Law of Alternative Investments in Bangladesh

Introduction

An alternative investment is a kind of investment that does not fall into one of the traditional investment categories. That is why it is called ‘alternative’ investment. There are three traditional categories of investment: (i) stocks, (ii) bonds and (iii) cash. Other than these three, any other class of financial assets may be termed alternative investment. Examples include: precious metals, art, wine, antiques, coins, stamps, film production, aviation, franchise, cryptocurrencies, private equity, venture capital, hedge funds etc**.**

Private equity, venture capital and hedge funds are a few of the popular alternative investment vehicles around the world. The purpose of both private equity and venture capital is to invest working capital into startups (new businesses) and help them restructure to accelerate growth, in the hope of future high return. The concept of private equity is broader, while venture capital is a particular subset of private equity. In both forms, capital is invested in exchange for an equity stake in the business rather than given as a loan.

These investments are generally made by established private equity firms or venture capital firms. These firms pool together money from institutions and high net worth individuals and make up the private equity or venture capital funds. A team of investment professionals (called managers) of these firms then raises and manages the funds and hunts for young or promising companies to invest.

The basic difference between private equity and venture capital is that while venture capital often goes into younger companies involved in unproven but promising technologies, funds described as private equity are more attracted to established businesses. It is called ‘venture’ capital because it invests in new ventures/undertakings. The other difference is that venture capitalists are usually with the target company for a long time, providing working capital for growth. Venture capitalists rarely obtain majority control in the target company. But in a private equity investment the aim is generally to acquire the target company, restructure and maximize profitability, and then sell it. So those in private equity tend to buy and sell quickly, while venture capitalists are there for a long haul.

Hedge funds also work in a similar way: accredited investors, e.g. banks, financial institutions, large corporations, or high net worth individuals, pool their money together and give it to a hedge fund. The hedge fund then invests the money in diversified ways using different investment strategies in order to generate high returns for their investors. Hedge funds offer wide investment latitude and can basically invest in anything: land, real estate, stocks, derivatives, and currencies. Hedge funds are considered distinct from private equity funds and venture capital funds, in that hedge funds generally invest in relatively liquid assets and allow investors to invest and withdraw capital periodically, whereas private equity funds and venture capital funds generally invest in illiquid assets and only return capital after a number of years.

Alternative investment funds in Bangladesh

The concept of alternative investment fund ("AI fund") is new in Bangladesh. Bangladesh Securities and Exchange Commission (Alternative Investment) Rules 2015 ("AI Rules") introduced three kinds of AI funds in Bangladesh: They are:

(1) Private equity fund
(2) Venture capital fund, and
(3) Impact fund

The Rules provides that the Commission may introduce other kinds of alternative investment in future.

Private equity has been defined as an equity investment in "potentially high growth non-listed portfolio companies with minimum 3 years' operational history". This includes "buyouts" of such companies.

Venture capital has been defined as an equity investment in "start-ups with less than 3 years' operational history or green field companies or emerging early-stage undertakings mainly involved in new products, services, technologies or intellectual property rights based activities or new business model". The definition does not mention buyouts of such companies.

Impact fund has been defined as an equity investment in "companies, organizations, and funds which are engaged in activities with the intention to general a measurable and beneficial social or environmental impact in addition to financial returns, as justified with internationally recognized criteria."

So impact funds are different from private equity or venture capital in that they are supposed to invest in charitable organizations, so that there is some "impact" on society and environment. In addition to an intention to receive financial returns, there must additionally be some beneficent intentions.

No provision for hedge funds has been made in the Rules, presumably because of the risks involved and the dearth of investment choice in Bangladesh.

Constitution of alternative investment funds: overview

Here's how an AI fund is supposed to work in Bangladesh:

A fund is be constituted in the form of a trust. A trust deed is prepared in accordance with Trusts Act 1882, which is first be approved by the Commission and then registered under Registration Act 1908.

The trustee of the fund will also have to be separately registered with the Commission. Any public limited company as defined in Companies Act 1994 may act as trustee. The trustee is the custodian of the fund.

A fund management company, known as “fund manager”, is registered with the Commission, who is supposed to manage and invest the fund.

Once the fund is registered under the Registration Act, the trustee and the fund manager jointly apply to the Commission for registration of the fund.

So there are lots of registration requirements under the AI Rules: registration of the fund under Registration Act, and separate registration of the fund, the trustee and the fund manager with the Commission under the AI Rules.

