ISN-68877
PNABG436

A PRELIMINARY ASSESSMENT OF THE DEVELOPMENT OF MUTUAL FUNDS IN THE KINGDOM OF JORDAN

Bureau for Private Enterprise
U.S. Agency for International Development

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Sponsored by: *Financial Markets Project*
Project Number 940-2005
Prime Contractor: ArthurYoung

April 1987

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I. BACKGROUND.

The author was asked to travel to the Kingdom of Jordan with a view toward assessing whether the Amman Financial Market ("AFM") should encourage the establishment of a "mutual fund" or some other kind of investment company or investment pool. The trip was taken under the auspices of The United States Agency for International Development ("AID") through a fulfillment contract with Arthur Young & Company ("AYC"). The author spent the two weeks between February 19 and March 6, 1987 in Amman, Jordan and in other parts of Jordan and was asked to prepare this report in order to summarize his conclusions and set out any recommendations.

This report is not a statistical analysis. Much, if not all, of the evidence supporting the recommendations is anecdotal. There simply was not enough time or resources available to make a genuine statistical study of the market and the possibilities of investor interest in an investment company.

This report is composed of three parts. First, it discusses the current state of the Amman financial community as it relates to the establishment of a mutual fund. This first part of the report is drawn from the interviews and other discussions which the author had in Jordan and from an earlier report prepared by Jalil Shoraka, President of the Aries Group, Ltd. and entitled "A Preliminary Assessment of the Financial System of Jordan." Second, the report discusses briefly the investment company industry as it exists in the United States and the mechanisms that are peculiar to that industry. Third, the report discusses the principal statutory and regulatory problems which the author believes would be involved in developing a mutual fund industry in Jordan and sets out several recommendations all of which assume that an attempt will be made to encourage the development of one or more investment companies.

II. THE CURRENT STATE OF THE AMMAN FINANCIAL COMMUNITY.

As stated, the trip involved a series of interviews with people in Amman and elsewhere in Jordan who are knowledgeable about the financial community. (A list of these persons is attached as Exhibit 1.) All of these interviews were arranged under the direction of Dr. Hashem Al-Sabbagh, General Manager of the AFM and his able assistant Ibrahim Balbeisi. Special mention should be made of AFM staffer Nader Azar whose untiring efforts served to make the trip both worthwhile and enjoyable.

The Amman Financial Market, after a period of relative inactivity, has been making excellent progress in the past six months. Indeed, the volume of trading in both numbers of shares and JD value during the time the author was in Jordan and the two months immediately preceding was substantially greater than at any time over the past two years.

A number of reasons were given for this rapid upsurge. Most of these were summarized in an article in the March 5, 1987 edition of The Jerusalem Star. Of these reasons the most mentioned during the interviews were (1) the Central Bank of Jordan's decision to lower interest rates on bank deposits, (2) fluctuations in foreign currency rates, (3) investors perception that many stocks had become substantially undervalued, i.e., pure speculation, (4) the stability of the Jordanian economy which, despite its periods of difficulty, tends to attract Arab funds for investment.

Despite this upsurge in activity on the AFM, there appear to exist substantial amounts of liquid assets which conceivably could be invested in both debt and equity instruments now traded on the AFM. For example, commercial bank deposits are at a relatively high level. And, while interest in real estate remains high, the office building boom has probably come to an end, leaving substantial amounts of capital free for investment in the securities markets.

There do, however, remain significant obstacles to the creation of a successful mutual fund. Perhaps foremost among these is a perceived lack of investor confidence in the trading markets. It is difficult to say whether this lack of confidence stems from a feeling that the market is being manipulated or not. On several occasions the author was told that the market is at the mercy of three or four speculators who are carefully watched and whose every move is quickly replicated with an attendant distortion of the supply and demand function.

I tend to discount much of this. Especially, if volume remains high it becomes progressively more difficult for one or two persons to seriously effect the price of a security.

