

Analysis of The Application of IOSCO's Objectives And Principles of Securities Regulation For Islamic Securities Products



**EXECUTIVE COMMITTEE
OF THE
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TABLE OF CONTENTS

Sections	Page
Executive Summary	4
1 – Introduction and overview of the Islamic securities market	5
1.1 Mandate for the report	5
1.2 Islamic securities market overview	6
1.3 Current initiatives	9
1.4 Common products	11
1.5 Islamic fund structures	11
1.6 Sukuk structures	13
2 - Application of IOSCO objectives and principles of securities regulation	15
2.1 The IOSCO Core Principles and the regulation of Islamic capital markets	15
2.2 Method of analysis	15
2.3 Shariah compliance	17
2.4 Principles 1-13: The regulator, self-regulation, enforcement, and co-operation in regulation	19
2.5 Principles 14-16: Issuers	21
2.6 Principles 17-20: Collective investment schemes	23
2.7 Profit Sharing Investment Accounts (PSIAs)	25
2.8 Principles 21-24: Market intermediaries	27
2.9 Principles 25-30: Secondary market	29
2.10 General recommendations for securities regulators	30
3 – Conclusion	32
3.1 Key Findings	32
3.2 Recommendations for the Executive Committee	32
3.3 Recommendations for others	32
3.4 Summary of issues to the implementation of the Core Principles	33
Annex 1: Glossary of terms	35
Annex 2: List of contributors to the report	37
Annex 3: IOSCO Principles of Securities Regulation	38

Annex 4: Bibliography	41

Executive Summary

The market for Islamic capital securities and in particular Shariah-compliant funds and bonds (Sukuk) has grown rapidly in recent years. There has been a wider geographical expansion of these markets beyond the traditional spheres of activity in the Middle East and East Asia.

Although the IOSCO Core Principles were designed to be flexible enough to accommodate variations in the conventional securities markets, there has been a degree of uncertainty as to how the IOSCO Core Principles are applicable to the Islamic securities market. IOSCO thus set a mandate to assess the compatibility of IOSCO's core principles with the products and practices of Islamic finance. This report principally deals with this mandate and builds on the initial report from the IOSCO Islamic Capital Market Task Force (ICMTF) in 2004.

Key Findings of the report

The analysis of this report has not identified any concerns with respect to the compatibility of the IOSCO Core Principles with the Islamic securities market. However, whilst the applicability of the IOSCO Core Principles has been confirmed by this analysis, it has also been found that the implementation of the principles may benefit from further consideration in some specific areas. This report has seeks to highlight these areas and the associated issues.

The overall findings are broadly consistent with the findings of the ICMTF report which notes that: "[there is] ...no need to formulate separate regulatory principles [as] IOSCO's objectives and principles of securities regulation can be applied to Islamic capital markets."¹

Recommendations

As a result of the analysis conducted, the following recommendations are made. These are discussed in more detail in the main body of the report.

(1) Co-operation and information sharing: The lack of a uniform approach to Islamic capital markets regulations is not in itself problematic; regulation of conventional financial markets also differs between jurisdictions. There are some initiatives in this area but in general there is a lack of information exchange and awareness of the products and practices of Islamic finance. In general, IOSCO could encourage further information exchange and co-operation between regulators. Thematic work on disclosure standards for Islamic funds and Sukuk is recommended.

¹ <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD170.pdf>

(2) Other recommendations:

- Accounting Standards - Accounting disclosures should be based on internationally acceptable standards (such as IFRS). Regulators, in considering their accounting requirements, should give due regard to the specific characteristics of Islamic securities markets. Standard-setting agencies such as the IASB may wish to consider the application of IFRS to Islamic financial instruments with other bodies (such as AAOIFI).
- 'Profit Sharing Investment Accounts' (PSIAs) - Should the any other body decide to undertake any work on Islamic finance, the subject of PSIAs would be an appropriate topic for consideration.

(3) General recommendations for securities regulators: (These recommendations are more explicitly discussed in sections 2.4 and 2.10)

- Securities regulators should consider the regulatory classification of Islamic securities products and ensure that they are treated in a fair, transparent and consistent manner.
- Whilst no judgement is made on the various approaches to Shariah compliance (ranging from deliberate non-regulation to direct and centralised regulation), it would be beneficial for individual regulators to consider defining their position on this.

(4) IMF and World Bank - Financial Sector Assessment Program (FSAP): The IMF and World Bank could consider the issues detailed in this report when conducting reviews as part of the Financial Sector Assessment Program (FSAP).²

(5) Implementation of the Core Principles: The report has identified some issues in the implementation of the Core Principles that securities regulators may wish to consider further. These are summarised in section 3.4.

² The IOSCO principles are identified by the Financial Stability Forum as one of the 12 key international standards and became part of the report on observance of standards and codes and the FSAP during the pilot programme in 1999. See page 11 <http://www.imf.org/external/np/mae/IOSCO/2002/eng/041802.pdf>

Section 1 – Introduction and Overview of the Islamic Securities Market

1.1 Mandate for the report

At the 2002 IOSCO annual conference in Turkey, IOSCO mandated the formation of an Islamic Capital Market Task Force (ICMTF), whose report was published in July 2004. The objective of the ICMTF was to assess the extent of the development and potential regulatory issues relating to Islamic capital markets, as well as gather more general information on Islamic products and activities.³

However, since 2004 the Islamic securities market has developed further. The emergence of a diverse range of capital market products, along with the expansion of market activity, especially outside the traditional jurisdictions in the Middle East and Asia, led IOSCO to consider it prudent to carry out further work in this area. IOSCO thus set a new mandate, narrower than that of the ICMTF, to assess the compatibility of IOSCO's core principles with the products and practices of Islamic finance. Jane Diplock, the Executive Committee (EC) Chair, speaking at the GCC regulators' summit in Bahrain 2008 stated:⁴

“IOSCO's vision is for markets which operate across the world on sound principles and standards, and regulators who can cooperate and exchange information across borders. It aims to ensure that markets are fair, efficient and transparent; to protect investors; and to reduce systemic risk. It is recognized as the global securities standard setter by the international financial community and in particular the Financial Stability Forum, the World Bank and the International Monetary Fund. It has developed 30 broad Principles for securities regulation and promotes the full implementation of these in the regulatory framework of every member jurisdiction. IOSCO is also interested in examining how compatible the IOSCO 30 Principles for securities regulation are with Islamic finance securities products and an informal working group is examining this issue led by the UK Financial Services Authority.”⁵

Philippe Richard, (the former IOSCO Secretary General speaking at a seminar in Dubai on the 15th of May 2007) spoke along similar lines: "Islamic finance is one of the segments that fit into IOSCO's framework but, for IOSCO to achieve its objectives, work needs to be done to identify any regulatory gaps in these markets".

In discharging its mandate, the working group notes that IOSCO is a secular institution with no religious or political affiliation. It would therefore be inappropriate for it to mandate how observance of a particular set of religious principles should be determined or regulated. It is also not the objective of this report to promote a uniform approach to regulating Islamic finance. Rather, this report aims to further the understanding of regulatory issues in this area of finance.

³ See introduction to ICMTF report, July 2004: <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD170.pdf>

⁴ Gulf Co-operation Council, consisting of: Bahrain, Kuwait, Oman, Kuwait, Saudi Arabia and the United Arab Emirates

⁵ <http://www.iosco.org/library/index.cfm?section=speeches>

1.2 Islamic securities market overview

The Islamic finance industry encompasses the full spectrum of financial services activities, including banking, insurance and securities. The industry has, from a small base, experienced significant growth over recent years. Some estimates put market growth at approximately 15% per annum over the last three years, with a current total worth of approximately \$800bn worldwide as of June 2008.⁶ The development of Islamic finance in the last two decades of the 20th century consisted largely of the expansion of banking and trade-related financing activities. Islamic securities markets (and insurance markets)⁷ had until the turn of the century lagged behind, but are now also experiencing significant growth themselves, much of which has been in Sukuk (Shariah compliant securities) and Islamic funds.

In spite of the recent credit crunch, inflationary pressures, an increase in commodity prices and widespread economic slowdown, the prospects for growth in Islamic securities markets are likely to be positive. Part of this reflects the windfall from higher commodity prices, especially in oil revenues for the GCC states. However, it can also be attributed to the rapid expansion and increasing sophistication of the GCC financial markets themselves. In Asia, Malaysia has a relatively mature and established domestic securities market. Furthermore, the geographical spread of Islamic securities products and activities is likely to grow in the UK, Indonesia, Hong Kong, Singapore, France,⁸ North Africa and the energy rich Central Asian states. Even jurisdictions where Muslims are a small minority are displaying interest in Islamic finance as a way of accessing petrodollars.⁹

One notable feature of the modern Islamic finance industry is that transactions are normally structured using a set of underlying contract types which were used in the early Islamic period.¹⁰ It is common when discussing Islamic financial products to refer to the main underlying contract (for example Musharaka, a partnership structure, or Ijara, a lease). However, a product or overarching transaction may incorporate different transaction types within it, and simply naming the leading contract may not be sufficient to describe all the economic activities and effects involved. As well as Musharaka and Ijara, other contract types that can be used include Murabaha (cost plus mark-up), Mudaraba (where working capital is placed with an entrepreneur to trade), Salam (commodity based spot payment/deferred delivery) and Istisna (manufacturing based spot payment/deferred delivery).

