

CONCEPT NOTE DIGITAL ASSET MANAGEMENT COMPANIES



SECURITIES
AND EXCHANGE
COMMISSION
OF PAKISTAN



BACKGROUND

The transformation from a traditional to a digital economy is the key defining aspect of the 21st century. With the increased role of data as a driver of economic growth, digital technology has introduced innovative business models, products, services and delivery channels.

The COVID-19 pandemic has increased the pace of digitalization. In the financial space, this has included the introduction of various reform by the State Bank of Pakistan in the form of Customer's Digital Onboarding Framework, Digital Banks and more recently RAAST for P2P fund transfers and settlement services which allow bank customers to send and receive funds in their accounts using their bank's mobile application.

Keeping pace with technological changes and delivering adequately to stakeholders in regulated sectors is a priority at the Securities & Exchange Commission of Pakistan (SECP). One example where we have enabled technological development in the asset management sector is the introduction of SECP's specifications pertaining to digital account opening by asset management companies and digital distribution platforms to ease digital onboarding of mutual fund investors. Since the introduction of digital account opening specifications, asset management companies (AMCs) have so far opened 5000 account with an investment amount of Rs. 325 million.

Digitalization has reduced client acquisition and retention costs and allowed access to a wider base of capital. Individual investors form a key potential source of capital for financial markets. Currently, the middle-class population represents more than half of digital asset management clients.

CHALLENGES FACED BY ASSET MANAGEMENT COMPANIES

In an environment where investors and savers lament the lack of investment options, financial savings that are directed towards capital markets do not show an encouraging growth pattern. In particular, a minimum rate of return on savings deposits has been implemented by the central bank to encourage savings which has crowded out other investment options for investors. The mutual funds industry, which started out in the 1960s with two state-owned funds, National Investment Trust (NIT) and Investment Corporation of Pakistan (ICP), represents one avenue of investment for investors. The mutual fund industry has shown reasonable growth in number of investors as well as assets under management, however, remains significantly under-penetrated relative to comparable jurisdictions globally.

The mutual fund industry in Pakistan has only approximately 320,000 investors (0.14% of total population) which can barely sustain this sector of the capital markets. Pakistan's mutual fund investor base is under-penetrated in comparison to other jurisdictions. For example, India has over 1.85 crore mutual fund investors which represents approximately 1.33% of total population.

In Pakistan, there are currently 21 AMCs with asset under management of Rs. 1.2 trillion. In order to encourage growth, competition and innovation in the sector, there is a strong case for leveraging technology in an effort to expand financial access to grass root level.

Retail investors also typically need financial advice to encourage and channel their savings into appropriate investment vehicles. Financial advice can help investors overcome their inexperience and lack of familiarity with investments such as mutual funds. However, this financial advice is typically uncommon in developing markets. Digital avenues can help overcome this issue of access to financial advice.

PROMISING POTENTIAL OF DIGITAL ASSET MANAGEMENT COMPANIES (DIGITAL AMCS)

As envisioned, a Digital Asset Management Company (Digital AMC) will provide all the asset management services, from launching of allowed Collective Investment Schemes (CIS), online account opening to issuance and redemption of units and inter CIS conversions through digital means, where the investor is no longer required to visit any distribution point physically.

A Digital AMC, being internet-based, will have the ability to overcome some of the challenges identified above and should increase investor penetration in the mutual fund sector. Digital AMC should also spur innovation and competition in this segment of the capital markets, thus supporting sector development. Since the Digital AMC will be allowed to distribute units of mutual funds online, this should

¹ <https://economictimes.indiatimes.com/mf/mf-news/70-mutual-fund-investors-in-india-earn-less-than-rs-5-lakh-annually/articleshow/88022620.cms#:~:text=According%20to%20Sebi%20data%20quoted,of%20the%20mutual%20fund%20industry.>



also assist in development of a wider range of digital mutual fund distribution platforms.

