

Corporate Governance of Mutual Fund In Bangladesh

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Abstract

The mutual fund industry in Bangladesh was thrown open to the private sector in 1999. Since then the AMC's with mutual funds has grown in excess of Tk. 3500 crore with over 80% of the fund being managed by private sector AMC's. To protect the interest of the investors, SEC prescribed a structure to be followed by the financial institutions and mutual funds alike. The structure depends upon independent directors and statutory auditors. In order to safeguard investors' money in the current unstable situation of Bangladesh stock market, corporate governance guidelines have been institutionalized. This paper attempts to critically review the requirements of mutual fund regulations in Bangladesh and their implementation by the various AMC's.

Keywords: Mutual Fund, Asset Management Company, Corporate Governance, Merchant Banks

1. Introduction

Bangladesh has a small community of 29 merchant banks licensed by the SEC. These merchant banks lack skilled personnel and possess too small a market share to exert any impact in the domestic capital market. The pool of organized investment funds is miniscule hence the merchant banks have failed to build up a viable retail client base. Complementing the role of merchant banks are 323 securities firms that are members of the stock exchanges. These companies suffer from low capitalization, weak governance, and inefficient operations.

Here were the corporate governance plays a big role. It is the system by which companies are directed and controlled. It considers such matters as how board of directors operate the role of executive, compensation in determining firm performance, and the role of multiple shareholders.

Corporate governance in financial intermediary's (mutual funds) in Bangladesh is a paramount issue as economic reforms have not only increased growth prospects, but they have also made markets more competitive. This means that in order to survive companies will need to invest continuously on a large scale. And due to this large scale investment it is imperative for firms to rely on capital markets to a greater degree for their needs of additional capital. Simultaneously, the increasing institutionalization of the capital markets has enhanced the disciplining power of the market. In case of mutual funds it's applicable that they will invest in these shares and it's important that there is good corporate governance to make sure

- Streamlining the Guidelines with the Code of Corporate Governance
- Protection of depositors
- Improvements in prudential regulation
- Full and fair disclosure of all material information with particular emphasis on accurate, objective presentation of financial information; no colorful accounting

Therefore, corporate governance comprises the legal infrastructure organizing business (corporate law, security law, accounting rules), business ethics and the overall business environment. Good corporate governance is highly correlated with better operating performance and market valuation of companies in this case mutual funds. By preserving and protecting rights of the investors– in particular those of minority. It encourages innovation and long-term investment in mutual funds.

The objective of this study is to look into the corporate governance of mutual funds of Bangladesh through reviewing the contribution of directors of the AMC's in maintaining the governance, and protect and enhance shareholders

value. And also reviewing the SEC regulations for the AMCs and how well it is being maintained or violated. This report gives an account of :

- the structure and history of mutual funds
- a review of literature on corporate governance of mutual fund
- observations and findings of the four tier structure of mutual funds
- Suggestions for policy implication and conclusion

2. History of Mutual Fund

Investment Corporation of Bangladesh (ICB) launched by government in 1980 was the first ever Mutual Funds for the sake of investors and of the capital market. The first private sector to take initiative of organizing a mutual fund was Asset & Investment Management Services of Bangladesh Limited (AIMS) in 1999.

Though the mutual fund industry grew over time there has only been close ended fund since the beginning of the mutual funds. The country's first ever open-end mutual fund hit market in the first quarter of 2010, expanding the orbit of stock market and providing share holders a very useful and convenient investing vehicle. Prime Finance Asset Management Company Limited (PFAMCL) float the mutual fund, with initial size of Tk500 million.

In this fiscal year total market capitalization of mutual fund was Tk. 3595.5 crore; 32 percent higher than that of previous fiscal year. In general the investment in mutual fund is normally assumed to be safe investment due to volatility in capital market but the market capitalization of mutual fund was comparably lower than other sector.