The growth of the Sukuk market

One of the most important growth segments is the Sukuk market, which is projected to grow by 30-35% per annum.¹¹ Sukuk are financial instruments which represent a beneficial

⁶ Eurekahedge: Key Trends in Islamic Funds 2008

⁷ Gross Takaful contributions were \$2.007bn (2006) E & Y World Takaful Report 2008:

[http://www.ey.com/Global/assets.nsf/UK/World_Takaful_Report_2008/\\$file/World_Takaful_Report_2008.pdf](http://www.ey.com/Global/assets.nsf/UK/World_Takaful_Report_2008/$file/World_Takaful_Report_2008.pdf)

⁸ Wilson (2008)

⁹ See, for example, http://www.info.gov.hk/hkma/eng/speeches/speechs/edmond/20080707e_index.htm, and also http://www.forbes.com/markets/2007/11/20/japan-sharia-deal-markets-econ-cx_jc_1120markets1.html.

¹⁰ See El Gamal 'Islamic finance: law, economics and practice', Cambridge 2006

¹¹ Moody's 'Special Report on Sukuk', 2008

entitlement to an underlying asset, and can be structured in various ways (see section 1.6). Approximately \$5bn of Sukuk was issued in 2004, increasing to \$32.5bn in 2007. Three quarters of the Sukuk issued in 2007 were from corporate issuers, with the remaining quarter issued by sovereign governments. By the end of 2007, volumes of globally outstanding Sukuk totalled \$97.3bn. The total number of Sukuk transactions numbered 119 (compared to 109 in 2006) and the average transaction size was \$270m (compared to \$175m in 2006).¹²

In terms of geographical origin, the majority of Sukuk originate from either the GCC or South East Asia, with particularly high volumes being generated in Malaysia, the UAE and Saudi Arabia. Malaysia is the single largest issuer of Sukuk, accounting for approximately \$64.4bn (66%) of outstanding Sukuk worldwide (or over 95% of all Sukuk issued from Asia). The UAE issued 58% of all the Sukuk originating from the GCC in 2007 (c.\$11bn), and Saudi Arabia accounted for a further 30% of issuances in this region (c.\$5.7bn).

Of the different Sukuk structures available, Musharaka, Mudaraba and Ijara Sukuk have been the most commonly utilised (between them accounting for the ten largest sukuk issuances to August 2007). However, with proclamations from Shariah scholars on the permissibility of certain contractual stipulations within some structures, it is possible that usage of the Ijara structure will become more widespread.¹³

The Islamic funds industry

The Islamic funds industry is also growing rapidly – almost 650 Shariah-compliant funds, worth approximately \$44bn, were listed as of June 2008. Factoring in unlisted funds increases this figure to an estimated \$59bn. The number of funds has more than doubled in the last three years, with 345 funds launched between 2005 and 2007, and this may grow to 950 funds by 2010.¹⁴

Approximately 6% of listed Islamic funds are invested in Sukuk (these funds are often treated as the nearest Shariah-compliant equivalent to fixed income funds), though the majority of funds are invested in equity (52%). A further 18% of funds are invested in private equity and real estate, 13% are invested in commodity Murabaha (the Shariah-compliant equivalent of money market funds), 8% are balanced funds including equity, and the remaining 4% are invested mainly in leasing based instruments. Islamic funds have in general a greater degree of concentration in equity and real estate asset classes in comparison with conventional mutual funds, which have an average of 42% invested in equity, but over 22% in fixed income assets.

Although there has been a trend towards geographical diversification, concentrations are still evident, with approximately 62% of investments in GCC based assets. Fund sizes also tend to vary depending on country/region of focus, with a notable gulf between GCC countries (average fund sizes in Saudi Arabia and Kuwait are \$170m and \$100m respectively) and

¹² IMF Policy Discussion paper PDP/08/03

¹³ Deutsche Bank Global Markets Research, August 2007

¹⁴ Forecasts from Ernst & Young Islamic funds report 2008:

[http://www.ey.com/Global/assets.nsf/UK/Islamic_funds_and_investment_report_2008/\\$file/EY_Islamic_funds_investment_report_2008.pdf](http://www.ey.com/Global/assets.nsf/UK/Islamic_funds_and_investment_report_2008/$file/EY_Islamic_funds_investment_report_2008.pdf)

South East Asia (average fund sizes in Malaysia and Indonesia are \$44m and \$10m respectively). Newer types of investments have also emerged, such as Shariah-compliant structured products and exchange traded funds, but these are still in the early stages of development.

Hedge funds, which are common in the conventional fund management industry, are rarer in the Islamic funds industry due to Shariah concerns over strategies such as short selling, and the limited availability of commonly accepted Shariah-compliant instruments which are equivalent to derivatives. More recently, a Shariah-compliant hedge fund platform run by a large international bank has attracted over \$250m of funding.¹⁵ Failaka, an Islamic fund information services provider, lists only two active hedge funds, neither of which publicly discloses details of performance or assets under management.¹⁶

1.3 Current initiatives

As the Islamic securities markets continue to expand both geographically and in terms of market size, the development of regulatory standards, standardisation in documentation, practices and the ratings of products will be essential. In this regard there are several initiatives which are worthy of mention, which are detailed below. It should be noted that no assessment of the applicability or quality of these initiatives has been undertaken as part of this report.

International Islamic standard-setting bodies

There are efforts to strengthen the development of Islamic financial standards by international standard-setting bodies such as the Malaysia based Islamic Financial Services Board (IFSB). Although the IFSB's core membership consists of regulatory bodies, unlike IOSCO, the IFSB work is cross-sectoral. The IFSB's remit covers banking, insurance and securities regulation. This is reflected in the wide range of initiatives it has undertaken, for example developing corporate governance standards for Islamic collective investment schemes and capital adequacy requirements for Sukuk securitisations.¹⁷ The IFSB has over 164 members, including 41 regulatory bodies and international institutions such as the World Bank and the International Monetary Fund. Another body is the Bahrain based Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI), which has produced standards on accounting, auditing, ethics, Shariah and governance.¹⁸ The adoption of AAOIFI and IFSB standards by national financial regulators has been mixed.¹⁹

¹⁵ 'Riddle of how to help hedge funds confirm with Islamic rules' Financial Times, 19 June 2008

¹⁶ Failaka funds database: failaka.com

¹⁷ <http://www.ifsb.org/index.php?ch=4&pg=140>

¹⁸ <http://www.aaofi.com/keypublications.html>

¹⁹ Financial Times Special Report on Islamic Finance, 19 June 2008

International trade bodies

There are several initiatives by international bodies such as the International Capital Markets Association (ICMA), the International Swaps and Derivatives Association (ISDA), and the International Islamic Financial Market (IIFM). The IIFM was founded by the central banks and monetary agencies of Bahrain, Brunei, Indonesia, Malaysia, Sudan and the Islamic Development Bank based in Saudi Arabia. It has a mandate to participate in the establishment, development, regulation and promotion of Islamic capital and money markets.

There is also a joint project by ISDA and IIFM to create a version of the ISDA Master Agreement suitable for the Islamic finance market. The conventional Master Agreement is the global standard contract for cross-border transactions in OTC derivatives, and is used in approximately 90% of global conventional transactions. The growing number of Shariah-compliant transactions now creates a need for similar standardisation in Islamic markets. Version 1 of the ISDA/IIFM Ta-Hawut (Hedging) Master Agreement will cover Murabaha transactions. The IIFM has a Memorandum of Understanding with the ICMA.²⁰ The two bodies have established joint working groups to develop standardised best practices for issuing and trading Sukuk.

Rating Agencies

Rating agencies have developed specific methodologies for rating Sukuk because of their unique legal and risk structures. Although Sukuk have often been described as asset-backed securities, in reality the credit risk of the issuance may not reflect the performance of the underlying asset. Rating agencies have therefore sought to distinguish between different issuances, depending on whether the Sukuk holder has recourse to the issuer (where usually the issuer will provide a guarantee) or to the underlying asset.²¹ In some instances, Islamic financial institutions may be issuers of Sukuk themselves, and it is worth noting that rating agencies may also use modified methodologies to assess the financial strength of Islamic financial institutions themselves because of the different character of the business models.

Islamic Indices

Some firms, including Standard & Poor's, FTSE and Dow Jones,²² have developed Islamic indices. These offer benchmarks for the performance of Islamic investments, including those conventional investments which are acceptable under Shariah, and allow the development of tracker products. They have necessitated the development of "Shariah screens" to determine which instruments qualify to be included in such indices, and these screens may be used by investors as a proxy for their own assessment of the compliance of any particular instrument.

²⁰ Signed on 30 Jan 2007, see

http://www.icmagroup.org/content/market_practice/regulatory_policy.Par.0007.ParDownloadFile.tmp/ICMA_regpol_April07.pdf

²¹ Standard and Poor's 'Islamic Finance Outlook' 2008; see also Fitch Ratings 'Criteria Report: Fitch's Approach to Rating Sukuk' 5 March 2007

²² <http://www.djindexes.com/mdsidx/?event=showIslamic> and also http://www.ftse.com/japanese/Indices/FTSE_Global_Islamic_Index_Series/index.jsp

1.4 Common products

The analysis of this report will be focused on the main Islamic finance securities products which are prevalent at the time of drafting. These are detailed in the table below:

Common product types	Factors to consider
Sukuk The following are the main sukuk types: <ul style="list-style-type: none">▪ Ijara (leasing)▪ Murabaha (cost plus mark-up)▪ Mudaraba (entrepreneurship)▪ Salaam (commodity based spot payment/deferred delivery)▪ Istisna (manufacturing based spot payment/deferred delivery)▪ Musharaka (partnership)▪ Hybrid (convertible and exchangeable)	<p>The points below are merely illustrative of factors to possibly consider in assessing product types against IOSCO principles and should not be taken as an exhaustive list.</p> <ul style="list-style-type: none">▪ Ratings▪ Market transparency▪ Liquidity▪ Supply/demand▪ Valuations▪ Islamic indices▪ Screening processes▪ Accounting treatment▪ Impact of Shariah compliance on market dynamics▪ Development of exchange traded funds (ETFs)▪ Disclosure requirements
Funds <ul style="list-style-type: none">▪ Equity▪ Commodity▪ Real estate▪ Ijara▪ Private equity▪ Hedge Funds	
Other <ul style="list-style-type: none">▪ Derivatives/hedging instruments▪ Money market instruments▪ Trade/project Finance▪ Spot equity	

Given the growth of Islamic funds and Sukuk detailed earlier, we describe the features of these products below.

