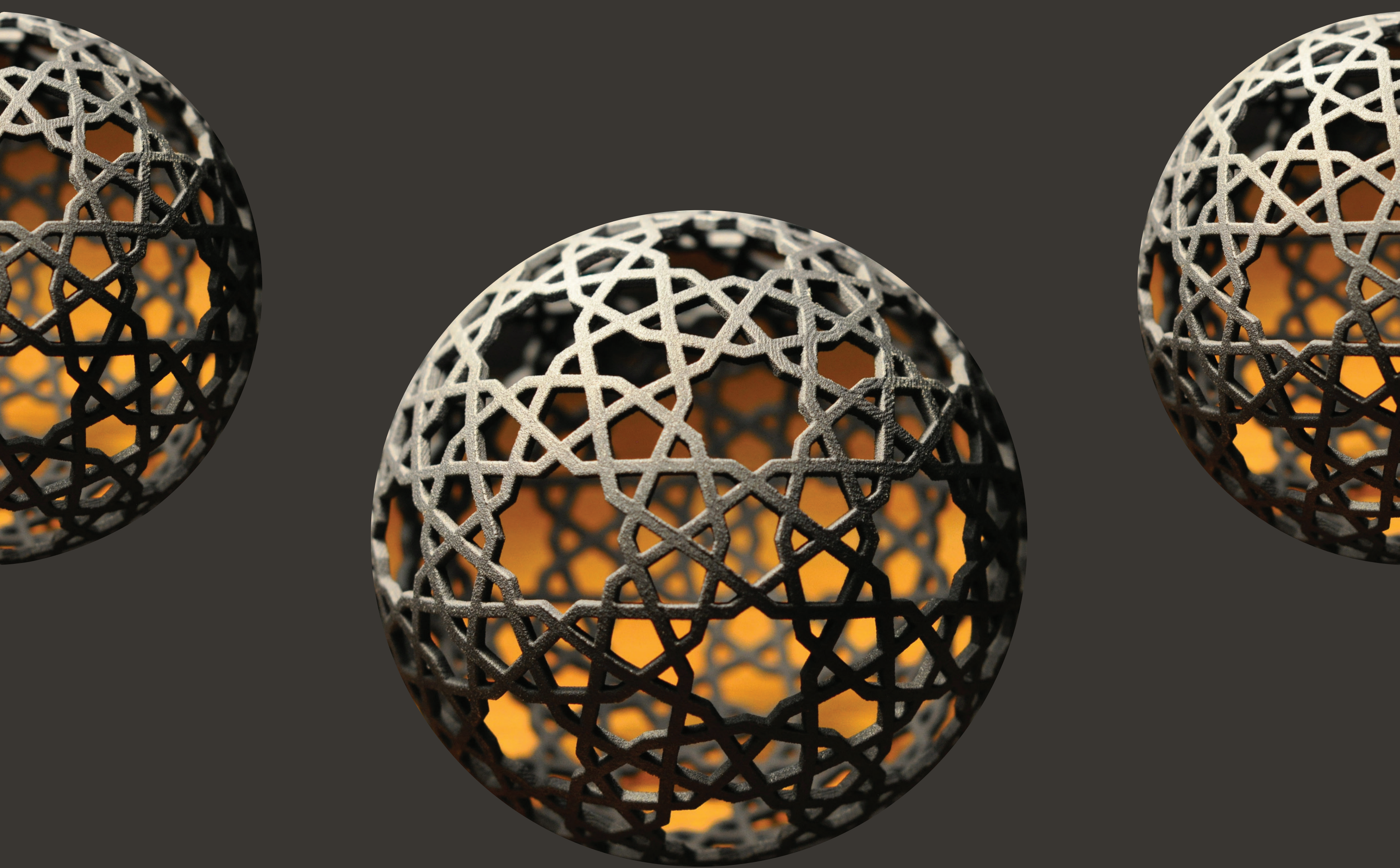
DISCLOSURE REQUIREMENTS FOR ISLAMIC CAPITAL MARKET PRODUCTS

ISLAMIC FINANCIAL SERVICES BOARD

OICU-IOSCO

Suruhanjaya Sekuriti
Securities Commission
Malaysia



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Islamic Financial Services Board
International Organization of Securities Commissions
Securities Commission Malaysia