There are two entities which look after a fund: a trustee and a fund manager. The trustee is the custodian of the fund, who will receive payments from investors and deposit the money received by the fund in a scheduled bank account. The trustee will issue units to the investors and maintain a register of unitholders. It will enter into an investment management agreement with the fund manager, and that’s where the fund manager comes in. The fund manager’s job is to invest the fund and make investment-related decisions. It will prepare an “investment and fund management guidelines” and will make investment according to these guidelines.

So in an alternative investment the word “investment” has two distinct connotations: you invest in the fund by purchasing units, and then the fund manager in turn invests the fund by purchasing other companies’ shares.

Each fund will be formed to make a particular type of investment, whether private equity, venture capital or impact fund, and will operate within its defined boundary. So, for example, a private equity fund cannot invest in a company which has less than 3 years’ operational history.

There are at present 17 registered fund management companies in Bangladesh and 6 registered AI funds. In 2019 around US$ 15 million were invested in several start-ups in the country, which was much lower than previous year’s (2018) US$ 27 million.

The trustee

In order for an entity to be eligible to act as the trustee of an AI fund, it must meet the following criteria (Rule 14 of the AI Rules):

(a) be a public limited company incorporated under Companies Act 1994;
(b) has minimum paid up capital of Tk.1 crore;
(c) has adequate manpower and logistic support to discharge its duties as a trustee;
(d) has appointed a compliance officer for the trust having a minimum of five years’ service experience in the financial market;
(e) neither the trustee nor any of its affiliates or directors have any relation with the fund manager;
(f) neither the trustee nor any of its directors is a loan defaulter;

(g) does not act as arranger or advisor of the fund nor pursue any investor to or not to invest; and
(h) has no track record of default, negligence or non-compliance with any of the securities laws for discharging its duties, if it is in any way connected with the securities market.

Previously only banks, financial institutions and insurance companies could act as trustees of AI funds, and the trustee had to have Tk.5 crore as its paid up capital. A recent amendment (BSEC Notification dated 14.05.2020) made all public companies having only Tk.1 crore paid up capital eligible for the task. This means the Commission is broadening the horizon of the alternative investment industry.

Rule 15 contains the trustee's duties and responsibilities. The trustee will issue units to the investors upon receiving full payment against such units. The trustee must ensure that the issuance of units is carried out in accordance with the provisions of the AI Rules, the constitutive documents of the trust and any directions, guidelines or orders issued by the Commission. It shall receive payments from eligible investors for subscription of units and deposit the money received by the fund in a scheduled bank account maintained entirely for this purpose.

It is the trustee's duty to call the unit holders' meetings and enforce the decisions thereof. Appointing auditors is also the trustee's duty. It is also the trustee's duty to appoint an independent valuer for valuation of the fund's investment, and to appoint a Shariah Council if it is an Islamic fund.

The trustee will ensure that the title to all assets of the fund is lawfully vested in the trust. It shall hold the assets of the fund in its custody on behalf of the unit holders. It is not allowed to legally or beneficially own units of the fund.

The trustee will engage a fund manager and monitor the fund manager's activities in respect of investments out of the investible fund. The trustee will approve an investment committee for the fund upon recommendation of the fund manager. It will form an advisory committee for the fund from amongst the unit holders and hold periodical meetings of the committee. It will submit quarterly reports to the Commission on investments and investee companies, income and expenses of the fund and returns paid to investors, lock-in, information and status of complaints lodged by the unit holders and any other information as the Commission may require from time to time.

The fund manager

The fund manager must be a registered company. A foreign entity may act as a fund manager if registered in Bangladesh as such. The fund management company is required to be separately registered with the Commission under Rule 3 of the AI Rules. To be eligible to be registered with the Commission it must meet the following eligibility criteria:

(a) be a company or statutory body;

(b) it is stated in its memorandum of association that its object is to provide alternative investment fund management services;
(c) has a paid up capital of at least Tk.5 crore (if a foreign entity or foreign fund management company applies for registration of a fund manager through a wholly owned subsidiary company, the applicant must have a paid up capital of at least Tk.15 crore, but if such an application is made through a partially owned subsidiary company, the minimum paid-up capital requirement is Tk.10 crore);
(d) has minimum net worth of 75% of its total paid up capital;
(e) maintains adequate financial, technical, infrastructural and organizational facilities and human resources, and employ appropriate systems, procedures, technologies, processes and personnel to discharge alternative investment fund management services in a proper and efficient manner on an ongoing basis;
(f) prepares its financial statements as per International Accounting Standards (IAS) and International Financial Reporting System (IFRS) as applicable in Bangladesh, and audited as per Bangladesh Standards of Auditing (BSA);
(g) appoints a Chief Executive Officer (CEO) and/or a Chief Investment Officer (CIO) and a compliance officer each having a relevant academic background and at least 7 years relevant professional experience;
(h) neither the company nor any of its directors is a loan defaulter;
(i) neither the company nor any of its affiliates or directors has any relation with a Trustee to any alternative investment fund or mutual fund;
(j) has no track record of default, negligence or non-compliance with any of the securities laws for discharging its duties, if it is in any way connected with the securities market;
(k) maintains satisfactory internal controls and written compliance and risk management procedures addressing all applicable regulatory requirements.