1.5 Islamic fund structures

Generally, arrangements under which investors' funds are pooled or managed as a whole by a manager to generate profits or other benefits for those investors are regarded as collective investment schemes (CIS). In this analysis, we use the term "Islamic CIS" or "Islamic fund" for any CIS which is offered or marketed to potential investors as Islamic or Shariah compliant.

Islamic funds are normally structured using the accepted types of Islamic finance contracts. The contract between the investor and the manager is generally one of the following:

- **Mudaraba:** This is the structure most akin to a conventional CIS, where investors provide the capital to another person (called *Mudarib*) who will have the day to day control of the investor funds and will use their expertise to manage those funds within agreed parameters. The manager is entitled to participate in any profits at a pre-agreed percentage, but does not bear any risk of loss (absent misconduct or negligence).
- **Musharaka:** This is akin to a partnership structure where all participants are investors with participation in the profit or losses incurred by the enterprise. However, only some partners will be involved in the management of the enterprise (like the general partner in a conventional limited partnership). In this structure, the profit participation ratio is determined by the contribution ratio, with the managing partner being able to claim additional participation in profits in recompense for their labour and efforts.
- **Wakala:** This is a principal-agent relationship in which the fund manager acts as the agent of investors in investing their funds within a pre-agreed investment strategy. The primary fee will normally be fixed, for example as a percentage of assets. There may also be a performance based fee, but simple sharing of profits would not generally be thought acceptable.

Other Islamic contractual arrangements may also be used for investment activities of the fund, or its other dealings with counterparties. An Islamic CIS must operate in accordance with Shariah principles, not only in its relations with investors but also in its investment and other fund management activities. The effects of this include the following:

- The prohibition against interest (*riba*) will prevent a fund lending or borrowing at interest, or investing in interest-bearing securities.
- The fund may not invest in unethical or socially detrimental activities such as those involving alcohol, pornography or gambling. It may also not invest in conventional financial institutions, or enterprises which receive or pay substantial amounts in interest. As mentioned above, there are “Shariah screens”²³ available for determining whether investments are acceptable.
- Where an investment produces a small proportion of its return from unacceptable sources – for example a trading company which also arranges interest-bearing loans for its customers – that investment may be regarded as acceptable if it is “purified” by giving the unacceptable proportion of the return to charity.

²³ There are different screening methodologies, for an example see:
http://www2.standardandpoors.com/spf/pdf/index/Shariah_Methodology.pdf

- A fund may not sell goods or instruments which it does not (or will not certainly) own. This limits the ability to sell short or to enter into some types of futures contract.
- The prohibition against *gharar* (excessive uncertainty/ambiguity)²⁴ will also limit some types of contract, including for example contracts for differences. On the other hand, this prohibition can encourage a high level of disclosure and precision in contracts with investors.
- Debt obligations are generally not considered to be tradable. However, baskets of investments which contain a proportion of debt obligations may be accepted as tradable, although the precise limit of this proportion remains a topic of debate.
- Unlike most conventional funds, some Islamic CIS may incorporate profit sharing with parties other than investors. The most obvious example is where investments are “purified” by giving part of the return to charity.

1.6 Sukuk structures

Sukuk is a generic term used to encompass a broad range of financial instruments designed to conform to the principles of Shariah. In general, Shariah prohibits the use of interest in financial transactions and so the creation of a pure debt security is not possible. Sukuk are often structured in a way so as to generate the same economic effects as conventional bonds, but in a Shariah-compliant manner. This is achieved through the use of assets and various contractual techniques to conform to the principles of Shariah. Moody's describe Sukuk as "trust certificates or participation certificates that grant the investor a share of the asset along with the cash flows and risk commensurate with such an ownership". This somewhat simplifies the position, and in fact, there is an array of different Sukuk.²⁵

Since in principle most Sukuk have tangible assets as their underlying, one might be inclined to think that Sukuk are instruments similar to classic asset-backed securities. However, a detailed analysis of commercial terms and legal structures shows that Sukuk performance may not be governed by asset performance. In economic terms, there are three common types of Sukuk:²⁶

- A: Fixed-Income Sukuk – risk related to credit risk of originator;
- B: Asset Backed Sukuk (ABS) - risk related to performance of underlying asset; and
- C: Hybrid Sukuk (combination of originator credit risk and underlying asset risk)

²⁴ The term is difficult to translate precisely, and Islamic jurists differ on its interpretation.

²⁵ The most common are the Mudaraba, Musharaka and Ijara Sukuk, which account for over 95% of the Sukuk issued in 2007. There are at least 14 different contracts that may be used as the basis of Sukuk.

²⁶ Credit Rating agencies such as Moody's make a clear distinction between asset-based and asset-backed Sukuk in determining the credit rating of the transaction.

Category A Sukuk tends to be asset-based rather than asset-backed. They may have underlying assets, but essentially they require some form of guarantee or "purchase undertaking" from the issuer. The credit risk is therefore linked to the originator. This is similar to a conventional debt security in terms of risk characteristics and performance. The majority of Sukuk issued in the market thus far are of this type. Category B Sukuk are instruments which are more akin to conventional asset-backed securities. The risk of these instruments is related to the performance of the underlying asset. Hybrid Sukuk (category C) have also emerged, with risk profiles linked to both the performance of the underlying asset and the credit risk of the issuer.

Certain developments in the Sukuk market should be noted:²⁷

- Differences in underlying risk: as noted above there is a wide range of Sukuk structures. Some Sukuk are more akin to debt-based instruments, others have equity-like characteristics, whilst others mirror conventional asset-backed structures.
- Increasing sophistication of structures: there is a new generation of innovative and increasingly complicated Sukuk. These include convertible and hybrid Sukuk.
- A widening range of acceptable assets: traditionally only tangible assets (real estate, aircraft, plant and machinery etc.) were considered acceptable under Shariah. More recent Sukuk have been based on other types of asset such as intellectual property or rights to certain cash flows from specified activities (e.g. electricity meter reading rights etc.).²⁸
- Secondary market restrictions: there are Shariah limitations on the trading of debt which impact on the tradability of certain Sukuk in the secondary markets (though there is not unanimity about the precise boundaries). This mainly impacts on shorter-term, "bill-like" Sukuk. Longer-term, "bond-like" Sukuk are usually structured so as to be tradable in the secondary markets.

²⁷ For more information on regulatory, legal and other obstacles facing the global Sukuk market see IMF Policy Discussion Paper PDP/08/03 'Islamic Bond Issuance-what sovereign debt managers need to know', July 2008.

²⁸ www.assaif.org/content/download/589/4403/file/SABIC%20Sukuk.pdf see also: 'Sukuk market at a crossroads' <http://www.cpifinancial.net/V2/fa.aspx?v=0&aid=87&sec=Islamic%20Finance>

Section 2: The IOSCO Objectives and Principles of Securities Regulations

2.1 The IOSCO Core Principles and the regulation of Islamic capital markets and securities products

The IOSCO 'Objectives and Principles of Securities Regulation' ("IOSCO Core Principles") are an internationally accepted framework for the regulation and supervision of securities market. IOSCO has set three objectives for securities regulation which are:

- The protection of investors;
- Ensuring that markets are fair, efficient and transparent; and
- Reduction of systemic risk.

These objectives are supported by the 30 principles which provide guidance on IOSCO's recommendations for the desirable attributes of the regulatory framework for public securities markets within a jurisdiction. The IOSCO Core Principles are used by a number of governments for evaluating legislation, regulation and supervision of securities markets. The Financial Stability Forum has endorsed the IOSCO principles as one of the 12 key standards for financial systems.²⁹ In addition, international financial institutions such as the World Bank and the IMF assess the securities sector of a given jurisdiction on the basis of these principles.³⁰

Given that the Islamic securities market is a fast growing component of the securities industry as a whole, it is important to ensure that the application of the IOSCO Core Principles in this sector is adequately assessed. The conventional securities markets encompass considerable legal, market and conceptual variations, and the Core Principles were designed to accommodate these. Whilst it was felt that this flexibility would to a great extent cover the activity of the Islamic securities market (which does share some commonality with its conventional counterpart), there was a degree of uncertainty as to whether there might yet exist some gaps between IOSCO Core Principles and the principles and practices of the Islamic securities market. These might, for example, be due to differing market practices and use of alternative transaction structures arising from Islamic principles, in particular the prohibition of interest-based financial activity, investment restrictions on prohibited industries, and the use of contracts dating from the early Islamic period as mentioned earlier in this report.