Digitalization is the gateway to open enormous opportunities to create convenience for customers, decrease time to market for providers, and provide cost effective solutions for all concerned. A Digital AMC can take the conventional asset management services from the confines of bricks and mortar structures to digital channels with significant potential to reach the currently unserved low-income strata. Thus, they can become drivers of financial inclusion using digital channels.

Similar to how digital banks today are serving millions of customers through branchless agents, providing secure and convenient digital financial services to the masses through their digital payment platforms; Digital AMCs can similarly also follow suit to increase the footprint of asset management services substantially.

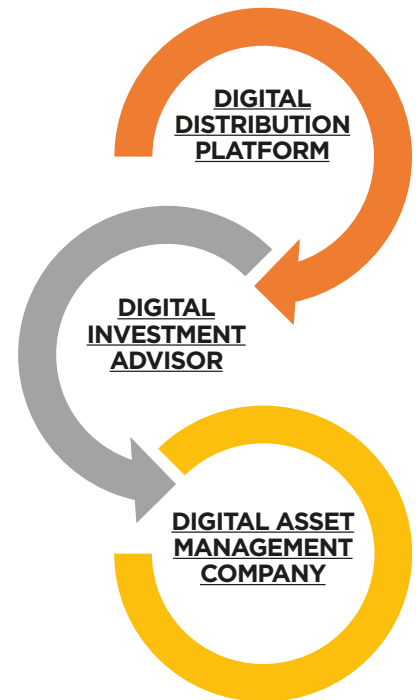
EVOLUTION STAGES IN DIGITAL ASSET MANAGEMENT ECO-SYSTEM

Presently, Pakistan is witnessing a revolution in branchless banking where a large segment of the population previously unbanked has entered the realm of digital financial services. This shows a promising future for digital asset management services.

The idea of digitalizing the entire asset management eco-system was initiated by facilitating and allowing digital distribution platforms. Currently there are 4 mutual fund digital distribution platforms in Pakistan. These digital distribution platforms inspired the concept of digital Investment Advisory services. Despite Digital Investment Advisory being a relatively new concept, the SECP has already authorized one entity to carry out digital investment advisory services, while other entities have also applied to undertake investment advisory digitally.

The concept of a completely digital asset management ecosystem (Mutual Fund Digital Distribution Platform, Digital Investment Advisor and Digital Asset Management Company) is being pursued by SECP to enable provision of customized solutions and access to additional digital investment channels for investors. Further, the development of a complete digital ecosystem will cater to the needs and expectations of the younger generation who are more tech-savvy and prefer digital investment platforms.

With continuous facilitation and engagement, this evolution will encourage prospective investors to enter a space with a promising future and should also promote healthy competition among asset management service providers leading to improved customer service, product offerings and return on investment.



WHAT SHOULD BE THE FOCUS OF DIGITAL AMCS

The key ambitions underlying the development of Digital AMC's include:

- i. Increasing the retail investor base and creating value through technology, collaboration & alliances;
- ii. Promoting financial inclusion, competition and innovation through technology-based solutions;
- iii. Providing ease of accessibility for the mass population, especially the low-income strata that is currently untapped;
- iv. Providing affordable/cost effective asset management services digitally; and
- v. Tailoring products and services to the needs of the target customers and enhancing customer experience.

The current volume of business generated via online distribution channels is miniscule in the overall context of the NBFC sector. Mutual fund sales occur predominantly through AMC's own sales teams, branch networks and parent banks' branch network whereas distribution through AMCs websites and mutual fund digital distribution platforms is very low, albeit growing at a fast pace. In order to provide impetus to digitalization of assets management services, it appears now is the right time to introduce the concept of Digital AMCs and incentivize licensing of Digital AMCs that would focus on providing the services exclusively through digital platforms.

Initially, Digital AMCs can focus on offering money market/capital protected products, which can serve as alternate to bank deposits while generating better returns for the investors. The range of products offerings by Digital AMCs can be increased and liberalized over time.