2013

The views expressed in this publication are those of the author(s) and not necessarily the views of the Islamic Financial Services Board, International Organization of Securities Commissions, and the Securities Commission Malaysia or Directors or Managers of these institutions or the governments they represent.

Published in 2013 by

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ISBN 9789675687303

ABOUT THE ISLAMIC FINANCIAL SERVICES BOARD (IFSB)

The IFSB is an international standard-setting organisation which was officially inaugurated on 3 November 2002 and started operations on 10 March 2003. The organisation promotes and enhances the soundness and stability of the Islamic financial services industry by issuing global prudential standards and guiding principles for the industry, broadly defined to include banking, capital markets, and insurance sectors. The standards prepared by the IFSB follow a lengthy due process as outlined in its Guidelines and Procedures for the Preparation of Standards/Guidelines, which involve, among others, the issuance of exposure drafts, holding of workshops and where necessary, public hearings. The IFSB also conducts research and coordinates initiatives on industry-related issues, as well as organises roundtables, seminars, and conferences for regulators and industry stakeholders. Towards this end, the IFSB works closely with relevant international, regional, and national organisations, research/educational institutions, and market players.

For more information about the IFSB, please visit **www.ifsb.org**.

ABOUT THE INTERNATIONAL ORGANIZATION OF SECURITIES COMMISSIONS (IOSCO)

The IOSCO, established in 1983, is the acknowledged international body that brings together the world's securities regulators and is recognised as the global standard setter for the securities sector. IOSCO develops, implements, and promotes adherence to internationally recognised standards for securities regulation, and is working intensively with the G20 and the Financial Stability Board (FSB) on the global regulatory reform agenda. IOSCO's membership regulates more than 95% of the world's securities markets. Its members include over 120 securities regulators and 80 other securities markets participants (e.g., stock exchanges, financial regional, international organisations, etc.). IOSCO is the only international financial regulatory organisation that includes all the major emerging markets jurisdictions within its membership.

For more information about IOSCO, please visit **www.iosco.org**.

ABOUT THE SECURITIES COMMISSION MALAYSIA (SC)

Established on 1 March 1993 under the Securities Commission Act 1993, the SC is a self-funding statutory body with investigative and enforcement powers. It reports to the Minister of Finance and its accounts are tabled in the Parliament annually. The SC regulates and supervises market operators, market intermediaries, and all matters relating to securities, derivatives contracts, and unit trust schemes. The SC also registers prospectuses of corporations, approves corporate bond issues, and regulates corporate mergers and acquisitions. Underpinning all these functions is the SC's ultimate responsibility of protecting the investors. Apart from discharging its regulatory functions, the SC is also obliged by statute to encourage and promote the development of the securities and derivatives markets in Malaysia.

For more information about the SC, please visit **www.sc.com.my**.