2.2 Method of analysis

The approach employed in this paper has been to consider the applicability of each of the 30 IOSCO Core Principles, as set out in the 'Objectives and Principles of Securities Regulation' dated May 2003. Where the Core Principles are quoted in this document, they are quoted for brevity only at a principle level. In order to follow the points made, reference should be made to the underlying document and to the February 2008 'Methodology for Assessing

²⁹ http://www.fsforum.org/cos/key_standards.htm

³⁰ 'The need for a cross sectoral approach to the supervision of Islamic financial services' Phillip Richard, IOSCO Secretary General speaking at the 4th Islamic Financial Services Board Summit (2007). For more on the FSAP see page 11: <http://www.imf.org/external/np/mae/IOSCO/2002/eng/041802.pdf>

Implementation of the IOSCO Objectives and Principles of Securities Regulation’’ (‘Assessment Methodology’).³¹

The analysis has been divided into five sections:

- Section 2.4: Principles 1-13, Principles relating to the Regulator, Self-Regulation, Enforcement, and Co-operation in Regulation
- Section 2.5: Principles 14-16, Principles for Issuers
- Section 2.6: Principles 17-20, Principles for Collective Investment Schemes
- Section 2.8: Principles 21-24, Principles for Market Intermediaries
- Section 2.9: Principles 25-30, Principles for the Secondary Market

Principles in each of these sub-sections have been divided into two categories:

- Category A – Principles whose implementation is wholly compatible with Islamic securities products
- Category B – Principles whose implementation raises issues for further consideration

A short rationale is provided as to why Core Principles falling under category B may require further consideration, along with a recommendation. It has also been noted if the issue is relevant for all types of Islamic financial products, or just a specific category, such as Islamic funds. In addition, there are two issues which require highlighting:

Shariah compliance

This issue is relevant to the discussion of the regulation of Islamic finance products and services and interacts with a number of different Core Principles in various ways. As a consequence, it is discussed separately in section 2.3.

Profit Sharing Investment Accounts (PSIAs)

This is also considered separately, in section 2.9. PSIAs are normally employed in an Islamic banking context in place of conventional deposit accounts, but have some similarities with CIS, and there are variations in their regulatory treatment. The implications of the IOSCO principles for PSIAs are considered separately in the sub-section following the discussion on CIS (Principles 17-20).

³¹ Methodology for Assessing Implementation of the IOSCO Objectives and Principles of Securities Regulation, IOSCO, February 2008.

2.3 Shariah compliance

Governance

This section is relevant to a number of Core Principles, in particular 1,3,14,17,19 and 21.

Islamic securities products differ from conventional products in that they should conform to the Islamic canon (Shariah). There are differences in the interpretation of Shariah, and this can lead to differences of opinion about whether or not a particular product or transaction is permissible. As mentioned earlier, IOSCO principles are an internationally accepted framework for the regulation and supervision of securities markets. However, the marketing of any product as “Islamic” or “Shariah compliant” does constitute a representation to investors, and the basis upon which this is done is therefore of relevance to securities regulators who use disclosure requirements as a tool to protect investors and ensure orderly markets. This report has found that different jurisdictions have adopted different models with respect to Shariah governance.³² Without making any judgement on the appropriateness of any given approach, these have been detailed below:

- **Conventional approach:** Regulators do not possess the remit or may, as a matter of stated policy, not regulate Shariah compliance directly; however, the regulators may require disclosure of material information to investors, which includes, as the case may be, details of Shariah compliance.³³
- **Shariah systems approach:** Firms are required to have their own Shariah boards. The governance, function and operation of Shariah board decisions are regulated.³⁴
- **Centralised approach:** There are firm based Shariah boards, and also a central Shariah board which assesses the compliance of financial products and institutions.³⁵
- **Other:** Approaches which have not been specifically identified in this report or hybrid versions of the previous models.

At one end of the spectrum, some regulators do not possess the remit or may as a matter of stated policy not regulate Shariah compliance. However, these jurisdictions may still have general disclosure requirements which ensure that salient product features such as Shariah compliance are disclosed to customers.³⁶ At the other end of the spectrum, a regulator may

³² The IFSB have established a working group on Shariah Governance, see <http://www.ifsb.org/shariah.php>

³³ For example, in France, the compliance of the issue with Shariah rules does not fall within the remit of the AMF. It is the responsibility of the issuers, with assistance from their advisers, to incorporate into the prospectus the relevant elements, including appropriate details of the Shariah board involved in the transaction, which provide the necessary information to enable investors to make an informed decision.

³⁴ For example, Dubai: see DFSA's Islamic Financial Business Module (ISF):
http://www.complinet.com/dfsa/display/display.html?rbid=1547&element_id=4598

³⁵ For example, in Malaysia the Shariah Advisory Council of Securities Commission Malaysia (SAC) was established in May 1996 to advise the Commission on Shariah matters pertaining to the ICM.
http://www.mifc.com/0607_sc_council.htm http://www.sc.com.my/eng/html/icm/icm_default.html

³⁶ For example, the UK FSA requires financial promotions to be "clear, fair and not misleading", and this is reinforced by their Treating Customers Fairly (TCF) initiative:
<http://www.fsa.gov.uk/Pages/Doing/Regulated/tcf/index.shtml>

take a top down approach, and not only stipulate the requirements for Shariah compliance (including the establishment of firm based Shariah boards), but also establish a central Shariah board, comprised of approved scholars to oversee the process. More commonly than the latter approach, some regulators have adopted what is sometimes known as the "Shariah systems approach": seeking to regulate the governance, function and operation of private firm level Shariah boards, but leaving these boards with autonomy in deciding on the Shariah compliance of products and transactions.

Disclosures

Disclosure requirements form an important part of the discussion on Shariah compliance. Information considered material to the decision making process of an investor should be fully disclosed in a timely and accurate manner. The guidance to the Core Principles notes that "full disclosure of information material to investors' decisions is the most important means of ensuring investor protection". Securities products designed to adhere to a specific set or religious and/or ethical principles may by definition require the communication of a wider set of material information to investors. Where Shariah-compliant products and activities are concerned, this might include disclosures of the names of Shariah advisors, their roles and responsibilities, a pronouncement that the product is Shariah-compliant (and possibly the basis upon which this decision is reached), and detailing of contingent strategies to address the possibility of post sale Shariah non-compliance (e.g. disinvestment criteria and policy).

There are variations in treatment of such disclosures, which are detailed further in the discussion of Principles 14 and 19. As mentioned earlier, some jurisdictions have mandated specific disclosures relating to Islamic securities, whilst others have general disclosure requirements for all securities. It is not the purpose of this report to determine if the disclosures related to the Shariah compliance of a product should be mandated by regulation, as this is for the individual regulator to determine. In the 2004 report, the ICMTF noted that in general, non-financial disclosures are voluntary and that securities regulators were widening the scope of what constituted relevant non-financial information, to ensure that investors could make informed decisions. We agree with the message of the 2004 report that: "individual IOSCO members may wish to consider encouraging disclosures in relation to meeting the specific investment needs of investor groups; be they ethical or those seeking Shariah-compliant investments".

Recommendation: Securities regulators may wish to consider the effectiveness of their disclosure regimes and ensure that customers of Shariah-compliant products are able to access the relevant information they require to make a decision. This is particularly important in jurisdictions where the Shariah compliance of a product is not directly regulated. Some observers note that in addition to strengthening the regulatory environment, more effective disclosures also serve to make a product or transaction more Shariah-compliant by mitigating *gharar*. Where it is found that further disclosures would be beneficial, regulators may wish to facilitate this via a range of methods, including (but not restricted to) the adoption of formal rules, dissemination of guidance, or other formal/informal communications with industry.

2.4 Principles 1-13: Principles relating to the Regulator, Self-regulation, Enforcement, and Co-operation in Regulation

Category A – The implementation of these Principles is wholly compatible with Islamic securities products

A. Principles Relating to the Regulator

Principle 2

The regulator should be operationally independent and accountable in the exercise of its functions and powers.

Principle 5

The staff of the regulator should observe the highest professional standards including appropriate standards of confidentiality.

B. Principles for Self-Regulation

Principle 6

The regulatory regime should make appropriate use of Self-Regulatory Organizations (SROs) that exercise some direct oversight responsibility for their respective areas of competence and, to the extent appropriate to the size and complexity of the markets

Principle 7

SROs should be subject to the oversight of the regulator and should observe standards of fairness and confidentiality when exercising powers and delegated responsibilities.

C. Principles for the Enforcement of Securities Regulation

Principle 8

The regulator should have comprehensive inspection, investigation and surveillance powers.

Principle 9

The regulator should have comprehensive enforcement powers.

Principle 10

The regulatory system should ensure an effective and credible use of inspection, investigation, surveillance and enforcement powers and implementation of an effective compliance program.

D. Principles for Cooperation in Regulation

Principle 11

The regulator should have authority to share both public and non-public information with

domestic and foreign counterparts.

Principle 12

Regulators should establish information sharing mechanisms that set out when and how they will share both public and non-public information with their domestic and foreign counterparts.

Principle 13

The regulatory system should allow for assistance to be provided to foreign regulators who need to make inquiries in the discharge of their functions and exercise of their powers.

Category B – Principles whose implementation raises issues for further consideration

Principle 1

The responsibilities of the regulator should be clear and objectively stated.

