

بِسْمِ اللَّهِ الرَّحْمَنِ الرَّحِيمِ

9040628276

مؤسسة النقد العربي السعودي

المركز الرئيسي

إدارة الإشراف البنكي

التاريخ: ١٤٣٨/٥/٢٠

الرقم: ٣٦٥ / ١٨٣١٢ / ١٨٣١٢

الموافق: ١٩ / ٥ / ١٩٣٨

المرفقات: ١٩

تعميم

المحترم

سعادة/

السلام عليكم ورحمة الله وبركاته

مرفق بطيه مسودة أولية لمشروع المعيار الذي يعتزم مجلس الخدمات المالية الإسلامية (IFSB) إصداره المتعلق بـ "المبادئ الإرشادية لحوكمة المنتجات الاستثمارية الإسلامية" (Guiding Principles on Governance for Islamic Collective Investment Scheme).

لذا نأمل توجيه المختصين في البنك بدراسة مسودة المعيار المشار إليه أعلاه وتزويد المؤسسة بشكل عاجل بما لديكم من ملاحظات ومرئيات ، وذلك قبل تاريخ ٢٥/٥/٢٠٠٧م.

طيفر

وتقبلوا تحياتي ،،،

وكيل المحافظ للشئون الفنية



د. عبد الرحمن بن عبد الله الحميدي

جميع البنوك المحلية .

٨٤٠٧



ISLAMIC FINANCIAL SERVICES BOARD

**EXPOSURE DRAFT OF
GUIDING PRINCIPLES ON GOVERNANCE FOR
ISLAMIC COLLECTIVE INVESTMENT SCHEME**

Comments on this Exposure Draft should be sent
to the IFSB's Secretary-General not later than DD MMM YY
at email ifsb_sec@ifsb.org or facsimile +603-26984280

[Version 1: 5 March 2007]

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ACRONYMS

BCBS	Basel Committee on Banking Supervision
BOD	Board of Directors
CIS	Collective investment scheme
IAH	Investment account holder
IFRS	International Financial Reporting Standard
IFSB	Islamic Financial Services Board
ICIS	Islamic collective investment scheme
IIFS	Institutions offering only Islamic financial services (excluding Islamic insurance/ <i>Takaful</i> institutions and Islamic mutual funds)
IOSCO	International Organization of Securities Commissions
IRR	Investment risk reserve
OECD	Organisation for Economic Co-operation and Development
PER	Profit equalization reserve
SSB	<i>Shari'ah</i> Supervisory Board
UCITS	Undertakings for collective investment in transferable securities

Bismillahirrahmanirrahim.
Allahumma saili wasallim 'ala Sayyidina Muhammad wa'ala ālihi wasahbihi

PREAMBLE

1. In December 2006, the Islamic Financial Services Board (IFSB) issued its Guiding Principles for Corporate Governance of institutions offering only Islamic financial services (IIFS) – known as IFSB-3.¹ In order to further strengthen the governance practice in the Islamic financial services industry (IFSI) with a broader view of promoting soundness and stability of the Islamic financial system, the IFSB Technical Committee during its meeting in Jeddah in December 2005 approved that the IFSB develops a second tier of its governance standard by focusing on collective investment schemes (CIS) which are claimed to be *Shari'ah*-compliant, sometimes referred to as Islamic unit trust, Islamic mutual funds or Islamic investment funds, depending on the jurisdiction.²
2. For the purpose of synchronizing key terminologies in this document in line with more internationally recognized standards for investment funds,³ the IFSB decides that the term "Islamic collective investment scheme" (ICIS) is more appropriate to be used for the rest of this document. In line with this premise, where appropriate, the key terminologies herein are defined and adapted accordingly.⁴
3. As ICIS is primarily a capital market instrument, the standard would mark a first prudential standard developed by the IFSB in the area of Islamic capital market (ICM). In this respect, the standard has specific aims of complimenting the internationally recognized governance standards by reinforcing international best practices while addressing the specificities of ICIS. The IFSB recognizes that certain governance issues are of equal concern to all CIS, whether Islamic or otherwise. Therefore, this document will not attempt to reinvent the wheel by proposing a wholly new governance framework for ICIS. Instead, it would focus on filling the appropriate best practice gaps identified by the IFSB, particularly with regard to governance issues which are specific to ICIS.
4. The IFSB has carried out its own survey on ICIS. Its findings are quite consistent with the surveys conducted by the IOSCO on CIS,⁵ that – regardless of the diverse CIS framework applied in different jurisdictions – they still share many similar governance concerns, such as independence of oversight over CIS operators' conducts and execution of fiduciary duties, transparency in disclosures of material information, etc. In the case of ICIS, the requirement to comply with the *Shari'ah* not only reinforces the call for good governance, but also influences the way governance structure and process shall be implemented. Therefore, the IFSB believes that existing applicable international principles in respect of good governance have not been found to contravene or be

¹ IFSB3 contains seven guiding principles for strengthening corporate governance of IIFS which complement the existing international corporate governance standards set by the Organisation for Economic Cooperation and Development (OECD) and the Basel Committee on Banking Supervision (BCBS). In addition to reinforcing especially focuses on the protection of investment account holders (IAH) and compliance with *Shari'ah* rules and principles, which are two important specificities of IIFS.

² For example, the Accounting and Auditing Organisation of Islamic Financial Institutions (AAOIFI), Financial Accounting Standard No. 14 includes a definition for "investment fund". The Dubai Financial Services Authority (DFSA) in its Collective Investment Law 2006 defines "Islamic fund". Meanwhile Banque du Liban in its Basic Circular no. 98 (2005) also defines "Islamic Collective Investment Schemes".