REGULATORY GAPS

For the success and growth of Digital AMCs, regulatory support and appropriate incentives are of utmost importance. As noted above, SECP has supported digitalization of the asset management industry through issuance of guidelines for mutual fund digital distribution platforms and specifications for online account opening by AMCs. This needs to be further augmented by providing specific incentives for establishing and licensing of new Digital AMCs in the regulatory framework.

The existing regulatory framework for AMCs was reviewed to create enablers for Digital AMCs. Critical regulatory gaps, challenges and barriers restricting digitalization of AMCs were identified. Below is the proposed regulatory framework addressing those gaps.

Definition/Requirement	Proposed	Rationale																											
Definition	<p>Digital Asset Management Company</p> <p>Digital Asset Management Company mean an NBFC licensed by the Commission to provide asset management services digitally.</p> <p>A new NBFC can be formed to undertake the business as a Digital AMC or an existing Asset Management company can convert itself into a digital AMC.</p>	<p>Currently, there is no concept of digital asset management company in the regulatory framework therefore it is proposed that a digital asset management company will provide the same asset management services as per existing definition of Asset Management Services.</p> <p>NBFC Rules, 2003- 2(iii) “asset management services” mean the business of providing services for management of collective investment schemes;</p> <p>NBFC & NE Regulations, 2008- 2(i) “Asset Management Company” means an NBFC licensed by the Commission to provide asset management services;</p>																											
Minimum Equity Requirement	<p>Rs. 50 million (against current requirement of Rs. 200 million for conventional AMCs)</p>	<p>In order to encourage innovation and entry into this space, the minimum equity requirements are proposed to be reduced to Rs. 50 million. This contrasts with the current requirement of Rs. 200 million for conventional AMCs.</p> <p>The proposed capital requirement is to ensure financial soundness whereas CIS Investor assets will always be secured with third party trustee(s) to ensure segregation from assets of the Digital AMC.</p> <p>Benchmarking Detailed MER structure of other jurisdictions is attached as Annexure-A.</p> <p>Similarly, the SBP in its framework for Digital Banks has specified the MCR for Digital Retail Banks and Digital Full Bank which is as under:</p> <table border="1" data-bbox="997 1384 1471 1563"> <thead> <tr> <th rowspan="2">Bank</th> <th rowspan="2">MCR Pilot Stag (Rs in billion)</th> <th rowspan="2">MCR Commercial Launch (Rs in billion)</th> <th colspan="3">MCR during each financial year after Commercial launch (Rs in billion)</th> </tr> <tr> <th>Yr1</th> <th>Yr2</th> <th>Yr3</th> </tr> </thead> <tbody> <tr> <td>DRB</td> <td>1.5</td> <td>2</td> <td>2.5</td> <td>3</td> <td>4</td> </tr> <tr> <td>DFB</td> <td>6.5 b</td> <td>N/A</td> <td>8</td> <td>10</td> <td>-</td> </tr> </tbody> </table> <p>The SECP has also introduced the concept of online only broker and has specified the equity requirements at 50% of the trade only broker which is as under:</p> <table border="1" data-bbox="997 1686 1471 1767"> <thead> <tr> <th>Category of securities broker</th> <th>Minimum Net worth (Rs in million)</th> </tr> </thead> <tbody> <tr> <td>Trading Only</td> <td>15</td> </tr> <tr> <td>Online Only</td> <td>7.5</td> </tr> </tbody> </table> <p>Therefore, keeping in view the above, the MER of mutual funds managed by a Digital AMC is also reduced in comparison to MER of offerings by conventional AMCs.</p> <p>Room has been created for existing AMC which are non-compliant with MER requirement to convert into Digital AMC.</p>	Bank	MCR Pilot Stag (Rs in billion)	MCR Commercial Launch (Rs in billion)	MCR during each financial year after Commercial launch (Rs in billion)			Yr1	Yr2	Yr3	DRB	1.5	2	2.5	3	4	DFB	6.5 b	N/A	8	10	-	Category of securities broker	Minimum Net worth (Rs in million)	Trading Only	15	Online Only	7.5