There is no issue with the applicability of this principle to the Islamic securities market. As noted in section 2.3, jurisdictions may vary in the degree to which they regulate Shariah compliance. Although this variation is not problematic, the emergent nature of the Islamic securities industry means that some regulators may not yet have adopted a specific approach to dealing with this market and therefore there may be a lack of clarity with regards to their responsibilities and regulatory remit.

Recommendation: For the sake of clarity, it would be beneficial for securities regulators to clearly state their responsibilities as well as the details of their regulatory approach to the regulation of Islamic securities, especially those who have a responsibility for Shariah compliance or have regulations regarding the governance of the Shariah decision making process (in section 2.3 the four general approaches are described in more detail).

Principle 3

The regulator should have adequate powers, proper resources and the capacity to perform its functions and exercise its powers.

As with other elements of securities regulation, in cases where a financial securities regulator performs the additional role of regulating Shariah-compliance or has regulations regarding the governance of the Shariah decision making process it should also possess the appropriate powers and competence to discharge its responsibilities.

Recommendation: If regulators have a responsibility for Shariah compliance or have regulations regarding the governance of the Shariah decision making process, they should possess the appropriate powers and have the relevant competence to discharge their responsibilities effectively.

Principle 4

The regulator should adopt clear and consistent regulatory processes.

There are variations in the regulatory approach to Islamic finance. In some instances regulators have accommodated Islamic securities within the framework of existing regulations, while others have made modifications so as to create regulatory convergence between Shariah-compliant products and services and their conventional counterparts. Other regulators still have developed a distinct set of regulations to deal specifically with Islamic finance.

Recommendation: Irrespective of the approach taken, regulators should ensure that their processes are applied in a consistent, transparent and fair manner. In particular, where the regulator is directly involved in issuing rulings on Shariah issues, it should consider promoting the disclosure of decisions and their underlying rationale.

2.5 Principles 14-16: Principles for Issuers

Category A – The implementation of these Principles is wholly compatible with Islamic securities products

Principle 15

Holders of securities in a company should be treated in a fair and equitable manner.

Category B – Principles whose implementation raises issues for further consideration.

Principle 14

There should be full, timely and accurate disclosure of financial results and other information that is material to investors' decisions.

Information considered material to the decision making process of an investor should be fully disclosed in a timely and accurate manner. For example, relevant disclosures for an issuer of corporate bonds for example, would normally be included in a prospectus or other offer document. The prospectus would cover information on the issuer and include such matters as financial information, principal business activities, organisational structure, profit forecasts and major shareholders.

In Section 2.3 it was noted that additional disclosures might be relevant for investors in Islamic securities. These might include such things as the composition of the Shariah board, how the product meets Shariah requirements, and details related to ensuring ongoing Shariah compliance. However, it is recalled that the responsibility for ensuring such disclosure may vary among jurisdictions.

In addition to this, Islamic securities products may also require further disclosures such as enhanced disclosures of financial and/or legal information. This is because although Shariah-

compliant financial instruments might be similar to, or designed to replicate the function of certain conventional securities, the underlying structure may mean the product has a different risk profile. As with conventional securities, the disclosure regime for Islamic securities products should be relevant for the underlying economic substance and risk profile of the product.

In particular, whilst Sukuk may closely resemble collective investment schemes in terms of legal structure, economically they are usually designed to replicate the function of conventional bonds. They should therefore arguably be required to have similar disclosures, if the cash flows and protection of principal are the same. Note, however, that as described in section 1.6, Sukuk may resemble either straightforward debt securities or asset-backed securities, and the relevant information disclosing this (focusing on the issuer for the former and the underlying asset for the latter) should be detailed in the prospectus or offering documents.

Recommendation: Regulators may wish to consider the relevant disclosure standards for Sukuk within their own jurisdiction.

Principle 16

Accounting and auditing standards should be of a high and internationally acceptable quality.

The IOSCO principles also focus on certain issues relating to accounting and auditing standards. These are:

- Comparability and reliability of information
- Internationally acceptable standards
- Quality of accounting standards

Financial information plays a crucial role in enabling an investor to make an informed decision about an investment. Accounting and auditing standards are relevant for a number of Core Principles, primarily Principle 16, but are also referred to in the Assessment Methodology under Principles 19 and 20. It should be recognised from the outset that the differences between the Islamic and conventional securities markets (and indeed the wider financial services industry) have meant that there is a diversity of opinion on the applicability of conventional accounting standards to Islamic securities. Some observers suggest that IAS/IFRS can be applied to Islamic financial instruments, but others state that some modifications are necessary and others still favour a separate, Islamic finance specific, standard.

There are a number of reasons for these differences. Some are simply differences in accounting terminology, which should be relatively easy to resolve. For example, IAS 31 "Interests in Joint Ventures"³⁷ and AAOIFI's FAS 4 "Musharaka (Partnership) Financing"³⁸ describe substantially similar types of transaction. In such cases there may only be a need for supplementary information in the notes to the accounts to provide clarity on the nature of the

³⁷ <http://www.iasb.org/NR/rdonlyres/4DC9F175-FACA-4AFC-AFC5-0B7AF4CAF17A/0/IAS31.pdf>

³⁸ <http://www.aaofii.com/accestandards.html>

book entry. However, other instances of divergence may reflect more fundamental issues. As alluded to earlier in this report, accounting for an Islamic instrument can be complicated by the fact that merely labelling the Islamic contract may be insufficient to determine its economic risks and characteristics, or its regulatory treatment. A recurring example of this is related to Mudaraba financing structures, which may be used in restricted investment accounts.³⁹ The treatment of these accounts can vary; they are sometimes considered to be off-balance sheet items, but in other cases they are viewed as on-balance sheet liabilities. Essentially, how they are treated will depend on whether it is judged that the financial institution is responsible for addressing shortfalls in the account. It may sometimes also be difficult to determine whether a transaction creates a true equity ownership in an underlying asset, or merely an entitlement to a flow of revenue.

As discussed in section 1.3, AAOIFI was in part established to develop accounting and auditing standards specifically for Islamic finance. It is generally accepted that these build on, and aim to be consistent with, conventional accounting standards. Some regulators have mandated the use of AAOIFI accounting standards,⁴⁰ but this has not become general practice across all jurisdictions.

In conventional finance, significant convergence has been achieved in recent years as an increasing number of jurisdictions are seeking to apply IFRS. The lack of standardised practice regarding Islamic financial instruments may cause difficulties in comparing financial statements and disclosures between different jurisdictions. Accounting disclosures should be based on internationally acceptable standards (such as IFRS). In fact, a priority for IOSCO Standing Committee 1 is to promote consistent regulatory interpretation and enforcement of IFRS, and monitor this on an ongoing basis. Regulators should consider whether their accounting requirements are adequate for the purposes of reporting on Islamic securities. Standard-setting agencies such as the IASB may wish to consider the application of IFRS with regard to Islamic financial instruments with other bodies (such as AAOIFI).

Recommendation: Accounting disclosures should be based on internationally acceptable standards (such as IFRS). Regulators, in considering their accounting requirements, should give due regard to the specific characteristics of Islamic securities. Standard-setting agencies such as the IASB may wish to consider the application of IFRS with regard to Islamic financial instruments with other bodies (such as AAOIFI).

2.6 Principles 17-20: Principles for Collective Investment Schemes (CIS)

Overall, while principles underpinning Islamic funds have a significant impact on the way in which an Islamic CIS is operated, and the incentives for their managers, there is no inherent inconsistency between them and the IOSCO principles for CIS.⁴¹ Indeed, in certain respects Shariah principles could be beneficial.⁴² However, for some principles there are issues of

³⁹ See section 2.6 of this report

⁴⁰ For example Bahrain, Dubai International Financial Centre, Syria, Sudan, Qatar. Malaysia and Pakistan have used AAOIFI as a basis for their national accounting standards.

⁴¹ The IFSB has also published an exposure draft entitled 'Guiding principles on governance for Islamic collective investment schemes' (2007), http://www.ifsb.org/docs/ed_islamic_collective_investment.pdf

⁴² Notably in terms of the legal clarity and disclosure required to mitigate gharar, as discussed earlier in section 2.3

implementation which are specific to Islamic finance, and these are discussed at the relevant points.

As mentioned earlier, one common issue in Islamic finance is appropriate product categorisation. Islamic products can sometimes be categorised differently, or not be captured at all, under existing regulatory frameworks due to unfamiliar features in their underlying legal, economic and risk structures. The key regulatory aim in the present context is to ensure appropriate and consistent regulation of those products that have the economic characteristics of a collective investment arrangement. Hence the adoption of the “substance over form” approach reflected in this analysis. Accordingly, most Sukuk, irrespective of the structures used, are not treated as CIS as their economic characteristics are substantively those of corporate or sovereign bonds.

Category A – The implementation of these Principles is wholly compatible with Islamic securities products

Principle 18

The regulatory system should provide for rules governing the legal form and structure of Collective investment schemes and the segregation and protection of client assets.

Principle 20

Regulation should ensure that there is a proper and disclosed basis for asset valuation and the pricing and the redemption of units in a collective scheme.

Category B – Principles whose implementation raises issues for further consideration.

Principle 17

The regulatory system should set standards for the eligibility and the regulation of those who wish to market or operate a collective investment scheme.

In general, the minimum competencies required to operate or market an Islamic fund are the same as those required to operate or market any kind of CIS such as: honesty and integrity of the operator; competence to carry out the functions and duties of a scheme operator; financial capacity; operator specific powers and duties; and internal management procedures. Specifically for Islamic funds, there is a need for expertise and systems in the area of Shariah compliance. The extent to which this is a regulatory requirement will depend on the approach embraced by the relevant regulator. However, regardless of the nature of regulation adopted in each jurisdiction, the requirement for Shariah expertise will bear more heavily on a CIS operator, who will have to ensure the continuing compliance of the fund, than on the marketer.