3. Structure of mutual fund in Bangladesh

Mutual funds are portfolios of different securities such as stocks, bonds, treasuries etc. Mutual funds pool money of both individual and institutional investors allowing the funds to achieve:

- economies of scale by reducing costs and increasing investment returns
- divisibility and diversification
- active management with superior stock picking and market timing
- reinvestment of dividends, interest and capital gains
- tax-efficiency
- buying and selling flexibility

There might be varieties of mutual funds that differ in terms of their investment objectives, underlying portfolios of shares, risks and returns, fees and expenses, etc. Mutual funds are professionally managed investment schemes that collect funds from small investors and invest in stocks, bonds, short term money market instruments, and other securities. This ensures a diversified portfolio for the investors at much less efforts than through purchasing individual stocks and bonds. There are two types of mutual funds open ended and close ended.

3.1 Open ended fund

- No restrictions on the amount of shares the fund will issue
- If demand is high enough, the fund will continue to issue shares
- Open-end funds also buy back shares when investors wish to sell
- The fund will be closed to new investors if its assets become too large

3.2 Close ended fund

- Publically traded
- Raises fixed amount of capital (only once) through issuing IPO
- Issue fixed amount of share
- It is listed and traded like a stock on a stock exchange
- The stock prices of a closed-end fund fluctuate according to market forces as well as the changing values of the securities in the fund's holdings

Fund managers who undertake trading of the pooled money and are responsible for managing the portfolio of holdings usually manage mutual funds. Generally, mutual funds are organized under the law as companies or business trusts and managed by separate entities. Merchant banks & portfolio manager are licensed to operate under SEC (Merchant Banker & Portfolio Manager Rules) 1996.

3.3 Mutual funds have four-tiered structure

- Sponsors – promoter of the company
- Trustees – they hold the property of the mutual fund for the benefit of the unit holders
- AMC's - Asset Management Companies (AMCs) are authorized to act as issue and portfolio manager of the mutual funds which are issued under SEC (Mutual Fund) Rules 2001. There are 19 AMCs in Bangladesh at present
- Custodian – who is registered with the SEC, holds the securities of various schemes of the fund in its custody.

According to rules, all asset backed securitizations and mutual funds must have an accredited trusty and security custodian. For that purpose, SEC has licensed 8 institutions as Trustees and 8 institutions as custodians. All mutual funds are required to be registered with the SEC before they launch any scheme.

4. Review of Literature

(Khorana 1996) has shown that in the mutual fund industry, effective fund governance can be facilitated by “internal” (board) or “external” (fund inflows) sources. (Wellman and Zhou 2005) indicate that board quality is the most important factor to explain mutual funds' performance among all possible fund governance factors. And (Qian 2006) provides another approach to examine the role of fund governance and document that the way that investors withdraw from or invest in funds can be an effective governance mechanism. Mutual funds with higher flow sensitivity have lower trading scandals.

(Tufano and Sevick 1997) examine the composition and compensation of open end U.S. mutual fund boards. Their results appear to contradict the notion that directors serving on several boards are ineffective monitors. Shareholder fees, a common proxy for governance quality, are lower in funds whose directors' sit on a large fraction of the fund sponsor's other boards.

(Gomes 2000) says there are both costs and benefits associated with controlling shareholders leading to a potential conflict of interest with minority owners for two principal reasons. First, regulations do not effectively protect the rights of minority shareholders. Second, the governance structure in many countries potentially makes controlling shareholders, who hold the majority of the votes and often have managerial representation, impervious to takeover threats and monitoring.

(Gillan and Starks 2003) document that U.S. institutional investors are active in participating annual meetings compared with the institutional investors in other countries. Thus, voting is possibly a way for mutual funds to voice their opinions and mutual funds may use their voting power to enhance corporate governance mechanisms.

(OECD 2004) while laying down the principles of corporate governance suggested institutional investors act in a fiduciary capacity and as such they should disclose their overall corporate governance and voting policies with respect to their investments, including the procedures that they have in place for deciding on the use of their voting rights. They should also disclose as to how they manage material conflicts of interest that may affect the exercise of key ownership rights regarding their investment. (Chou, Ng, and Wand 2007) found evidence of well governed funds performing their fiduciary duties towards their shareholders whereas poorly-governed funds lacked in this aspect. (Paul Dunn 2009) examined the disclosure transparency of socially responsible mutual funds. This study found that disclosure transparency increases when mutual fund managers have a great commitment to providing socially responsible mutual fund.