Despite the substantial increase in volume on the AFM over the last several months, the brokerage community at the AFM seems somewhat demoralized. Much of this can be discounted as simply the usual complaints. One complaint that did seem to make sense, however, was that the regulations governing the AFM needed updating. All of the brokers interviewed argued that the rules were too restrictive and were antiquated. Each broker recommended that the trading floor be automated. Surprisingly, most of them urged the creation of a Jordanian equivalent to the United States Securities and Exchange Commission. Their point seemed to be that there was a need to separate the regulatory function from the market itself. Although, as stated elsewhere in this report, the point is well taken, I doubt that the persons making these assertions recognize the degree of regulatory control exerted by quasi-private entities such as the New York Stock Exchange over the floor trading community in the United States. Nevertheless, the perspective of these Jordanian brokers is important because mutual funds are not bought, they are sold. Without an energetic and enthusiastic force of retail brokers it is doubtful that the full potential of organizing investment companies will be felt.

An area which should be more deeply examined, in the investment company context, is that of commercial banking. The author was told time and again that the commercial banks in Jordan were highly liquid. The statistics collected by Jalil Shoraka in his report (see p. 5) seem to bear this out. This liquidity, together with the access such banks have to a large number of depositors, would suggest a built-in market for the sale of mutual funds.

Another sector of the Jordanian financial community which bears examination in the context of the development of an investment company industry is the relatively large group of insurance companies now operating in Jordan. (The author was told that the government is making an attempt, through an increase in capitalization requirements, to reduce this number.) Insurance companies also have a customer base which could be targeted for the sale of mutual fund shares. Indeed, the one insurance company executive whom the author interviewed expressed a degree of enthusiasm regarding this possibility.

Despite the possibilities in the commercial banking or insurance company industries, the key sector of the Jordanian financial community with regard to the promotion of mutual funds will be the merchant bankers. It is from within these investment houses that the push to develop new financial products must come.

III. THE INVESTMENT COMPANY INDUSTRY.

The term "mutual fund" is just another, less technical, way of describing an "open-end investment company" in the United States. An open-end investment company is an incorporated entity which continuously buys and sells its own shares in the marketplace. Trading in those shares does not take place in the secondary market. This is to be contrasted with a "closed-end fund" which, in theory at least, makes a single offering of its securities with the result that those securities trade, subsequently, like the securities of any other non-investment company in the secondary marketplace.

The vast majority of investment companies in the United States are of the open-end variety. While there has been no lack of problems in the investment company industry, these pools of capital are by far the best vehicle which has been found to enable the small investor to invest his money in the organized securities markets. Indeed, the remarkable growth of mutual funds in the early 1960's ultimately led to the unfixing of commission rates on the New York Stock Exchange in 1975 because of the dominating influence these pools of capital came to enjoy. Indeed, the amount of capital that mutual funds have to invest and disinvest in the stock market can, on any given day, seriously distort the supply and demand function and has led to the establishment of what are known as "block positioners," investment bankers who commit their own capital to the purchase of a portion of a block of securities from a selling mutual fund which in order to take advantage of the commission and later to resell the block at, hopefully, a slightly higher price per share.

It is important to understand the dynamics of the mutual fund industry. It has long been the conventional wisdom that "mutual funds are not bought, they are sold." The meaning behind this is fairly simple, i.e., that a strong retail sales force is necessary in order to contact potential purchasers of mutual fund shares and to explain the risks and rewards attached thereto. It is, for example, highly doubtful, in the author's judgment, that a single closed-end fund which often sells with minimal advertising would be very successful among the investment constituency in Jordan.

The principal problem in selling to the small investor is the same in Jordan as it is elsewhere. There is a need to inspire confidence in a small investor before that investor will invest his or her money in an equity security. Witness the flow of money into Jordanian depository institutions, insurance companies, and real estate after the speculative bubble on the Amman Financial Market burst in early 1983.

There is little doubt in the author's mind that any pool of investment capital should be managed by a professional money manager who is part of the private sector Amman financial community. There currently does not appear to be any cadre of professional money managers in the country with perhaps the exception of a few merchant bankers and some few people located in the commercial banking sector.

More appropriate would be the creation of a regulatory atmosphere in which the professional money manager and the professional securities analyst would thrive in the private sector. This does not mean that the author recommends a replication of the incredibly complex system which overlays investment companies in the United States. Whether correct or not, the imposition of a regulatory framework over an industry which is intensely complex and rapidly changing seems to inspire the confidence of the investment community to an extent that it would not otherwise be.