Eligibility: Securities regulators may or may not choose to consider Shariah compliance within their regulatory remit, but in general, the primary concern for most securities regulators is to ensure that the operator and marketer of the CIS fund meet high standards of

competence. Regulators may wish to consider establishing criteria to ensure the operator of the fund has the relevant competency to ensure the fund adheres to Shariah principles and in addition to ensure that appropriate disclosures are made at the point of sale. In addition, some securities regulators may consider it relevant to examine whether the fund operator has the relevant competencies and the internal management procedures to ensure compliance. Individual regulators may wish to assess whether the relevant AAOIFI standards and proposed IFSB standards might be useful in this regard.⁴³

Supervision and on-going monitoring: In general the systems and controls which underpin effective supervision of Islamic funds should not be fundamentally different to any other type of CIS. However, if regulators have undertaken to regulate Shariah compliance at the entry stage, it would be appropriate for these requirements also to be monitored on an on-going basis.

Delegation: The principle and methodology can be applied as they stand. Even where a third party is used to give an opinion on the selection process for investments, or on other issues of Shariah compliance, this must not relieve the operator of any of its legal or regulatory responsibilities.

Principle 19

Regulation should require disclosure, as set forth under the principles for issuers, which is necessary to evaluate the suitability of a collective investment scheme for a particular investor and the value of the investor's interest in the scheme.

Analysis of general disclosure requirements has been detailed in 2.3. In addition to this, where there is a possibility that some of the fund's income will be distributed to entities other than its investors (for example, where some income may be given to charity), this will also require disclosure.

Recommendation: Similar to the recommendation related to Principle 14, regulators may wish to consider the relevant disclosure standards for Islamic funds within their own jurisdiction.

2.7 Profit Sharing Investment Accounts (PSIAs)

PSIAs are instruments commonly used in Islamic banking. They are often (though not always) pooled investments. There are two types:

- Restricted: the investments are specified
- Unrestricted: the investments are unspecified

Often they are structured under Mudaraba agreements, which in principle means that the investor bears the full investment risk (unless there is misconduct, negligence or breach of contract). In practice, many Islamic banks seek to mitigate the investment risk to investors

⁴³ AAOIFI Standards GSIFI 1,2,3. The IFSB Standards on Shariah Governance will be published in Q4 2008.

and bring the risk profile of the PSIAs in alignment with that of a fixed income deposit. This normally involves the use of reserve accounts, though such techniques have not been universally accepted.⁴⁴

There is as yet no consensus among regulators as to how unrestricted PSIAs should be regulated. Some regulators consider that in practice PSIAs are economically and functionally equivalent to bank deposits, and should therefore be regulated as such.⁴⁵ This would mean that related issues would be more likely to fall within the remit of the BCBS than that of IOSCO. However, other regulators consider PSIAs to be distinct from bank deposits and treat them as such by, for example, requiring clear disclosure that neither principal nor return is guaranteed.⁴⁶ In the latter case, it has been suggested that the principles applicable to CIS may also be of relevance in regulating PSIAs.⁴⁷

There appear to be three broad regulatory approaches that could be taken:

- PSIAs are similar to banking deposits, and should be regulated in substantially similar ways;
- PSIAs are similar to CIS, and should be regulated in a substantially similar way; or,
- PSIAs fall into neither of the abovementioned categories, and should be subject to a bespoke regulatory regime: in this case a comparison has been made with certain investment life assurance products in conventional finance, which share some characteristics with CIS, but are not regulated as such.

This report does not seek to determine which of the above approaches should be taken, but notes that regulators who treat PSIAs as CIS (and therefore apply Principles 17-20 to them) should be mindful that issues may arise, especially in the overlap with the banking regulatory regime which will impact on Principle 17 – Eligibility and regulation. In addition, the following issues may also need to be considered:

Principle 17 - Eligibility and Regulation

There are likely to be acute issues relating to conflicts of interest, since a bank, by the nature of its operations, will often take positions on its own account which may impact on the interests of PSIA holders.

⁴⁴ AAOIFI says (Statement of Financial Accounting 2), “Holders of unrestricted investment accounts and their equivalent receive their share of profits according to what is agreed in their contract with the Islamic bank and bear their share of loss based on the relative contribution of their invested funds.” The IFSB’s draft standard Guiding Principles on Governance for Islamic Collective Investment Schemes notes explicitly (paragraph 7) that at least some PSIAs will fall within its ambit and the standard was specifically designed to address PSIAs as well as more conventionally structured schemes

⁴⁵ This is the approach adopted by the UK FSA. See Ainley et al, ‘Islamic Finance in the UK: Regulation and Challenges’, November 2007

⁴⁶ This is the approach adopted by the Dubai Financial Services Authority.

⁴⁷ This is the IFSB’s approach as detailed in the exposure draft on guiding principles on governance for Islamic CIS - in particular paragraph 7

Principle 18 - Legal form, protection and segregation of funds

The legal form and structure of a PSIA may be unclear and, to the extent that investors' funds are segregated, it is not clear that the segregation would be upheld in extreme circumstances, such as insolvency. This situation may be exacerbated for unrestricted PSIA holders who have their capital co-mingled with the banks own equity, but may lack the protection normally given to depositors.

Principle 19 - Principles of disclosure

In principle, it is possible to specify appropriate disclosures for PSIA. Regulatory bodies might consider the appropriateness of standards and exposure drafts from both AAOIFI and the IFSB. However, the lack of clearly defined structure and governance arrangements as detailed in Principle 18 could make it difficult to ascertain how to focus disclosure requirements effectively.

Principle 20 - Asset valuation, pricing and redemption of units

Islamic banks offering these products may use reserves (often referred to as Profit Equalisation Reserves or Investment Risk Reserves) or other means to smooth earnings. In a normal CIS structure (which involves unitisation, whether in the form of a share or other unit), such practices might pose an obstacle to the principle of CIS regulation which aims to ensure fair and equal treatment of investors (both those outgoing and those remaining in the CIS) and which underpins fair valuation and pricing requirements.

Recommendation: Deciding on the appropriate regime for PSIA is beyond the scope of this report, and should also be of concern to banking regulators. Should any other body decide to undertake any work on Islamic finance, the topic of PSIA would be an appropriate topic for inclusion.

2.8 Principles 21-24: Principles related to Intermediaries

Category A – The implementation of these Principles is wholly compatible with Islamic securities products

Principle 24

There should be a procedure for dealing with the failure of a market intermediary in order to minimise damage and loss to investors and to contain systemic risk

Category B – Principles whose implementation raises issues for further consideration

Principle 21

Regulation should provide for minimum entry standards for market intermediaries

Licensing and supervision: The IOSCO principles require a set of minimum standards for the licensing and supervision of market intermediaries. The minimum competencies for market intermediaries for conventional and Islamic securities business should be similar.

However, for those engaging in Shariah-compliant activities a number of issues arise similar to the licensing and supervision of Islamic CIS. The approach taken by the individual regulator will depend on its approach to the regulation of Shariah compliance, as discussed in section 2.3 earlier.

Recommendation: Where regulators have responsibility for regulating Shariah compliance or regulate the governance of the Shariah decision making process, they may wish to consider establishing criteria to ensure that intermediaries have the relevant competency and resources to ensure that transactions adhere to Shariah principles, both at the outset and also on an ongoing basis.

Principle 22

There should be initial and ongoing capital and other prudential requirements for market intermediaries that reflect the risks that the intermediaries undertake

Capital adequacy requirements and prudential regulations: Prudential regulations should take into account the nature of Islamic securities business. This can be accomplished in one of two ways: the regulator can either ensure that the Islamic products are matched to a conventional equivalent and will therefore share the same prudential regulatory requirements (such as in the UK, where Ijarah and Murabaha mortgages are considered to be equivalent to conventional mortgages), or the regulator can assign a separate prudential risk treatment for Islamic products.

Recommendation: Regulators should define their regulatory approach to determining the capital adequacy and prudential requirements for Islamic securities, and apply this consistently.

Principle 23

Market intermediaries should be required to comply with standards for internal organisation and operational conduct that aim to protect the interests of clients, ensure proper management of risk, and under which management of the intermediary accepts primary responsibility for these matters.

A regulator that chooses to regulate Shariah compliance may also require Islamic financial institutions to apply Shariah-compliant risk mitigation instruments wherever appropriate. Because of the limitations on the permissible instruments, the instruments used may be materially different from those used by conventional institutions. Such regulators may wish to require firms to disclose any instances where non-Shariah compliant risk management instruments have been used.

Recommendation: Regulators who are responsible for Shariah compliance may wish to require that Islamic financial institutions apply Shariah-compliant risk mitigation instruments.

2.9 Principles 25-30: Principles relating to the Secondary Market

The scope of review of these principles covers traditional exchanges, but also other organised markets, such as electronic trading systems including various forms of off-exchange markets such as electronic bulletin boards and proprietary systems developed by intermediaries.

Category A – The implementation of these Principles is wholly compatible with Islamic securities products

Principle 26

There should be ongoing regulatory supervision of exchanges and trading systems which should aim to ensure that the integrity of trading is maintained through fair and equitable rules that strike an appropriate balance between the demands of different market participants.

Principle 28

Regulation should be designed to detect and deter manipulation and other unfair trading practices.