(Cremers et al. 2005) reports that independent director ownership is positively associated with higher funds and fund-family return. The authors posit that increased ownership improves governance because directors have more to lose personally if the fund underperforms. Both sets of authors offer their evidence as indicative of the benefits of governance in mutual funds.

(Ding and Wermers 2005) examine the joint relationship between fund managers and fund directors for the first time with a combined database of manager and board characteristics. They find that when poor performing managers are replaced, it is more likely done by funds that have larger boards and higher proportions of outside directors.

(Bushee, Carter, and Gerakos 2007) examine institutional investor preferences for good corporate governance by looking at the institutional investor holdings. They further consider both board of director characteristics and shareholder rights as measures for corporate governance

(Wellman and Zhou 2007) found that funds with higher corporate governance rating out-performed funds with bad grades. They concluded that corporate governance significantly affects performance of mutual funds.

The literature reviews are quoted from various articles and journals which helped in better understanding of the corporate governance of mutual fund in various countries. It gave an insight of what other authors have to offer on this topic and the quantitative findings of some of the author's experimental work on corporate governance of mutual fund.

5. Methodology

The study is based upon the secondary information we extracted from various journals, articles and working papers, mostly the facts and views. The findings and observations are solely based on the first hand information extracted from the officials of the asset management companies. And a sample size of 9 AMC's out of 15 is used for representing the findings.

6. Limitations

- There is lack of both primary and secondary data as it is a first time study on the given topic.
- Information's of all the AMC's are not available and due to geographical problems they weren't accessible.

7. Observations

The key observations are based upon the information provided by the various officials of the Asset Management Companies. This information's are summarized below and the findings shown with respective figures.

7.1 Composition of Board of AMC:

According to the SEC guidelines for corporate governance, the number of Board of Directors should not be less than 5 (five) and more than twenty. Appointment of at least one-fifth of the total number of the company's board of directors should be 'independent non-shareholders directors' in the Board. A review of the composition of the board of 9 AMCs reveals:

- Out of 9 AMC 6 are limited companies were as only 3 companies is private limited company.
- There is less uniformity in the size of the Board of directors. The numbers of directors are within the given guideline; range from 5-14 with the average size of the board being 7.33. Information regarding size of the Board of directors of AMCs is given in Figure I
- 7 out of nine companies fulfill the obligation of at least one-fifth of the total number of the company's board of directors to be independent directors. Although 2 of the companies do not meet this criterion, each company has at least 1 independent director. And out of the 9 companies two have 3 independent directors, four companies have 2 independent directors and 3 companies have 1 independent director.
- The independent directors of the AMCs are mostly people with years of experience in the finance world and who are at the height of their careers. Mostly chairman, managing directors and founders of different companies. They are mostly PhD holders and have foreign masters degree in Business administrations. The age of the independent directors tends to be somewhere between 55-70 years.
- Most Chairmen's of these AMCs are also independent directors.

7.2 Composition of Board of Trustee

- Out of 7 trustees, 1 is organized as Board of trustees the remaining 6 exist as public limited company.
- The size of the Board of directors is not uniform. The numbers varies from 6-13 making the average size of the board to be 6.87. Information of size of the Board of Directors of trustees is shown in Figure II.
- The minimum number of independent directors in the Board of trustee in 1 and the maximum number is 5. One company however has no Independent directors.
- Similar to the Board of Directors of AMC, Board of trustees also tend to prefer independent directors who are in positions of Chairman and founders of various reputable firms and are experienced in the field of finance.

7.3 Custodians

- Out of 9 AMCs, 8 have appointed only one custodian for all their schemes. Only RACE Management Pvt. Co. Ltd. appointed two custodians.
- The most popular custodian among the 9 AMCs is a foreign bank called Standard Chartered Bank and ICB (Investment Corporation of Bangladesh). There are also local banks like BRAC bank limited and Agrani bank who act as custodians. Custodians and number of AMCs under them are shown in Figure III.

7.4 Registrar & transfer agents

- The registrars and transfer agents for the mutual fund and the AMCs couldn't be traced. There is no information available about the R&TA online or in the stock exchanges or to the AMCs.