³ The International Organization of Securities Commissions (IOSCO) has, amongst others, established the Principles of Securities Regulation 17-20 which relate to CIS, known as the CIS Core Principles. The European Council has issued directives on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities, better known as the UCITS Directives.

⁴ In particular, we have used IFSB-3, the IOSCO Public Documents (IOSCOPD), as well as the UCITS Directives as main references. Please refer to page 30.

⁵ See for example, IOSCOPD no. 219, *Examination of Governance for CIS Part I – Final Report*, June 2006 and IOSCOPD no. 222, *CIS in Emerging Markets*, July 2006..

incompatible, in general, with *Shari'ah* rules and principles. Therefore, we hold the view that rigorous compliance with internationally accepted governance best practice is actually compatible and in line with objectives (*maqasid*) of the *Shari'ah*.

Definition of ICIS

5. Considering the diverse legal and regulatory framework for ICIS around the world and the rapid introduction of new ICIS products through sophisticated financial engineering and innovation, the IFSB faced a major challenge in forming an appropriate definition for ICIS. However, we acknowledge that "independence"⁶ of review and oversight, as well as integrity and transparency, cannot be judged solely based on whether the ICIS is established as a separate legal entity, nor simply by having its organs of governance from amongst non-executives. What is more important is an effective management of the conflicts, as well as the risks, encountered by the ICIS. Hence, in order not to miss the bigger picture, emphasis should be given on whether, when the collage of several fundamentals elements such as the nature of operation, risk profiles and strategic objectives of the fund's set-up, as well as the nature of relationship between the fund and its investors, a fund can be concluded as an ICIS.
6. Therefore, for the purpose of this standard, ICIS is defined as "any structured financial scheme which:
 - (i) allows a pool of investors to contribute capital to a fund (whether the fund is in a corporate or contractual form) by subscribing to units or shares of equal value. This unit or share represents ownership claims to the assets of the fund (which can be financial or non-financial assets), and entitlement to profits or losses derived from those assets;
 - (ii) are established and managed in accordance with *Shari'ah* rules and principles;
 - (iii) may or may not be managed by the institutions that establish/sponsor them; and
 - (iv) are financially independent of the institutions that establish them, although they may or may not be separate legal entities. Amongst others, an ICIS may take the form of:
 - (a) authorised open-ended funds that will redeem their units or shares, whether on continuous basis or periodically;
 - (b) closed-end funds, whether those whose units or shares are tradable (in regulated or unregulated securities market), or untradable;
 - (c) unit investment trust, contractual model and the European UCITS model;
 - (d) an individual fund or as an umbrella fund (multiple compartment funds comprising various sub-funds); or
 - (e) profit-sharing investment account (whether restricted or unrestricted) which fund is pooled in a form of a CIS and whereby each of the investment account holders (IAH) is governed by the same terms and conditions;while still meeting the criteria of (i), (ii) and (iii).
7. However, our scope of ICIS shall exclude:
 - (i) funds which are not pooled in a form of a CIS, such as certain types of investment accounts which are not based on profit-sharing and treated more like

⁶ While the definitions of "independence" for directors, internal auditors and compliance functions, as well as for the SSB, may vary somewhat across different jurisdictions, and are often reflected in regulations or supervisory standards, the Guiding Principles consider that the key characteristic of independence is the ability to exercise sound judgment after fair consideration of all relevant information and views without undue influence from management or inappropriate outside interests. The extent to which supervisory authorities establish stringent tests of either independence or non-independence for the respective organs of governance may depend, amongst other things, on the extent to which there is a party or parties who are in a special position to influence the IIFS in an abusive or manipulative manner. See also IFSB-3.

- (ii) capital guaranteed deposits;⁷
- (ii) funds established by Islamic insurance/*Takaful* operators, as they constitute a different segment of the Islamic financial services industry and will be addressed by the IFSB in separate documents; and
- (iii) pension funds, as they are arguably a different specie from ordinary CIS.

Scope of ICIS Governance

8. As highlighted by the IOSCO, the operation of CIS potentially entails conflicts between the interests of those who invest in CIS (**CIS Investors**) and those who organize and operate the CIS (**CIS Insiders** or **CIS Operators**).⁸ It must be borne in mind that the general goal is not to protect investors from suffering any market-driven loss, but rather to enable investors to understand the risks pertaining to investments in specific CIS. This would hopefully shield the CIS Investors from any loss due to misleading, manipulative and fraudulent practices, as well as malfeasance or negligence on the part of the CIS Insiders.
9. Accordingly, CIS Governance which is described as "a framework for the organization and operation of CIS that seeks to ensure that CIS are organized and operated efficiently and exclusively in the interests of CIS Investors (including both resident and potential investors), and not in the interests of CIS Insiders" is expected to minimize or otherwise address conflicts of interest and to ensure that the interests of well-informed investors in CIS are well protected and managed in the best conditions.
10. In the context of ICIS, good governance should further encompass:
 - (i) a set of organizational arrangements whereby the actions of the management of CIS Insiders are aligned, as far as possible, with the interests of its stakeholders, including the community (*Ummah*), guided by the objectives (*maqasid*) of the *Shari'ah*;
 - (ii) provision of proper incentives for the organs of governance such as the Board of Directors, *Shari'ah* Supervisory Board (SSB) and management to pursue objectives that are in the interests of the stakeholders and facilitate effective monitoring, thereby encouraging ICIS to use resources more efficiently; and
 - (iii) strict compliance with *Shari'ah* rules and principles.
11. The IOSCO recognizes that safe for the minor details, CIS are typically organized under two structures:
 - (i) **contractual model** –whereby the CIS as an investment fund only exist as a trust or contract between the operator and individual investors; and
 - (ii) **corporate model** – whereby the CIS takes the form of investment companies, legally registered as corporations.