Principle 29

Regulation should aim to ensure the proper management of large exposures, default risk and market disruption.

Category B – Principles whose implementation raises issues for further consideration

Principle 25

The establishment of trading systems including securities exchanges should be subject to regulatory authorisation and oversight.

In general, the minimum competencies required to operate a market which offers Shariah-compliant securities are similar to those that operate a market offering conventional securities. In some cases the exchange itself has the responsibility of determining whether a product is Shariah-compliant. In such instances the exchange should possess the necessary resources and skills to make this assessment. Periodic reviews are also relevant to ensure continuous compliance with Shariah principles.

Principle 27

Regulation should promote transparency of trading.

In general, it is the Shariah board of a fund or an index or a regulator which determines the methodology or screening process for identifying Shariah-compliant securities, although in some instances it is the exchange itself which performs this function. Where the exchange does so, it may wish to consider providing a clear indication that a security is Shariah-compliant by, for example, "tagging" it with a recognised marker. If a security's Shariah compliance status changes, the exchange should possess the operational capability to ensure

that this is disclosed in a timely manner and that it is no longer listed or traded as Shariah compliant.

Recommendation: Where exchanges wish to identify Shariah compliant securities they may wish to tag these securities with a recognised marker and update this as appropriate.

Principle 30

Systems for clearing and settlement of securities transactions should be subject to regulatory oversight, and designed to ensure that they are fair, effective and efficient and that they reduce systemic risk.

Securities borrowing and lending (SBL) is generally encouraged as a method to expedite securities settlement and reduce trade settlement failure. However, in a typical SBL structure there is an element of interest payment which conflicts with Shariah principles. Consideration should be given to alternative mechanisms to SBL, for example by using a mechanism of selling and buying that involves real transfer of ownership between contracting parties, or other Shariah-compliant SBL arrangements.

Recommendation: Regulators which are responsible for Shariah compliance and/or market practitioners may wish to consider developing alternative mechanisms to SBL which are consistent with Shariah principles.

2.10 General recommendations for securities regulators

Maintaining an appropriate regulatory framework for conventional financial markets in the context of rapid evolution, increasing cross-border financial flows and technological sophistication creates challenge for securities regulators, and this issue is perhaps even more pronounced in the nascent Islamic securities industry. As the ICMTF report noted, in some markets there may be a general lack of familiarity with the concepts, structures and practices in Islamic finance, which may cause a tension between regulatory requirements and the practices and investment structures in this non-traditional area. There are several key issues of which securities regulators should be mindful:

Lack of clarity in regulatory classification of Islamic finance products: Securities legislation has historically been crafted to deal with conventional products, and regulators may wish to consider whether their legislation covers Shariah-compliant securities adequately. Islamic securities which are structured to replicate the function of conventional products may be categorised differently, or not captured at all, under the existing framework, due to differences in their underlying legal, economic or risk structures.

This issue is exacerbated by the fact that within the Islamic securities industry, conceptual definitions can give rise to products with differing risk, legal and economic characteristics. Terms such as Musharaka, Mudaraba and Murabaha are generic categories which originate from the different nominate contracts used in early Islamic history.⁴⁸ These terms define types of transaction which underpin specific products – but they are not the products

⁴⁸ See El-Gamal 'Islamic finance: law, economics and practice', Cambridge 2006

themselves. As a result, different products utilising the same underlying contracts (or indeed a combination of contracts) may vary significantly different in terms of their risk profiles and economic substance.

Recommendation: Regulators should consider the implications of Islamic securities market activities for their domestic regulatory frameworks. In this context, they may consider the economic and risk characteristics of the contractual arrangements which underpin Islamic financial products, with a view to providing a consistent and appropriate level of regulation.

Lack of information exchange and awareness: It should be emphasised that the lack of a uniform approach to Islamic capital markets regulations is not in itself problematic; regulation of conventional financial markets also differs according to domestic legal and historical contexts. However, in spite of some existing initiatives, there is a scarcity of information exchange and a general lack of awareness of the products and practices of Islamic finance. Consequently, enhanced cross-border co-operation and information sharing would be beneficial.

Recommendation: It would be beneficial for IOSCO to encourage further information exchange and co-operation between regulators.

Information sharing across jurisdictions: In order to facilitate information sharing across borders and assure the fullest mutual assistance available between members, IOSCO has created a Multilateral Memorandum of Understanding (MMOU). The MMOU contains minimum requirements on all signatories to conduct investigations and enforcement actions, obtain records of securities transactions, and share that information with foreign regulators. By 2010, all IOSCO members will be required to become signatories to the MMOU.

Recommendations: IOSCO members, including regulators dealing with Shariah-compliant securities, should strive to obtain the legislative authority to join the IOSCO MMOU, as well as have the authority to conduct comprehensive and effective investigations and enforcement actions domestically, with the authority to share the results of such authority with foreign counterparts: regulatory, civil and criminal. IOSCO members should also endeavour to meet the signatory deadline of 2010.

Section 3: Conclusion

3.1 Key Findings of the report

The key finding of this report is that there are no concerns with respect to the compatibility of the IOSCO Core Principles with the Islamic securities market. However, there are certain aspects pertaining to implementation in which further work may be beneficial, and these are detailed in the recommendations, which are summarised as follows:

3.2 Recommendations for the Executive Committee

(1) Co-operation, information sharing and thematic work:

- The differences in approach to Islamic capital markets regulations are not in themselves problematic; regulation of conventional financial markets also differs between jurisdictions. There are some existing initiatives in this area (see section 1.3) but in general there is a lack of information exchange, and awareness of the products and practices of Islamic finance. In general, IOSCO could facilitate the understanding of accounting and risk management standards by encouraging further information exchange and co-operation between regulators. Thematic work on disclosure standards for Islamic funds and Sukuk is recommended.

(2) Other recommendations

- **Accounting Standards:** Accounting disclosures should be based on internationally acceptable standards (such as IFRS). Regulators should consider whether their accounting requirements are adequate for the purposes of reporting on Islamic securities. Standard-setting agencies such as IASB may wish to consider the application of IFRS with regard to Islamic financial instruments with other bodies (such as AAOIFI).
- **'Profit Sharing Investment Accounts' (PSIAs):** Though often utilised to replicate conventional banking deposit accounts, PSIAs can also resemble investment accounts or CIS (see section 2.9). Should any other body decide to undertake any work on Islamic finance, the subject of PSIAs would be an appropriate topic for consideration.

3.3 Recommendations for other bodies

(1) Securities regulators

- **General recommendations for securities regulators:** The general recommendation is that securities regulators should consider the regulatory classification of Islamic securities products and ensure they are treated in a fair, transparent and consistent manner. These recommendations are more explicitly discussed in section 2.10.
- **Defining an approach to Shariah-compliance:** Whilst no judgement is made on the various possible approaches to Shariah compliance (ranging from deliberate non-

regulation to direct and centralised regulation), it would be beneficial for regulators to consider defining their position on this.

(2) IMF and World Bank

- **Financial Sector Assessment Program (FSAP):** The IMF and World Bank periodically carry out joint reviews as part of the Financial Sector Assessment Program (FSAP).⁴⁹ The IOSCO principles form a key part of this review and the aforementioned institutions may find it useful to consider the issues detailed in this report. This is especially true in jurisdictions where the Islamic securities market is a significant component of the financial services sector, or is projected to become so.

3.4 Issues in the Implementation of the Core Principles

The report has identified some issues in the implementation of the Core Principles. These are summarised below:

- Principle 1: For the sake of clarity it would be beneficial for securities regulators to have a stated position on their regulatory responsibilities with respect to Islamic securities.
- Principle 3: Where regulators have responsibility for Shariah compliance, it is important to ensure that they possess the necessary powers and resources to regulate this in accordance with their remit.
- Principle 4: Regulators should ensure that processes are applied in a consistent, transparent and fair manner. In particular, where the regulator is directly involved in giving rulings on Shariah issues, it should consider disclosing key decisions, and the reasoning behind them.
- Principle 14: Regulators may wish to consider the relevant disclosure standards for Sukuk within their jurisdiction.
- Principle 16: Accounting disclosures should be based on internationally acceptable standards (such as IFRS). Regulators, in considering their accounting requirements, should give due regard to the specific characteristics of Islamic securities. Standard-setting agencies such as the IASB may wish to consider the application of IFRS with regard to Islamic financial instruments with other bodies (such as AAOIFI).
- Principle 19: Regulators may wish to consider relevant disclosure standards for Islamic funds within their jurisdiction.

⁴⁹ The IOSCO principles are identified by the Financial Stability Forum as one of the 12 key international standards and became part of the report on observance of standards and codes and the FSAP during the pilot programme in 1999. see page 11 <http://www.imf.org/external/np/mae/IOSCO/2002/eng/041802.pdf>

- Principle 21: Where regulators have responsibility for regulating Shariah compliance, they may wish to consider establishing criteria to ensure the intermediary has the relevant competencies
- Principle 22: Regulators should define their regulatory approach to determining the capital adequacy and prudential requirements for Islamic securities.
- Principle 23: Regulators who are responsible for Shariah compliance may wish to require that Islamic financial institutions use Shariah-compliant risk management techniques
- Principle 27: Exchanges which regulate the Shariah compliance of a security may wish to tag them with a recognised marker and update this as appropriate.
- Principle 30: Regulators who are responsible for Shariah compliance and/or market practitioners may wish to consider developing alternative mechanisms to Securities Borrowing and Lending which are consistent with Shariah principles.