7.5 Auditors of schemes

- The auditing of mutual fund schemes is concentrated with few firms. 2 firms S.F Ahmed & co. and Hoda Vasi Chowdhury & Co between them audits for 7 AMCs. The remaining 2 AMCs uses other auditing firms to audit there schemes. The number of mutual fund schemes audited by various auditors are summarized in Figure IV.

8. Policy Implications

It is prevalent that the mutual fund industry is still very small in Bangladesh, but it handles pool fund of large sum of money for a large number of investors. Thus corporate governance is very important in order to protect the rights of the shareholders. Henceforth, SEC plays a major role in controlling regulations of mutual funds

1. A minimum size of the board is set by the SEC regulations and most AMCs are following it. But in an overwhelming majority of the non-bank listed companies, the board is heavily dominated by sponsor shareholders who generally belong to a single family. The boards are actively involved in management. Most independent directors represent current or former government officials or bureaucrats. They are appointed directors to assist company in getting licenses or as payback for previous favors. In the context of Bangladesh, independent directors do not act as an advocate for minority shareholders or as a source of innovative ideas (BEI, 2003).
2. The Chairmen of the AMCs and Trustee companies are chosen out of the independent director. But the Chairman and the Chief Executive officer simultaneously should not be the same person and the Board should clearly define their respective roles and responsibilities.
3. For better governance, the corporate governance guidelines should demand from the AMCs a financial statement that presents fairly company's state of affairs, the results of its operation, cash flows and change in equity. The statement should have:
 - accounting estimates based on reasonable and prudent judgment
 - consistent application of appropriate accounting policies
 - IAS followed in preparation of the financial statements

- Disclosure on company's ability as a growing concern and if not so then the fact along with the reasons thereof,
 - Explanation on the significant deviation from last year in operating results, if so happened
 - Summarize of at least last three years key operating and financial data
 - Significant plans and decisions along with future prospects and risks
 - Number of Board Meetings held during the year and attendance by directors,
 - Aggregate number of shares held by: Parent/Subsidiary/Associate companies, Directors, CEO, Company Secretary, CFO, Head of Internal Audit. etc
 - Shareholders holding ten percent or more voting interest in the company
- The guidelines will definitely help to protect the rights of minority shareholders as well as ensure more transparency and accountability in the Management of the AMCs.
4. The numbers of auditors are very limited and this might be a source of risk to the investors. To ensure there is no collusion between the auditors and the AMC, the SEC can implement an audit committee. A sub-committee in the governing body that will make arrangement for internal audit and facilitate the completion of external audit. Audit committee tries to enhance the ability of the board to fulfill its legal responsibilities and ensure the credibility and objectivity of the financial reports. An audit committee must be composed of majority of independent or non-executive directors who are neither officers or employee of the company. (Hossain, 2004). Such a committee should act as a communication link between management, auditors, and the governing body.
 5. There is no regulation given regarding the number of independent directors on the Board of Trustees. It varies from board to board and there is even on Board of Trustee that do not have any independent director. The SEC should look into it and set a specific guideline for the number of independent director on a Board of trustee.

9. Conclusion

Good governance entails real costs. Some of the costs include hiring dedicated staff such as corporate secretaries, experienced and independent directors, or other governance specialists. It will likely require the payment of fees to external counsel, auditors, and consultants. This might seem like a load of cost but in absence of good corporate governance, board fails to ensure controls, poor disclosure and transparency becomes commonplace, and shareholder rights are mistreated. In extreme cases, systemic governance problems may even undermine faith in the financial markets and threaten market stability (Munshi 2012).

To improve corporate governance the Bangladesh Corporate Governance Project BCGP will work various stakeholders (e.g., regulators, financial institutions (mutual funds), family-owned businesses, business associations, chambers of commerce etc.) to

- improve corporate governance codes at the country level,
- raise awareness on corporate governance and its best practices
- develop a pool of trainers to help codify corporate governance principles in the market and also
- work with business enterprises on a one-one-one basis to improve their corporate governance practices.