The duties and responsibilities of the fund manager is spelt out in Rule 6 of the AI Rules. The main responsibility of the fund manager is to manage and invest the fund. It will prepare an ‘investment and fund management guidelines’ with approval of the trustee and ensure strict compliance of the guidelines. It will ensure that all investments are made as per these guidelines and are approved by the investment committee and the trustee before disbursement. No material change in the investment policy or objectives of the fund can be made without the approval of the unit holders and the trustee.

The fund manager must ensure that the investments made are properly identified and held for the benefit of the unit holders in accordance with the provisions of its constitutive documents, the AI Rules and other applicable laws. It will review policies and procedures and their implementation on a regular basis to ensure their continued appropriateness.

It must act responsibly in a fiduciary capacity towards the investors and shall disclose to the investors all conflicts of interests as and when they arise or seem likely to arise. It should establish and implement written policies and procedures to identify, monitor and appropriately mitigate conflicts of interest.

It is the duty of the fund manager to ensure transparency and disclosure of information to investors, in particular on the following: (a) financial, risk management, operational, portfolio, and transactional information regarding fund investments, (b) any fees ascribed to the fund manager or the trustee and any expenses charged to the fund, (c) any inquiries/legal actions by legal or regulatory bodies of any jurisdiction, (d) any material liability arising during the fund's tenure, (e) any breach of provision of the placement memorandum or agreements or any other constitutive documents, and (f) change in control of the trustee, sponsors, fund manager and portfolio companies.

The fund manager must also ensure that the company, its directors and employees and members of the investment committee do not have any material interest in any portfolio company. It will prepare code of conduct for its directors and employees to mitigate conflict of interests. It will closely monitor the activities of portfolio companies and if necessary, participate in the management and represent in the board of directors of such companies with approval of the trustee.

It is the fund manager's responsibility to address all complaints made by the investors. It will lay down procedure for settlement of disputes between the investors, the fund, the fund manager, the trustee or the sponsor through arbitration or any other mechanism as mutually decided.

The fund

As per Rule 8 of the AI Rules an alternative investment fund must be constituted in the form of a trust under the Trusts Act 1882 and registered under the Registration Act 1908. The fund must also be registered with the Commission under Rule 9.

Such a fund may be operated as a general fund or an Islamic fund. It must conform to the following criteria:

(a) minimum fund corpus of at least Tk.10 crore and subscription by the sponsors is not less than 10% of the corpus; the sponsors must subscribe at least 20% of its total subscription to the fund before registration of the fund ("sponsor" means one or more eligible investors subscribing initially, jointly or solely, to form a fund);
(b) minimum investment by the fund manager must be at least 2% of the fund corpus;
(c) along with its connected persons, the fund manager must not hold more than 30% of the units of a fund at any point of time.

Thus the minimum size of an alternative investment fund is Tk.10 crore, which will have a lifetime of 5 to 15 years. This lifetime may be extended or shortened by 2 years if allowed by two-third majority of the unit holders.

The units of the fund cannot be listed in the main board of any stock exchange, but the fund may, for transfer purposes, be listed in any alternative trading board (ATB) of the exchange.

Only eligible investors may make investment in an AI fund, i.e. purchase units in a fund. An eligible investor may buy/sell units of the fund from/to other eligible investors only. For the purposes of the AI Rules, basically any type of registered company may be an eligible investor, whether Bangladeshi or foreign, including banks, financial institutions, insurance companies, asset manager, merchant bankers, stock dealers etc. Registered trust/pension/provident/superannuation funds will be eligible. Any foreign individual may invest, but only high net worth Bangladeshi individual may invest. A “high net worth individual” has been defined as a person having minimum net worth of Taka 2 crore as certified by the tax authority. The minimum subscription to the units of a fund shall be Tk.10 lac by each investor.

The sponsors must maintain a continuous investment of not less than 2.5% of the fund corpus. An alternative investment fund is allowed to declare to its unit holders cash dividends only. All investments in a fund will remain locked in for a period of 2 years from the date of issuance of units.

