enable Banks/DFIs to act as an Authorized Participant, or Market Maker relaxation should be provided in exposure limit so that the Financial Institution can invest in ETF over and above the existing exposure limit allowed in Listed Equity Securities. Amendment in PR-6 of the State Bank needed

2. Amendments in Tax Laws

- ✦ Transfer of securities to/from AP to ETF should not attract capital gain. The aging should be frozen for the period the securities are in ETF.

3. Amendments by PSX/SECP pertaining to

- ✦ Removal/ Widening of circuit breakers
- ✦ Breakup of Marketable Lots (marketable lots and par value to be unregulated as it would be difficult to manage an ETF based on an index which has shares worth Rs. 10 and Rs. 1000 simultaneously).

Future Outlook

1. The future of the mutual industry is dependent on increasing awareness about the mutual fund industry and enhancing the outreach to investors across the country. Over the past few years there has been gradual increase in the retail base, which is presently around 40%. Asset management companies are offering a diversified range of mutual and pension funds to meet the risk appetite of investors, yet the awareness in the masses is lacking of the options available to them. Asset management companies have started conducting awareness & marketing campaigns/ road shows/ seminars individually as well as from MUFAP and SECP's platform. AMCs are also trying to enhance their distribution network. This will help in further enhancing the investor base of the mutual fund industry.
2. The growth of mutual funds is also dependent on resolution of taxation issues. The taxation of mutual funds should be based on three clear principles, as under:
 - ✦ Mutual funds are collective investment schemes and pass-through vehicles. Mutual funds on itself should not be taxed, but unit holders who hold investment in mutual funds may be subject to tax.
 - ✦ For investors it should tax neutral if they invest directly in securities or through mutual funds.
 - ✦ In many jurisdictions tax incentives are allowed to tax payers to promote savings and investments. Such investment should be for promoting long-term savings and not short term of two years or three years.
3. Another important development for growth of mutual fund industry will be giving SRO status to Mutual Funds Association of Pakistan (MUFAP). If SECP agrees to allocate a part of fee it receives from mutual fund industry, MUFAP can easily bear the cost of being front line regulator. Hopefully, MUFAP will be able to undertake the dual task of promoting the industry and being the front line regulator. A limited induction on MUFAP Board of independent directors will bring more transparency in working of MUFAP. I hope there will be progress on this in next year.

Mutual Funds can play very important role in mobilizing savings by offering investment products that can give good return to investors. This can lead to develop capital market and help the Government and private sector in raising funds for investment in equity, debt securities and long term bonds for infra structure projects.



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I would like to thank the Senior Vice Chairman Mr. Farid Ahmed Khan, Vice Chairperson Ms. Maheen Rahman, fellow Directors, Committee Chairpersons and Committee members for their dedication, teamwork and valuable support. I would also like to place on record appreciation for Mr. Shahid Ghaffar for his valuable contribution and endeavors for the development of Mutual Funds Industry. Lastly, I thank Ms. Mashmooma Zehra Majeed and the management team of MUFAP for the continued commitment and hard work.