In addition, to sustain the advancement of corporate governance practices and to effect positive change in the market in the long run, the BCGP will aim to build/enhance the capacity of key corporate governance service providers. It must be noted that corporate governance is not a one-off exercise but rather an ongoing process. No matter how many corporate governance structures and processes the company has in place, it is advisable to regularly update and review them. Markets tend to value long-term true commitment to good governance practice and not a single action or box-ticking exercise (Munshi 2012).

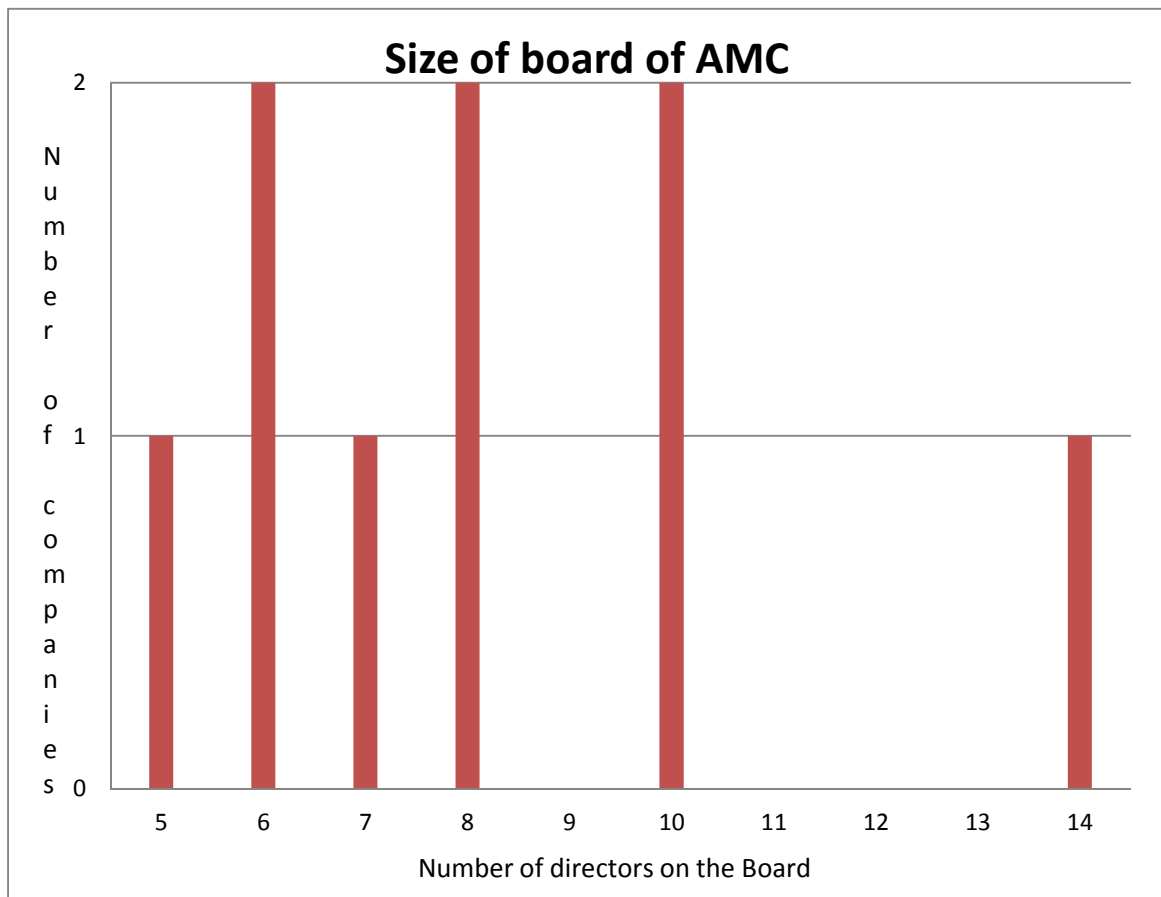
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Fig

ure 1. Size of AMC Board.