In certain jurisdictions, there could be found a CIS which is a hybrid of these two main models, thus the **Hybrid Model**.

⁷ This exemplifies how this standard differs from IFSB-3. Although IFSB-3 already contains governance principles which cater for the protection of IAH, it has not covered investment accounts which, when we analyze their fundamentals, clearly operate as ICIS. In other words, IFSB-3 does not cover investment accounts which have elements such as unitized subscriptions, and tradability of those units (whether in regulated or unregulated securities market), as dealt with in this standard.

⁸ Please refer IOSCO PD-219. Correspondingly, in the ICIS set-up, the main potential conflicts would be between the interest of **ICIS Investors** (which include resident and potential investors) against **ICIS Insiders** or **ICIS Operators**. For example, ICIS could be subject to the risk that ICIS Operators, although being legally committed to the fiduciary responsibilities of acting on behalf of the best interests of ICIS Investors, will use the ICIS's assets for their own gain to the detriment of ICIS Investors. ICIS Operators could rid themselves of unattractive securities that they own by dumping them into the ICIS, or CIS Operators could obtain rebates from third parties in connection with transactions for the CIS or could inaccurately value or inflate their assets in order to avoid showing poor performances.

12. However, in many of the IFSB member jurisdictions, the IOSCO's assumptions cannot be applied. The IFSB notes that amongst others, in many member countries (although not all) there barely exists any fiduciary law or trust law, and there is rare presence of independent custodian/trustee corporations. Some countries also do not have laws that recognize the creation of special-purpose vehicle (SPV) companies. SPVs are commonly used amongst international ICIS sponsors as a legal strategy to protect the fund's assets and separate the insolvency risks between the fund itself and its sponsors; however, the lack of legal recognition over SPVs under the insolvency laws of some countries has usually forced ICIS Sponsors to establish such entities in other jurisdictions such as the Bahamas, Cayman Island and British Virgin Islands.
13. These have forced many supervisory authorities to form a CIS regime whereby banks play multiple-roles in the operation of the CIS, including sometimes custodian/trustee of the funds' assets. Usually the external auditor will also become the administrator, as additional safeguards to retain investors' confidence.
14. Therefore, depending on the structural form, a number of different entities, such as the regulators, investors, sponsors, managers, auditors, broker-dealers, board of directors/governors (BOD), trustees and depositaries, SSB, Self-Regulatory Organizations (SROs) and insurance funds can play a role in the ICIS Governance framework. However, each organ of governance can only be effective if they collectively execute their roles well and recognize the importance of complementing one another. In this respect, ICIS are expected to view compliance with these regulations from a **holistic perspective**.

How to use the standard

15. This document contains five guiding principles (hereinafter collectively referred to as the **Guiding Principles**). The Guiding Principles are divided into four parts:
 - (i) Part I on general governance approach and Part II on transparency of disclosure reinforce the promotion of good governance practices as prescribed in other internationally recognized governance standards;
 - (ii) Part III on compliance with *Shari'ah* rules and principles addresses various specificities of ICIS which include (a) the process of portfolio screening by ICIS Operators, (b) the role of *Shari'ah* scholars in monitoring consistent compliance with the *Shari'ah*, especially through SSBs, and (c) the process of purification (*tazkiyyah*) of tainted income i.e. income which is contaminated by prohibited (*haram*) elements; and
 - (iii) Part IV on additional protection for ICIS investors highlights the issues of adequacy of representation for investors in the organs of governance of ICIS, as well as some prevalent practices revealed from the survey which require appropriate oversight, such as the transfers and commingling of funds, as well as smoothing/stabilising of dividend payments in ICIS.
16. The Guiding Principles provide some examples of current practices that can be considered as best practices; with due recognition that these practices will and should change as markets change and as technology, financial engineering and improved coordination between supervisory authorities make other strategies available. It is not the intent of the Guiding Principles to prescribe every possible control procedure. Instead the IFSB will keep continue to review and revise these recommendations from time to time.
17. To help illustrate the governance structure of ICIS based on the different corporate and contractual models of CIS framework set out by the IOSCO, charts of the five ICIS models are included in **Appendix I**. For further guidance on several ICIS frameworks applied in IFSB member-countries, a list of them is set out in **Appendix II**. In addition, there are at least 24 IOSCOPDs which have been issued on various aspects relevant to

CIS Governance and this is list out in **Appendix III**. Hopefully all these would facilitate supervisory authorities in reviewing and updating their own ICIS Governance requirements.

18. With regard to the disclosure requirements to promote better transparency in ICIS, the Guiding Principles recommend adoption of the "comply or explain" approach, in order to allow the implementation of these Guiding Principles to accommodate the diverse legal frameworks of the jurisdictions in which the ICIS operates and be commensurate with the size, complexity and nature of each ICIS.⁹

⁹ IFSB-3 explains that the "comply or explain" approach builds on the idea of market discipline, whereby stakeholders are empowered to react to unsatisfactory governance arrangements or substandard disclosures (which can be either false, substantially incomplete or misleading). The stakeholders' sanctions may range from reputational damage for the ICIS, to loss of trust in the management – forcing some managers to quit, to legal actions based on contractual terms. Supervisory authorities particularly should have adequate enforcement instruments, from the power of directing necessary disclosures, to imposing reprimands and fines to curb deliberate serial non-compliances.