An AI fund which has been granted registration for a particular category of investment cannot change its category subsequent to registration. A fund will realize and invest at least 50% of the fund corpus within a period of 5 years from the date of registration, and in the event of failure the fund manager must refund the amounts realized from the investors.

At least 75% of the fund corpus must be invested in non-listed securities of portfolio companies. Maximum 25% of the fund corpus may be invested in listed securities and units of alternative investment funds managed by other fund managers, of which maximum 10% may be invested in money market instruments. Investment in a single listed securities must not exceed 5% of the fund corpus. No AI fund is allowed to invest more than 25% of the fund in a single non-listed portfolio company. These restrictions are not applicable in case of buyouts by a private equity fund. AI funds may invest in non-listed portfolio companies only in equity and equity linked instruments, but never in pure debt securities, nor can they provide any loan.

In case of an Islamic fund the activities of the investees must be Shariah compliant. In determining the Shariah compliance status of the investee and investments, the fund manager will disclose the Shariah screening methodology prepared by the Shariah Council in the constitutive documents. Investment by an Islamic fund must be made only in the securities/companies classified as Shariah compliant as per the screening methodology and declared as Shariah compliant by the Shariah Council.

An alternative investment fund is required to be wound up (a) when the tenure of the fund as mentioned in the constitutive documents comes to an end, or (b) in the opinion of the trustee winding up of the fund is necessary in the interests of the unit holders, or (c) if 66% of the unit holders by value of their investment in the fund pass a resolution at a meeting that the fund be wound up, or (d) if the Commission so directs in the interests of the investors, or (e) by order of a competent court.

Following are the registered AI funds (private equity and venture capital funds) currently in operation:

SL.	Name of the Fund	Name of the Fund Manager	Nature of the Fund	Name of the Trustee	Fund Corpus (Tk.crore)
1	Alternative Investment Fund of Bangladesh	Strategic Equity Management Ltd	Private Equity	The Premier Bank Limited	500
2	BDVL Venture Fund 1	BD Venture Limited	Venture Capital	IPDC Finance Limited	50
3	Build Bangladesh Social Entrepreneurs Fund	Impress Capital Limited	Impact Fund	Green Delta Insurance Company Limited	83
4	IDLC Venture Capital Fund I	IDLC Asset Management Limited	Venture Capital	Green Delta Insurance Company Limited	45
5	LankaBangla 1st PE Fund	LankaBangla Asset Management Company	Private Equity	Green Delta Insurance Company Limited	25
6	Maslin VC Fund - I	Maslin Capital Limited	Venture Capital	Union Capital Limited	10

Conclusion

The success of global companies like Google and Facebook is not only attributed to their founders but also to the venture capital investors like Sequoia Capital, Kleiner Perkins, Accel Partners and Peter Thiel, among others, who financially assisted them when they were only startups. Promising startups in Bangladesh should also receive investments from alternative investment firms. Contribution from venture capital and private equity investments will no doubt help foster home-grown startups that can contribute to the capital market in Bangladesh.

As a new concept in Bangladesh, AI funds are yet to be explored fully. In order to meet the necessity of a huge consumer base, AI funds can invest in vast areas of businesses for expansion and fund companies in their early stages of operation. Such an initiative can eventually decrease the unemployment rate and create more opportunities in the economy.

There is a need for policy support to create an alternative investment industry, and the government might just have started doing that. Bangladesh Securities and Exchange Commission has facilitated the market by putting in place the necessary legal infrastructure in the form of the AI Rules. In line with this, Bangladesh Bank is also working to encourage banks and financial institutions to invest in AI funds by relaxing its guidelines on risk-based capital adequacy and lowering the risk weight against such investment tools. Previously the banks were instructed to calculate 150% risk weight against their investments in venture capital funds. According to the latest amendment the banks are allowed to lower the risk weight against investments in venture capital funds to 100%. The high risk weights worked as a discouraging factor, but the relaxation will work as an encouragement.

Along the same lines, the finance ministry has also cut the stamp duty on registration of trust deed of AI funds to 0.1% from previous 2%. It also set the maximum stamp duty at Tk.10 lac and the minimum duty at Tk.5,000 on the total value of the deed, bringing great relief to the fund managers and sponsors of AI funds.

Thus the policies and initiatives are set in motion, and it remains to be seen whether the promising startups, with the help of AI funds, are able to create an ecosystem that can contribute up to 2 percent of the GDP of Bangladesh by 2025, a somewhat fervent hope recently expressed by the Venture Capital and Private Equity Association of Bangladesh.