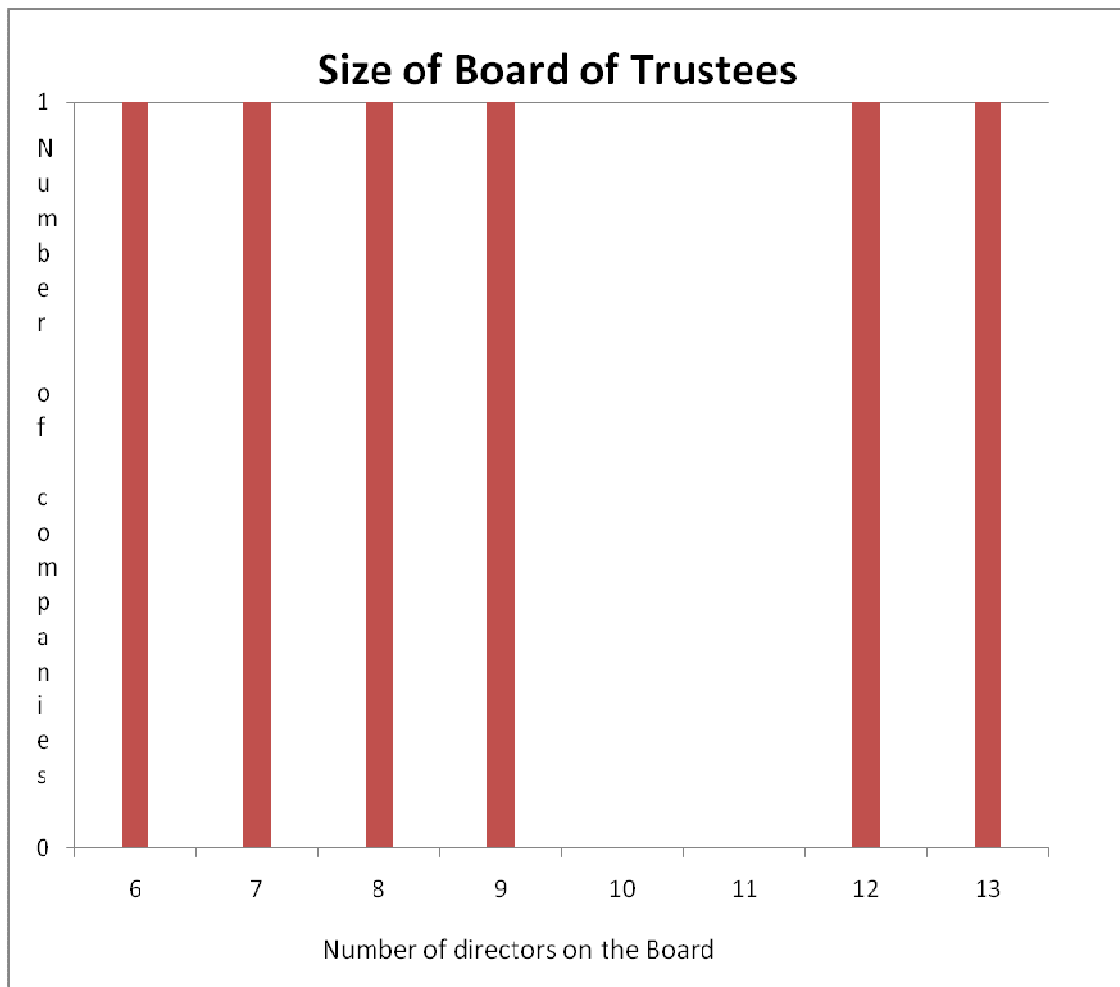


Figure 2. Size of Board of Trustees.