THE GUIDING PRINCIPLES

Part I – General Governance Approach of ICIS

Principle 1: ICIS shall establish a comprehensive governance policy framework which protects the independence and integrity of each organ of governance and set out mechanisms for addressing conflicts of interest.

Structure and Process

19. ICIS shall strive for consistent improvement of its governance by establishing a comprehensive governance policy framework which protects the independence and integrity of each organ of governance and set out mechanisms for addressing conflicts of interest. At the core of the comprehensive governance policy, there must be:
- (i) continuous adoption of international best practices; and
 - (ii) assurance that the ICIS's highest internal governing body (GB), (whether it takes the form of the BOD, the investment committee, or the management committee, etc.), shall be responsible for steering the establishment of the governance policy framework and overseeing its implementation.

Recommended Best Practices

20. ICIS shall establish the appropriate code of ethics/code of conducts to be complied by the members of its highest GB as well as its employees. There shall be adequate system in place to monitor compliance with these codes, and to ensure that any misbehaviour or misconducts are swiftly and effectively dealt with. In particular, members of the GB and the ICIS employees shall be required to declare whenever they find themselves in a position of making a decision on behalf of the ICIS but is in direct conflict with their personal interest or interest of parties related to them (like family, etc.). In such cases, it should be mandatory on them to abstain from getting involved in the decision making process.
21. For each of the organs of governance, the ICIS shall carry out a detailed analysis of the types of conflicts of interest situations that arise in the course of its operation and management. There shall be developed system to check the level of their conflicts of interest and adequate guidance to determine whether they should be:
- (i) strictly prohibited from subscribing to the ICIS;
 - (ii) allowed to subscribe to the ICIS but must hold on to their investment (prohibited from disposing) for a specific length of time; or
 - (iii) allowed to subscribe to the ICIS and dispose of their investment at any time but must disclose their transactions/ interests.
- This should cover all ICIS Insiders including the sponsors, managers, auditors, broker-dealers, GB, trustees/custodians, depositaries/administrators, as well as the SSB.
22. If the ICIS enters into an arrangement to delegate or outsource any of the functions of an organ of governance to external parties, the GB shall take reasonable steps to ensure that it implements and maintains systems and controls to monitor the party carrying out the relevant activity or function. This includes a progressive review of the carrying out of the relevant activities or functions, at least every 6 months. Immediate action shall be taken to remedy any non-compliance of the terms and conditions of the delegation or outsourcing arrangement, and the supervisory authorities should be notified in case of any major non-compliance.
23. As much as possible, the GB shall clearly fortifies the independence and integrity of the ICIS organs of governance through legal, financial and administrative separations. Physical firewalls such as different office premises for each of the ICIS insiders,

restriction and controls over market-sensitive information, and progressive independent reviews such as by the auditors, should be useful in creating an atmosphere of strong independence and integrity amongst the ICIS Insiders.

24. It would be helpful if the ICIS can establish adequate channels for stakeholders, especially ICIS Investors, to seek clarifications or convey their concerns to the GB. While some jurisdictions require the holding of general meeting of ICIS Investors for these purposes, a more fluid and open system – such as that which allow e-mail inquiries – can be put in place
25. Furthermore, the ICIS shall facilitate any ICIS Insiders who wishes to report or highlight incidents of malpractices within the ICIS or otherwise perpetrated by the ICIS. "Whistle-blowers", as these informants often called, plays a very important role in checking and stopping ethically or legally wrong practices that can bring the ICIS into trouble and disrepute.

Part II – Transparency in Disclosure

Principle 2: ICIS shall ensure that disclosure of material information is not only done with appropriate accuracy and timeliness, but also presented in an investor-friendly manner.

Structure and Process

26. Although generally under the principle of *Muḍārabah* the ICIS Investors as capital owner (*rabbul māl*) shall not intervene in the management of the investments made on their behalf, it does not mean they should also be deprived from accessing the appropriate information in order to monitor the performance of the ICIS. Without adequate disclosure, it would be difficult for ICIS Investors to even vote with their feet and simply withdraw their investments. It goes without saying that accuracy and timeliness of disclosures play a significant role in ensuring market discipline and efficiency. In this respect, it is the duty of ICIS to present to ICIS Investors with information that appropriately reflects the investment profile of the ICIS, as well as the associated risks.
27. Financial reporting is certainly a critical component of good governance. Those overseeing or involved in the financial reporting process have unique responsibilities because financial reporting is a public interest activity.¹⁰ As much as shareholders commit their funds to companies relying, in part, on management's representations and on the auditor's opinion that a particular company's financial statements fairly reflect the financial position, results of operations and cash flows of the company, the same goes to ICIS Investors who bear the risk of losing their capital. If ICIS investors cannot rely on the quality of information provided to them, it would influence their investment decisions. It has always been argued that information asymmetries effectively increase the cost of capital. Past scandals have taught us that when investors question the integrity of financial information, they become risk averse or risk avoiding, often to the detriment of the local economy. This is particularly true of financial institutions. When markets lose confidence in the integrity of financial information or when markets can no longer trust the issuer of financial information, the negative effects can be dramatic.
28. Therefore, it is only appropriate that ICIS Operators recognise their responsibility to the investors and the markets. This would increase market confidence in ICIS. Some of the key issues for those involved in the financial reporting process may include:
- (i) for ICIS managers, they must ensure that the financial statements reflect economic reality and comply with the relevant accounting and reporting standards. This is in the ICIS's best interests – as well as the investors, because transparency has a direct impact on the cost of capital. In fact, while a lack of transparency in the short term may appear to be beneficial, over a longer period it can be very costly.
 - (ii) for auditors, this means following appropriate auditing standards, acting with competence and integrity and providing a truly independent audit opinion.
 - (iii) for regulators, it means designing sound regulatory mechanisms, assessing compliance with appropriate standards and having effective enforcement mechanisms.
 - (iv) for trustees, SSB and other ICIS Insiders, it means ensuring that conflicts of interest are well managed and addressed.
29. It follows that the methods of disclosure can be divided into three categories:
- (i) disclosure at the offering stage of the investment (this takes the form of prospectus, placement memorandum, etc.) which is a mixture of integrity disclosure and investment-related disclosure;