ANNEX 1: GLOSSARY OF ARABIC TERMS ⁵⁰

Gharar: Gharar is an element of deception either through ignorance of the goods, the price, or through faulty description of the goods, in which one or both parties stand to be deceived through ignorance of an essential element of exchange. As an example, gambling is a form of Gharar because the gambler is ignorant of the result of the gamble.

Gharar is divided into three types, namely *gharar fahish* (excessive), which vitiates the transaction, *gharar yasir* (minor), which is tolerated and *gharar mutawassit* (moderate), which falls between the other two categories. Any transaction can be classified as forbidden activity because of excessive gharar.

Ijarah: *manfa'ah* (usufruct) type of contract whereby a lessor (owner) leases out an asset or equipment to his client at an agreed rental fee and pre-determined lease period upon the 'aqd (contract). The ownership of the leased asset remains in the hands of the lessor.

Istisna: A purchase order contract of assets whereby a buyer will place an order to purchase an asset that will be delivered in the future. In other words a buyer will require a seller or a contractor to deliver or construct the asset that will be completed in the future according to the specifications given in the sale and purchase contract. Both parties to the contract will decide on the sale and purchase prices as they wish and the settlement can be delayed or arranged based on the schedule of the work completed.

Maisir: Any activity that involves betting whereby the winner will take all the bets and the loser will lose his bet. This is prohibited according to Shariah.

Mudaraba: A contract, which is made between two parties to finance a business venture. The parties are a *rabb al-mal* or an investor who solely provides the capital and a *mudarib* or an entrepreneur who solely manages the project. If the venture is profitable, the profit will be distributed based on a pre-agreed ratio. In the event of a business loss, the loss shall be borne solely by the provider of the capital unless there is negligence or misconduct.

Murabaha: A contract that refers to the sale and purchase transaction for the financing of an asset whereby the cost and profit margin (mark-up) are made known and agreed by all parties involved. The settlement for the purchase can be settled either on a deferred lump sum basis or on an instalment basis, and is specified in the agreement.

Musharaka: A partnership arrangement between two parties or more to finance a business venture whereby all parties contribute capital either in the form of cash or in kind for the purpose of financing the business venture. Any profit derived from the venture will be distributed based on a pre-agreed profit sharing ratio, but a loss will be shared on the basis of equity participation.

Riba: An increase, which in a loan transaction or in exchange of a commodity, accrues to the owner (lender) without giving an equivalent counter value or recompense in return to the other party. It covers interest both on commercial and consumer loans, and is prohibited according to Shariah.

⁵⁰ Source: Securities Commission Malaysia

http://www.sc.com.my/eng/html/icm/icm_default.html, please note that have been minor alterations to some of the definitions

Sukuk: A document or certificate, which evidences the undivided pro-rata ownership of underlying assets or interest in a productive venture. The Sak (singular of Sukuk) is freely tradable at par, premium or discount.

Shariah: Islamic law, originating from the Qur`an (the holy book of Islam), as well as practices and explanations rendered by the prophet Muhammad and *ijtihad of ulamak* (personal effort by qualified Shariah scholars to determine the true ruling of the divine law in a subject matter on which the revelation is not explicit).

Takaful: This is a form of Islamic insurance based on the principle of *ta'awun* or mutual assistance. It provides mutual protection of and joint risk sharing in the event of a loss by one of its members. Takaful is similar to mutual insurance in that members are the insurers as well as the insured.

ANNEX 2: LIST OF CONTRIBUTORS TO THE REPORT

Members

Financial Services Authority, United Kingdom (FSA)
 Australian Securities and Investments Commission (ASIC)
 Central Bank of Bahrain (CBB)
 Autorité des Marchés Financiers, France (AMF)
 Jordan Securities Commission (JSC)
 Securities Commission, Malaysia (SCM)
 Financial Services Board, Republic of South Africa (FSB)
 Dubai Financial Services Authority, United Arab Emirates (DFSA)
 US Securities & Exchange Commission (SEC)

Observer

Qatar Financial Centre Regulatory Authority (QFCRA)

FSA	<ul style="list-style-type: none"> • David Bailey (Chair) - Manager, Capital Markets • John-Paul Dryden (Deputy Chair) - International Strategy & Risk • Ali Ravalia (Secretary) - Associate, Capital Markets • Arshadur Rahman - Associate, Wholesale Banks and Investment Firms Department
AMF	<ul style="list-style-type: none"> • Patrice Aguesse - Director, Corporate Disclosure Department-Regulation Policy and International Affairs Division • Francoise Buisson - Deputy Head, International Affairs, Regulation Policy and International Affairs Division
ASIC	<ul style="list-style-type: none"> • Mark Adams - Director, Regulatory Policy • Cheryl Cutmore - Manager International Policy, Office of International Relations
CBB	<ul style="list-style-type: none"> • Khalid Hamad - Executive Director
DFSA	<ul style="list-style-type: none"> • Peter Casey - Director, Policy • Dhammika Amukotuwa - Associate Director, Policy
FSB	<ul style="list-style-type: none"> • Dube Tshidi - Executive Officer • Kamcilla Naidoo - Lead manager, Capital Markets Department • Elmarie Kruger - Capital Markets Department
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SCM	<ul style="list-style-type: none"> • Ranjit Ajit Singh - Managing Director • Kamarudin Hashim - Head, Bond Market and Private Debt Securities Departments • Dr. Md. Nurdin Ngadimon - Senior Specialist, Islamic Capital Market Department • Neetasha Rauf - Manager, Corporate and International Affairs Department
SEC	<ul style="list-style-type: none"> • Robert J. Peterson - Assistant Director, Office of International Affairs • Sherman Boone - Assistant Director, Office of International Affairs • Erin McCartney - Senior Counsel, Office of International Affairs
Academic consultant	<ul style="list-style-type: none"> • Professor Rodney Wilson - University of Durham, UK

ANNEX 3: IOSCO PRINCIPLES OF SECURITIES REGULATION

A. Principles Relating to the Regulator

- 1 The responsibilities of the regulator should be clear and objectively stated.
- 2 The regulator should be operationally independent and accountable in the exercise of its functions and powers.
- 3 The regulator should have adequate powers, proper resources and the capacity to perform its functions and exercise its powers.
- 4 The regulator should adopt clear and consistent regulatory processes.
- 5 The staff of the regulator should observe the highest professional standards including appropriate standards of confidentiality.

B. Principles for Self-Regulation

- 6 The regulatory regime should make appropriate use of Self-Regulatory Organizations (SROs) that exercise some direct oversight responsibility for their respective areas of competence, to the extent appropriate to the size and complexity of the markets.
- 7 SROs should be subject to the oversight of the regulator and should observe standards of fairness and confidentiality when exercising powers and delegated responsibilities.

C. Principles for the Enforcement of Securities Regulation

- 8 The regulator should have comprehensive inspection, investigation and surveillance powers.
- 9 The regulator should have comprehensive enforcement powers.
- 10 The regulatory system should ensure an effective and credible use of inspection, investigation, surveillance and enforcement powers and implementation of an effective compliance program.

D. Principles for Cooperation in Regulation

- 11 The regulator should have authority to share both public and non-public information with domestic and foreign counterparts.
- 12 Regulators should establish information sharing mechanisms that set out when and how they will share both public and non-public information with their domestic and foreign counterparts.
- 13 The regulatory system should allow for assistance to be provided to foreign regulators

who need to make inquiries in the discharge of their functions and exercise of their powers.

E. Principles for Issuers

14 There should be full, timely and accurate disclosure of financial results and other information that is material to investors' decisions.

15 Holders of securities in a company should be treated in a fair and equitable manner.

16 Accounting and auditing standards should be of a high and internationally acceptable quality.

F. Principles for Collective Investment Schemes

17 The regulatory system should set standards for the eligibility and the regulation of those who wish to market or operate a collective investment scheme.

18 The regulatory system should provide for rules governing the legal form and structure of collective investment schemes and the segregation and protection of client assets.

19 Regulation should require disclosure, as set forth under the principles for issuers, which is necessary to evaluate the suitability of a collective investment scheme for a particular investor and the value of the investor's interest in the scheme.

20 Regulation should ensure that there is a proper and disclosed basis for asset valuation and the pricing and the redemption of units in a collective investment scheme.

G. Principles for Market Intermediaries

21 Regulation should provide for minimum entry standards for market intermediaries.

22 There should be initial and ongoing capital and other prudential requirements for market intermediaries that reflect the risks that the intermediaries undertake.

23 Market intermediaries should be required to comply with standards for internal organization and operational conduct that aim to protect the interests of clients, ensure proper management of risk, and under which management of the intermediary accepts primary responsibility for these matters.

24 There should be procedures for dealing with the failure of a market intermediary in order to minimize damage and loss to investors and to contain systemic risk.

H. Principles for the Secondary Market

25 The establishment of trading systems including securities exchanges should be subject to regulatory authorization and oversight.

26 There should be ongoing regulatory supervision of exchanges and trading systems which should aim to ensure that the integrity of trading is maintained through fair and equitable rules that strike an appropriate balance between the demands of different market participants.

27 Regulation should promote transparency of trading.

28 Regulation should be designed to detect and deter manipulation and other unfair trading practices.

29 Regulation should aim to ensure the proper management of large exposures, default risk and market disruption.

30 Systems for clearing and settlement of securities transactions should be subject to regulatory oversight, and designed to ensure that they are fair, effective and efficient and that they reduce systemic risk.

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