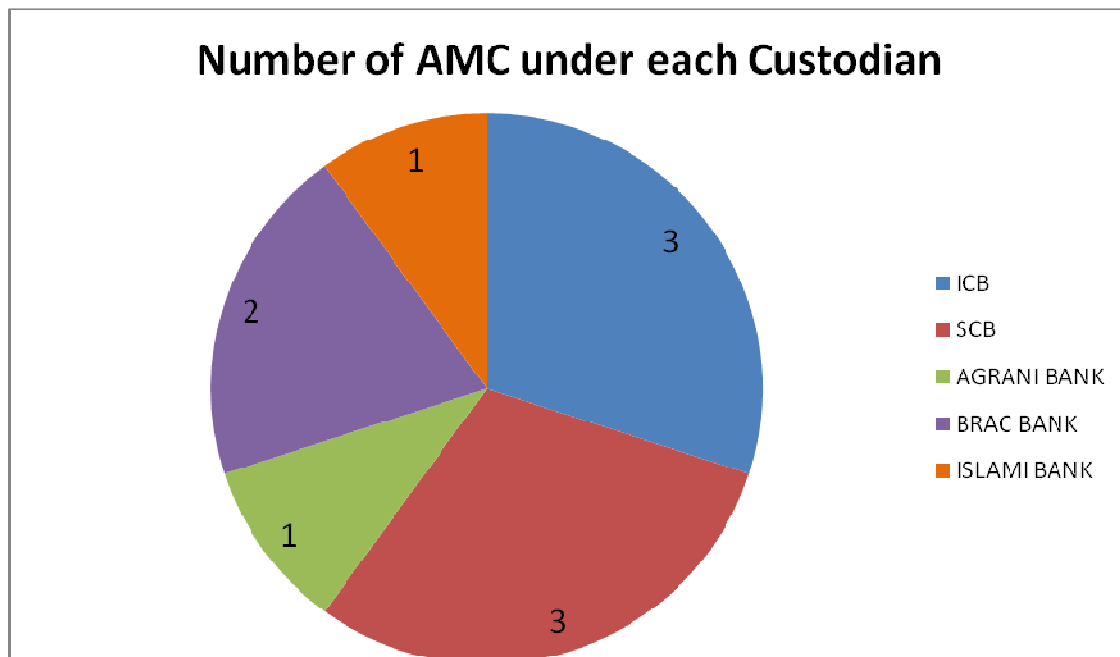


Figure 3.

AMCs under each Custodian.

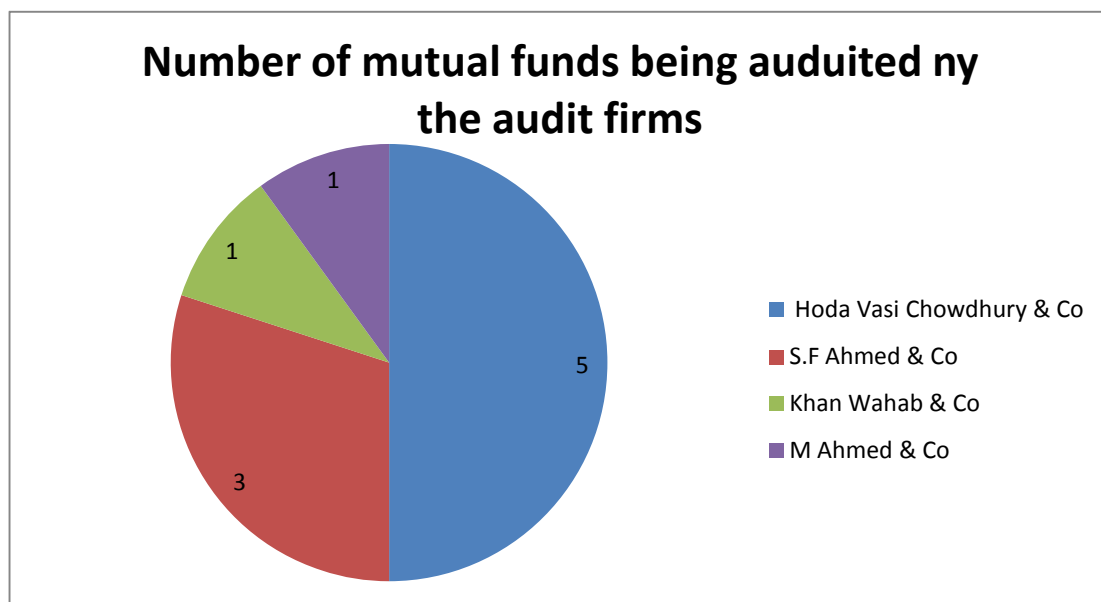


Figure 4. Mutual funds audited by audit firms.

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