¹⁰ Ian Ball, "Enhancing Transparency and Market Discipline in the Islamic Financial Services Industry", International Federation of Accountants, May 2004.

- (ii) progressive disclosure (which takes the form of quarterly reports, semi-annual reports and annual reports); and
 - (iii) timely disclosure (which sometimes may be a non-financial disclosure relating to significant events) that affects the governance evaluation of the ICIS.
30. In addition, ICIS shall include in their disclosure to the supervisory authorities and the ICIS Investors the status of their compliance with this standard in two components:
- (i) In the first component, the ICIS shall report how it applies these Guiding Principles. The ICIS may determine by itself the form and content of its disclosure based on their own governance policies in the light of the Guiding Principles, including any special circumstances applying to it which might have led to a particular approach; and
 - (ii) In the second component, the ICIS shall either confirm that it complies with the provisions of these Guiding Principles, or, where it does not so confirm, provide a clear and adequate explanation of the reasons for non-compliance.

Recommended Best Practices

31. Emphasis should be given on providing relevant and reliable information that is crucial to the ICIS Investors in understanding and properly evaluating how their investments are managed. This would not be achieved by simply disclosing as much information as possible and inundating the ICIS Investors with tonnes of information, as it will only bring information overload which eventually can confuse and mislead the investors.
32. It is recommended that ICIS ensures that the disclosure of the following information in all its key documents (such as the prospectus, constitution and annual report):
- (i) information about the GB – including its bylaws, size, membership, selection process, qualifications, other directorships, criteria for independence, material interests in transaction or matters affecting the ICIS, as well as the senior management (responsibilities, reporting lines, qualifications and experiences);
 - (ii) basic ownership structure – for example, major share ownership and voting rights, beneficial owners, major unitholders' participation on the board or in senior management positions, unitholders meetings;
 - (iii) organizational structure – for example, general organizational chart, business lines, subsidiaries and affiliates, management committees;
 - (iv) information about the incentive structure of the ICIS – for example, remuneration policies, executive compensation, bonus fees, etc;
 - (v) the ICIS's code or policy of business conduct and/or ethics (including any waivers, if applicable), as well as any applicable governance structures or policies (in particular, the content of any governance code or policy and the process by which it is implemented, as well as a self-assessment by the GB of its performance relative to this code or policy);
 - (vi) the ICIS's policies related to conflict of interest, as well as the nature and extent of transactions with affiliates and related parties (which may be in aggregate form for routine financing facility to employees), including any ICIS matters for which members of the GB or senior management may have material interests either directly, indirectly or on behalf of third parties; and
 - (vii) the financial administration of the ICIS, including methods of profit calculation, asset allocation, investment strategies and mechanics of smoothing the returns (if any, including any changes thereto).
33. It is important to ensure that information is readily available in a comparable, understandable, readable and reliable form, so that it is easily accessible not only by ICIS Investors, but by information intermediaries for consumers such as the media, financial advisers and consumer associations. The information intermediaries are likely to use the

information to draw attention to good and bad features more effectively than consumers would typically be able to do for themselves. This process would be helped by:

- (i) standardization of terms and language;
- (ii) comparable measures of, or ways of explaining, charges, risks, profit calculation, asset allocation, investment strategies and mechanics of smoothing the returns (if any); and
- (iii) easy access to such information¹¹.

34. In recent times, specialized software has been developed that allows ICIS investment managers and SSB to track portfolios with ease. Such software, when connected to the Internet, will also provide real time access to portfolios, as well as a host of third party information. As far as possible, ICIS should ensure that it updates its information and data facility to facilitate more efficient dissemination of information to the relevant stakeholders, including the ICIS Investors.

¹¹ For example, in Malaysia and Saudi Arabia, in addition to monthly and quarterly investment statements sent to the investors, they can also check the performance of their investment in the ICIS by accessing the web site of Bursa Malaysia (klse.com.my) and *Tadawul* stock market (www.tadawul.com.sa). Most of the ICIS are listed there, and it contains useful information for investors and researchers, including update on any changes to the fund based on the terms and conditions of the ICIS, as well as the unit price of the fund on the day of valuation whether on daily, weekly, bi-weekly or monthly basis. Similar information is widely available in the daily news papers.

Part III – Compliance with *Sharī'ah* Rules and Principles

Principle 3: IIF shall have in place an appropriate mechanism for monitoring *ex-ante* and *ex-post Sharī'ah* compliance.