Perhaps the most important change that should be made is to amend the Companies Act of Jordan to facilitate the establishment of both open- and closed-end investment companies. The current draft of the Companies Act, in Part IX, has a rudimentary section which does permit the establishment of such vehicles. It is important, however, that whatever form the statutory authorization of investment companies takes, that the regulatory authority be lodged in a single administrative agency. It is currently less important (although ultimately it will be quite significant) whether that be the Central Bank of Jordan or whether an entirely new Jordanian Securities and Exchange Commission should be established. Regulatory authority must be vested in one agency where the principals or founders of an investment company can go to obtain the answers to the inevitable regulatory questions which arise without too long an elapse of time.

IV. REGULATORY CONCERNS.

The following is a discussion of the principal statutory and regulatory concerns with which the author believes any attempt to develop an investment company should deal.

A. Conflicts of Interest.

The heart of investment company regulation in the United States involves the control and regulation of conflicts of interest between the investment company and its managers. An understanding of this concept requires, as an initial step, a further understanding of the structure of the U.S. investment company industry.

Almost all investment companies in the United States are "managed externally." In other words, mutual funds themselves are really skeletal organizations with few, if any, employees that work directly for the mutual fund. Rather, the administration and management of the fund is contracted to a management company.

It is also important to understand that a mutual fund is not first organized and then seeks a manager. Invariably the management company (or a closely affiliated company) is the organizer and promoter of the fund. After the fund is successfully marketed, the promoter then enters into an investment advisory contract with the fund pursuant to which the promoter performs investment advisory services for the fund and is compensated for so doing.

It should not be difficult to see that this relationship is fraught with potential for conflicts of interest. Indeed, it was, in large part, the existence of this relationship which resulted in the adoption of the U.S. Investment Company Act in 1940.

There are several means by which the relationship between the fund (ultimately its investors) and the investment advisor are governed. First, under U.S. law, the shareholders of the fund must approve, each year, the advisory contract and certain other matters. While theoretically sound, this is probably the least effective mechanism of those available for restraining conflicts between the fund and the advisor. Individual investments in mutual funds tend to be quite small; the investors themselves are unlikely to spend much time reviewing a complex advisory agreement.

Second, and far more significant, is the use of the "independent" director. Although externally managed investment companies have little in the way of staff, they are required, like any corporation, to have a board of directors. The fund's board, usually numbering about a dozen directors, will have members at least forty percent of which may not be affiliated in any way with the investment advisor. (The investment advisor itself will retain several seats on the board.) These independent directors are charged with a number of duties, the most important of which is to review the advisory contract each year, prior to its submission to the shareholders of the fund, to ensure that the contract is fair and appropriate. Especially is this review performed with respect to the compensation that the advisor is to receive during the year.

Finally, the Securities and Exchange Commission plays a substantial role in monitoring the conflict of interest provisions in the Investment Company Act. For, in addition to prohibiting many conflicts, the Investment Company Act empowers the Securities and Exchange Commission to waive, in any particular case, any of the Investment Company Act's specific prohibitions. In such a case, the investment company or its advisor, as is appropriate, will apply in writing to the Commission for a waiver of whatever prohibition is a problem, the Commission's staff will review the application and make a recommendation to the Commission. While many of these applications are eventually granted, (sometimes after a good deal of informal negotiation with the Commission's staff) the important point to be made is that there does exist a central regulatory authority which can provide answers to such problems.

B. Disclosure.

Under the United States Securities Act of 1933, offering of securities by companies must be registered with the Securities and Exchange Commission before the securities may be sold. This statute is as applicable to investment companies as it is to any industrial company. Thus all investment companies are required to register (a rather complex process the details of which are beyond the scope of this report) their offerings of securities. In the case of a closed-end fund, the process is conceptually like any other company. The offering is registered and the securities are sold after which they trade, like the securities of any other publicly traded company, in one of the U.S. public markets.

The situation with respect to open-end funds is a bit more complex. Recall that an open-end investment company or "mutual fund" is continuously offering (and redeeming) its securities on a public basis. It is thus engaged in a continuous public offering. This requires it, under U.S. securities law to continuously maintain its registration.