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Eligibility	<p>Additional Requirement for Board: At least one member of the Board of the Digital AMC shall have adequate knowledge and experience in any of emerging technologies and trends, such as cloud, open API, cyber security, advanced data and analytics etc.</p> <p>The Digital AMC shall employ at least one person having minimum of three (3) years of experience in the financial services, financial technology, telecommunication, aggregator technology platforms, Information Communication Technology or other pertinent digital or innovative financial and non-financial domains at a senior management level when applying to form a Digital AMC and will be subject to Fit and Proper Criteria as mentioned in Schedule IX of the NBFC & NE Regulations.</p>	<p>In order to satisfy the need for having senior level staff with requisite skillset for digital provision of services, international jurisdictions which have allowed digital investment advisory / digital distribution platforms / robo-advisory and licensing & regulatory framework for digital bank were reviewed and it was observed that there is a requirement of either a senior board member well versed with innovative technologies or a pertinent digital or innovative financial and non-financial domain with a minimum of 5% equity stake.</p>
Type of CIS allowed	<p>Money Market scheme, Income Scheme, Listed and Traded Funds (Exchange Traded Fund) [Can be subsequently liberalized after assessing the performance of Digital AMCs over time]</p>	<p>Keeping in view the initial stage of development of Digital AMCs, they are proposed to be limited to be offering low risk investments such as money market scheme, income schemes and listed and traded funds (ETF).</p>
Minimum Size of CIS	<p>Minimum size of any CIS at any time shall not fall below Rs. 10 million. [Current requirement is Rs. 100 million]</p>	<p>Since all the funds will be launched and offered digitally it is envisaged that fund size will be prone to increase/decrease at different intervals of time. Therefore, it is proposed that minimum fund size should be kept to a lower level than currently required for conventional AMC offerings.</p>
Total Expense Ratio (TER)	<p>The CIS offered by Digital AMC shall have low total expense ratio preferably within the range of 1% to 1.5%.</p>	<p>TER of funds launched digitally will be less in comparison to existing TER of Money Market 2%, Income and Index Fund 2.5%. Hence, a lower TER range is proposed for Digital AMC offerings.</p>
Sales Load	<p>Not Allowed or be kept at current level of 1.5% at par allowed to AMCs</p>	<p>Sales load should be kept to a minimum level or allowed only in case where distribution is done through digital distribution platform or aggregators. However, a final decision in this regard shall be based on online sales load allowed to conventional AMCs.</p>
Distribution	<p>The Digital AMC shall maintain a distribution strategy, in line with the overall business strategy.</p>	<p>Units of CIS launched by Digital AMC shall only be distributed through digital distribution platforms.</p>

Definition/Requirement	Proposed	Rationale
Business Plan	<p>The applicant shall submit a comprehensive feasibility study, business and enablement plan.</p> <p>The business plan shall include detailed financial projections and underlying assumptions covering a period of at least five years from the commencement of business and shall also include the following;</p> <ul style="list-style-type: none"> i. Digital Strategy; ii. IT Organogram; iii. Information demonstrating human resource capacity and competencies relating implementation of digital and IT business strategies and to offer digital CIS to investor. 	<p>Business plan is normal as per existing NBFC Regulatory Framework however; in this case additional business plan with IT strategy is required</p>
Portal/Website	<p>The portal/website of Digital AMC shall become live within six months of the grant of digital asset management services license and shall be subject to annual system audit.</p>	<p>Portal/website is mandatory for Digital AMC.</p>



PUBLIC COMMENTS

The concept of Digital AMC will be implemented through notification of legal framework. Since, the concept is new to the local market, therefore a concept paper is being issued along with preliminary legal framework, for soliciting public comments. Comments may please be e-mailed on or before August 15, 2022 to Ms. Sidra Tul Muntaha at email id: sidra.mansoor@secp.gov.pk.



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