Structure and Process

35. Considering that the offering of any ICIS is fundamentally underlined by its promise to be in strict compliance with *Sharī'ah* rules and principles, it would be incomprehensible for any ICIS to operate without *Sharī'ah* supervision of any sort. Although according to the survey conducted by the IFSB, the majority of ICIS do have SSB either in the form of a panel comprising several members or an individual adviser, unfortunately there are still ICIS which takes for granted the importance of establishing appropriate mechanisms for monitoring both *ex-ante* and *ex-post Sharī'ah* compliance by the ICIS.
36. A particular aspect of *Sharī'ah* compliance, which still appears to be generally lacking amongst ICIS is the conduct of external *ex-post Sharī'ah* compliance reviews. In its survey, the IFSB found that only a small minority of the IIF have external *ex-post Sharī'ah* compliance reviews. The GB of ICIS should use their best efforts in ensuring that the external auditors are capable of accommodating *ex-post Sharī'ah* compliance reviews (relying – where appropriate – on work carried out by internal auditors/*Sharī'ah* reviewers) within their terms of reference. Where possible, the GB and the internal auditor/*Sharī'ah* reviewer shall work closely with the external auditors to enhance the external auditors' capabilities for conducting such *Sharī'ah* compliance reviews as part of their audits. Meanwhile, the IFSB survey also indicates that a majority of the ICIS do have internal *Sharī'ah* compliance reviews; however, there is a need to ensure that these reviews are conducted by competent and adequately trained internal auditors/*Sharī'ah* reviewers, which is still a rarity at the moment.
37. Inevitably, in order to strengthen its *Sharī'ah* governance structure, an ICIS shall have appropriate functions that cater for:
- (i) the role of *Sharī'ah* scholars to monitor consistent compliance with the *Sharī'ah*, especially through SSBs;
 - (ii) the process of portfolio screening to ensure its investment portfolios remain within *Sharī'ah*-permissible assets/projects; and
 - (iii) the process of purification (*tazkiyyah*) of tainted income, whereby income which is contaminated by prohibited (*haram*) elements is removed from the ICIS.
- These mechanisms through which the ICIS ensures its compliance with *Sharī'ah* rules and principles shall be made publicly available through appropriate publication and communication channels.

Recommended Best Practices

38. As highlighted in Appendix II, certain jurisdictions have included specific requirements for ICIS to establish SSB in order to ensure adequate monitoring of compliance with the *Sharī'ah*.¹² On the other hand, most other jurisdictions leave this to the ICIS themselves and the market forces. As rightly assumed, the presence of SSB lends credibility to an ICIS, and it would be difficult for the ICIS to promote itself if cannot show to potential investors how would it deal with *Sharī'ah* issues that arises from time to time.

¹² For example, this is the requirement in Bahrain, Brunei International Financial Centre, Dubai International Financial Centre, Lebanon, Malaysia and Qatar Financial Centre. In the case of DIFC and Malaysia, the regulations also set out some rules regarding the size, independence and changes in the SSB.

39. Ideally, the SSB shall be comprised of three or more *Shari'ah* scholars who are well versed in Islamic jurisprudence and, in particular, on how *Shari'ah* rules and principles can be applied to modern financial transactions. Where the ICIS Operator is itself an Islamic institution, that institution may appoint its existing internal SSB to review the transaction, or alternatively it may appoint a group of scholars recommended by one of their advisors. However, regardless of how the SSB is appointed, it is important for them to be totally independent of the originator and act in the interest of the ICIS Investors.¹³
40. Following issuance of the ICIS share/unit certificates, the SSB should undertake a periodic review of the activities of the ICIS Operator and investment manager to ensure that the investment portfolio continues to be *Shari'ah*-compliant. The actual role of the SSB will vary from one ICIS to another, but in addition to the critical portfolio selection approvals as noted above, other roles may include:
- (i) the study of the offering memorandum, constitutional documents, and any major agreements controlling the relationship between the functionaries of the structure;
 - (ii) giving general advice to the operator/manager regarding compliance with *Shari'ah*; and
 - (iii) advising on the use of instruments and techniques for efficient cash management and their compliance with the principles of *Shari'ah*.¹⁴
41. It is noted that ethics binding the ICIS can be highly subjective and not easily quantified. In considering issues of this nature, it is important that the SSB works closely with the GB and the ICIS management on policies and guidelines that will adequately cover these issues. Islamic investing has much in common with the modern forms of investing known as ethical investing, socially responsible investing, faith investing, and green investing. Each of these investment sectors, or subsectors, has much of value to contribute; and each has something in common with the teachings of Islam. It is therefore important for SSB to keep abreast of what is happening in these areas.
42. The fact also remains that the industry still largely suffers from a shortage of well qualified *Shari'ah* scholars to sit in SSBs. Often those who are well-versed in knowledge of *Shari'ah* rules and principles, are not necessarily well-acquainted with modern finance. Likewise, those who are well-versed in the latter are not necessarily knowledgeable in the *Shari'ah*. This has forced some ICIS to find other ways to see to the *Shari'ah* supervision of their businesses. For example, some funds have retained the services of a single *Shari'ah* supervisor, who is assigned to track an Islamic index.¹⁵ Obviously, such an index fund will require less *Shari'ah* supervision for its portfolio than an actively managed portfolio, because its investable universe will already have been screened by the SSB of the index provider. Another way that an Islamic fund may ensure *Shari'ah* supervision without retaining the services of a SSB is for it to appoint a *Shari'ah* scholar to its GB.¹⁶ There the scholar may either chair a subcommittee or work alone to supervise the ICIS for *Shari'ah* compliance and oversee the other *Shari'ah*-related matters. However, undeniably the presence of a full panel of SSB would be more assuring to investors and quite possibly more effective.
43. Notwithstanding this, ICIS shall have in place an appropriate mechanism for consistent screening of their investment portfolios to ensure they conform to *Shari'ah* rules and

¹³ Amongst the supervisory authorities who have specific regulations for SSB in this respect is the Securities Commission of Malaysia. Under Para 6.04 of its Guidelines on Unit Trust Fund it is required that the SSB appointed must at least be three persons qualified in the Islamic financial jurisprudence (fiqh muamalat), independent from the fund management and are registered with the Commission.