Again, the details of an open-end fund keeping a registration statement "effective" are beyond the scope of this report. Suffice it to say only that the fund must continuously provide a current prospectus to each purchaser. In addition, the Investment Company Act requires that an investment company set forth in the prospectus which it is distributing to purchasers of its shares "a recital of policy" with respect to, among other things, the concentration of its investments in a particular industry or group of industries, the purchase and sale of real estate and commodities, portfolio turn-over, all investment policies which may be changed only by vote of shareholders, and other matters which the registrant deems matters of fundamental policy and elects to treat as such.

It is submitted that any Jordanian mutual fund regulatory system should provide for a formal disclosure system.

C. Sales Literature.

Because open-end investment companies make a continuous offering of their securities, it is customary to prepare sales literature in addition to the prospectus for use by the fund's salesmen. Under the Investment Company Act, any such sales literature must be filed with and reviewed by the Securities and Exchange Commission. In actual practice the Commission has delegated this function to the National Association of Securities Dealers ("NASD"), a trade group formed under the Securities Exchange Act of 1934 and over which the SEC has considerable authority. In general, the NASD's review tends to limit extravagant claims by funds about expected returns on a purchaser's investment.

D. Distribution Expenses.

Prior to 1980, the SEC traditionally took the position that it is improper for a mutual fund to pay any of the expenses of distribution of its shares. These expenses were always required to be financed out of any sales "load," if there was one, or out of the advisory fee. This position was based on the proposition that the existing fund shareholders received no benefit from the sale of additional shares of the fund, which primarily redounded to the benefit of the adviser since its compensation was tied to total fund assets. In 1980, however, the Commission abandoned this position by adopting a rule which permits the use of fund assets to pay distribution expenses subject to the following conditions:

1. any such payments must be made pursuant to a written plan;

2. the plan must be approved by a majority of the outstanding voting securities of the fund;

3. the plan must be approved by the funds board of directors as a whole and separately by its independent directors.

The regulation of distribution expenses is felt to be an extremely important part of the regulation of mutual funds in the United States. While this may not be felt to be quite so crucial, it is recommended that the regulatory system which governs Jordanian mutual funds have the authority to regulate and study the impact on investors of the use of fund assets to pay distribution expenses.

E. Custodial Functions.

The U.S. Investment Company Act provides for highly detailed and rather strict rules regarding the custody of mutual fund assets. As a practical matter, most investment companies maintain their assets in large banks which are physically equipped to handle these cumbersome custodial requirements. The Investment Company Act also provides for the electronic entry of deposits into a central securities depository or clearing agency.

The purpose behind these complex custodial requirements is obviously to reduce the opportunities for theft of portfolio securities by employees of the adviser. This system has worked reasonably well in the United States and should certainly be considered as an important feature of any investment company regulatory system.

V. CONCLUSIONS AND RECOMMENDATIONS.

The author believes that an investment company industry may, under carefully structured circumstances, become a dynamic part of the Jordanian financial community. Before such a development occurs, however, a number of matters must be accomplished. By far the most important consideration is the development of a legal and regulatory system in which the small individual investor will have confidence. In addition, the investment/merchant banking function in Jordan must be revitalized. The retail brokerage community is also a key feature and must be made aware of the mutual fund as a new and profitable product line.

Nevertheless, the first item of business should be the creation of a legal and regulatory business in which the nascent promoters of an investment company can function. In this regard the author makes the following preliminary recommendations.

1. The Jordanian Companies Act should be amended to provide for the incorporation of investment companies. In particular, the statute should provide, in substantially more detail than in the current draft, for open-end investment companies.

2. The companies Act should provide for a central regulatory authority governing the activity of investment companies in Jordan.

3. The statute should provide the central regulatory authority with substantial and flexible authority to issue regulations and rulings relating to the operations of investment companies.

4. The statute and the central regulatory authority should provide unambiguous regulations regarding the following areas:

   (a) conflicts of interest

   (b) disclosure

   (c) sales literature

   (d) use of fund assets to pay distribution expenses

   (e) custodial functions

EXHIBIT 1

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