¹⁴ Trevor Norman, "Securitisation Structures within an Islamic Framework", *International Securitisation Report*, July 2005.

¹⁵ For example, the Dow Jones Islamic Index, the FTSE Global Islamic Index and the Bursa Malaysia Islamic Index

¹⁶ For example, in Malaysia, in addition to the SSB, IIF operators are required to have at least two Muslim members on their board of directors.

principles. While Islamic indexes can be used to facilitate the portfolio selection by fund managers and as benchmarks to monitor the performance of *Shari'ah*-compliant securities across the stock exchanges, similar services are hardly available for non-securitised portfolios such as commodities and projects. The same could be said about private equities, such as in start-up companies which have often been evaluated by venture capital funds. Hence, it is pertinent for each ICIS to consider having its own internal screening process as well as appropriate benchmarking mechanisms, especially when it holds portfolios other than securities approved by Islamic indexes. The mechanisms should be made transparent to the potential investors in order to help him make an informed decision before participating in the ICIS and the SSB shall be vigilant in alerting the ICIS on any part of the portfolios that has become non-compliant.

44. Realizing the volatility of the stock market and the domination of *riba*-based conventional financial system in the market, sometimes ICIS cannot avoid from receiving income which is tainted with non-*halal* (impermissible) activities or *syubhah* (ambiguous) sources. This is exemplified by the investment in the equity of certain corporations which have earlier been considered *halal* but over a duration of time became non-*halal* as the corporation transcend certain boundaries of the *Shari'ah*. Sometimes such cases happen following the merger and acquisition of corporate entities. Therefore, ICIS shall have put in place appropriate mechanisms for removal of income and profit derived from such non-*halal* or *syubhah* sources before distributing the purified profit to the investors. The common practice has been to donate or forsake the tainted income to charity under direct supervision of the SSB. In surrendering non-*halal* income/profits, it might be appropriate for ICIS to consider certain implications vis-à-vis its wider obligations under anti-money laundering (AML) laws.
45. In this regard, the ICIS auditors need to have full awareness and adequate access to information relating to purification process, in order to ensure appropriate checks on the liquidation of the ICIS' assets, and the justification for separating its earnings. Hence, there should be established a smooth relationship between the SSB and the auditor.
46. For internal *Shari'ah* compliance reviews, the SSB or *Shari'ah* scholars of ICIS shall work together with either a separate *Shari'ah* control department or the designated internal auditors/*Shari'ah* reviewers. This would enable the SSB or *Shari'ah* scholars to advise the *Shari'ah* control department or designated internal auditor/*Shari'ah* reviewers on the scope of audit/reviews required. As the *Shari'ah* control department or designated internal auditors/*Shari'ah* reviewers shall be responsible for producing the internal *Shari'ah* compliance reports, they shall acquire the relevant and appropriate training to enhance their *Shari'ah* compliance review skills.
47. For external *Shari'ah* compliance reviews, the Audit Committee shall ensure as far as possible that the external auditors are capable of conducting, and do conduct, *ex post* *Shari'ah* compliance reviews within their terms of reference.

Part IV – Additional Protection for ICIS Investors

Principle 4.1: ICIS shall ensure any transfer or commingling of its assets with another ICIS shall be carried out with on terms and conditions that preserves the ICIS's Investors' interest, and always supported by appropriate and objective valuations.

Structure and Process

48. ICIS operators and managers sometimes shuffle and commingle funds and assets between separate ICIS under their management, especially to create an image of strong performance for all the funds managed by them. Although it is recognized that this practice is not peculiar to ICIS, it is important to ensure that the objective of securities regulation i.e. the prevention of misleading, manipulative and fraudulent practices by ICIS Insiders is appropriately observed. Bearing in mind that under the principle of *Mudārabah* and *Wakālah* the ICIS Insiders could be bound by specific mandates and instructions, adequate oversight should be put in place in order to protect ICIS Investors from malfeasance or negligence on the part of the ICIS Insiders.

Recommended Best Practices

49. ICIS Operator must ensure that any transaction in respect of the ICIS's assets, especially those undertaken with a related party (including another ICIS under the same operator or manager), is conducted on terms at least as favourable to the ICIS as any comparable arrangement on normal commercial terms negotiated at arm's length with an independent third party. Any such transactions shall be carried out upon request or consent from the ICIS Investors themselves. Wherever it has been disclosed in the offering documents that the transferring and commingling between sister-ICIS will be a feature of the fund, any such transactions shall at least be reported to the GB and the SSB, and shall proceed only upon their approvals.
50. The ICIS Operator shall satisfy themselves that a competent valuer is assigned to evaluate and appraise the ICIS's assets, as well as to calculate the net tangible asset (NAV) of the ICIS. Reasonable care shall be exercised to ensure that the valuer has carried out his duties in an objective manner. Where possible, the valuer shall be of highest expertise in the relevant market of assets being assessed. Although the valuer may not be legally independent from the ICIS Operator, there shall be adequate independence in terms of functions and reporting structure between the valuer and the ICIS Operator. Alternatively, the valuation report can be verified by an independent party such as the ICIS administrator, trustee/custodian or auditor.
51. The ICIS Operator should seek assurance that the valuation system is robust and will produce accurate results. Periodic review of the outputs from the system shall be carried out at least annually (depending on the type of assets), and on any significant system change.

Principle 4.2: IIF shall be transparent in the imposition of any fees, creation of any reserves and the smoothing of any dividend payments.

Structure and Process

52. One of the most common abuses by fund operator/manager is the imposition of hidden fees that cost the investors a lot. Often, the fund operator/manager would gain lucrative amount from their manipulation of fee calculation, even times when the fund itself is far from performing.

53. Meanwhile, some ICIS adopt the practice of smoothing/stabilising returns from the funds, whereby the return within periods of bad or weak performance, is cushioned by returns during good and strong periods. This is often done through the creation of Profit Equalisation Reserves (PER). Arguably, this practice may be seen as a good governance practice for the ICIS investors as it buffers them from a weak market. However, a closer look reveals complicated governance issues. For example, such practices may create a false and misleading impression to investors and the market that an ICIS has been performing well. This might well result in some investors being misled and allegations of market abuse and manipulation. There are also issues of accuracy in accounting and financial disclosure. The fact that there is no regulated process on how PER can be utilised certainly makes it a subject of potential abuse and misappropriation. Reference should be made to IFSB-3 on how this issue should be addressed.

Recommended Best Practices

54. Full, accurate and timely information on fees and expenses should be disclosed in a way that allows ICIS Investors to make informed decisions about whether they wish to invest in a fund and thereby accept a particular level of costs. This includes disclosure in the offering documents as well as periodic reports. The disclosure should enable investors to understand what fees and expenses are charged and the cost structure (e.g. the management fee, operational costs such as custody fees) of the ICIS. It should describe the fees and expenses actually paid on a historical basis, and may also describe the fees and expenses likely to be paid on an anticipated basis. Information on fees and expenses should enable investors to compare costs between ICIS.
55. A performance fee, if imposed, should not create an incentive for the ICIS Operator to take excessive risks in the hope of increasing its performance fee. For example, there is a greater likelihood that the performance fee will create an incentive to take excessive risks if the management fee is set at a very low level, below the actual management costs, and the ICIS Operator relies on a high performance fee to recover its management costs. If such an incentive cannot be avoided, it should be identified and minimized.
56. A performance fee should be consistent with the fund's investment objectives and should not create an incentive for the operator to take excessive risks and should not deny investors an adequate remuneration of the return from the risks taken on their behalf and previously accepted. The following items should be unambiguously determined:
- (i) how the performance of the fund will be assessed (over what timeframe, including or excluding subscription/redemption fees, etc.),
 - (ii) what benchmark reference that the performance will be compared to. This reference must be verifiable and provided by an independent party; and
 - (iii) what the calculation formula will be (including the description of the methods used to offset gains with past losses, if applicable).
- A performance fee should not result in a breach of the principle of equality of ICIS Investors.
57. ICIS shall further create practices, procedures and entitlements that adequately address any undesirable ambiguity in the smoothing of any dividend payment. This call for appropriate transparency in the method and manner of which the PER will be created and utilized. Adequate disclosure shall be produced in through the offering documents as well as periodic reports.

DEFINITIONS

The following definitions are intended to give readers a general understanding of the terms used in this document. It is by no means an exhaustive list.

Islamic collective investment scheme (ICIS)	Please refer to page 2.
Investment risk reserve (IRR)	IRR is the amount appropriated by the ICIS out of the income of ICIS Investors, after allocating the <i>Muḍārib's</i> share, in order to cushion against future investment losses for ICIS Investors.
<i>Muḍārabah</i>	A <i>Muḍārabah</i> is a contract between the capital provider and a skilled entrepreneur whereby the capital provider would contribute capital to an enterprise or activity, which is to be managed by the entrepreneur as the <i>Muḍārib</i> (or labour provider). Profits generated by that enterprise or activity are shared in accordance with the terms of the <i>Muḍārabah</i> agreement, whilst losses are to be borne solely by the capital provider unless they are due to the <i>Muḍārib's</i> misconduct, negligence or breach of contracted terms.
Profit equalization reserve (PER)	PER is the amount appropriated by the ICIS out of the <i>Muḍārabah</i> income, before allocating the <i>Muḍārib's</i> share, in order to maintain a certain level of return on investment for ICIS Investors and to increase owners' equity.
Restricted investment account	The accountholders authorize the IIFS to invest their funds based on <i>Muḍārabah</i> or agency contracts with certain restrictions as to where, how and for what purpose these funds are to be invested.
Stakeholders	Those with vested interest in the well-being of ICIS, including: (i) employees; (ii) customers (including IAH and normal depositors); (iii) suppliers; (iv) the community (particularly the Muslim <i>ummah</i>); and (v) supervisors and governments, based on the unique role of ICIS in national and local economies and financial systems.
Unrestricted investment accounts	The accountholders authorize the ICIS to invest their funds based on <i>Muḍārabah</i> or <i>Wakālah</i> (agency) contracts without laying any restriction. The ICIS sometimes commingle these funds with their own funds and invest them in a pooled portfolio.