CONTENTS

FIGURES AND CHARTS

ACRONYMS

AAOIFI	Accounting and Auditing Organisation for Islamic Financial Institutions
ABS	Asset-backed securities
ADB	Asian Development Bank
AOSSG	Asian-Oceanian Standard Setters Group
BCBS	Basel Committee on Banking Supervision
BIS	Bank for International Settlements
CAGR	Compound Annual Growth Rate
CIS	Collective Investment Scheme
CMB	Capital Markets Board of Turkey
DCF	Discounted Cash Flow
DFSA	Dubai Financial Services Authority
DIFCI	Dubai International Financial Centre Investment
EWCA	England and Wales Court of Appeal
FSB	The Financial Stability Board
IAH	Investment Account Holders
IAIS	International Association of Insurance Supervisors
IAS	International Accounting Standards
IASB	International Accounting Standards Board
ICIS	Islamic Collective Investment Scheme
ICM	Islamic Capital Market
IDB	Islamic Development Bank
IFN	Islamic Finance News
IFRIC	International Financial Reporting Interpretations Committee
IFRS	International Financial Reporting Standards
IFSB	Islamic Financial Services Board
IFSI	Islamic financial services industry
IIFM	International Islamic Financial Market
IIFS	Institution(s) offering Islamic financial services
IILM	International Islamic Liquidity Management Corporation
IMF	International Monetary Fund
IOSCO	The International Organization of Securities Commissions
IRTI	Islamic Research & Training Institute
ISDA	International Swaps and Derivatives Association
ISDP	International Debt Disclosure Principles
LIBOR	London Interbank Offered Rate
MASB	The Malaysian Accounting Standards Board
MIA	The Malaysian Institute of Accountants
NASDAQ	National Association of Securities Dealers Automated Quotations

OTC	Over The Counter
PER	Profit Equalisation Reserve
PwC	PricewaterhouseCoopers
REIT	Real Estate Investment Trust
SC	Securities Commission Malaysia
SME	Small and Medium Enterprises
SPV	Special Purpose Vehicle
S&P	Standard and Poor’s
TA	Technical Assistance
TID	The Investment Dar
UK	United Kingdom
USD	United States Dollar
XBRL	eXtensible Business Reporting Language

FOREWORD

Islamic finance has today established itself as an increasingly important component of the global financial system with an impressive growth record over the past decade. *Sukūk* issuances, for example, have charted a cumulative annual growth rate of 44% between 2004 and 2011[1]. This expansion is underpinned by an increase in the demand for *Sharī`ah*-compliant financial assets, products and services and the active role played by regulators and the industry globally to promote the development of Islamic financial markets. Islamic finance is currently present in the major financial centres, and this is a recognition of its growing significance and scale.

The Islamic capital market (ICM) as a part of the Islamic financial system plays an important role in offering various modes of financing and investment opportunities to individuals and corporations. Diversification of financial instruments and product innovation in the ICM can add value and increase the risk-return choices for the investors.

Sukūk, or Islamic bond, represents an important avenue for international fund-raising and investment activities generating significant cross-border flows globally, and is the most popular financial instrument in the ICM. The *Sukūk* market has evolved as a major contributing factor driving the internationalisation of Islamic finance, which, has been facilitated by further developments of the international Islamic financial infrastructure, prompting Islamic financial institutions to venture beyond their domestic borders. Islamic funds have also grown in numbers providing an avenue for Muslim investors as well as other investors seeking alternative assets to invest in.

In widening the acceptability and global appeal of the ICM, efforts need to be focused, among others, on having in place an effective disclosure regime for its products. This is an important tool for investor protection and will help strengthen the overall regulatory environment. It can also promote greater cross-border activities by facilitating transparency and a greater understanding of the nature of the investment and its related risks and rewards.

In line with this, the IFSB has conducted a research on the disclosure requirements by capital market regulators in various jurisdictions. Having reviewed several *Sukūk* prospectuses and offering circulars from 2006 to 2010, the IFSB has concluded that the contents of the *Sukūk* prospectuses and offering circulars were dependent upon the jurisdictions in which the *Sukūk* were offered as well as target investors. *Sukūk* issuers tend to comply only with the local regulations whereby domestic investors are the target investors. However, the *Sukūk* prospectuses and offering circulars may contain more disclosures (to meet the disclosure requirements by the relevant authorities) when global investors are involved which reflects that there is no international standard in respect of specific disclosure requirements on *Sukūk* issuance.

This has prompted the IFSB to lead a discussion to identify the possible legal, accounting, *Sharī'ah* and regulatory issues with regard to the current disclosure regulations of various supervisory authorities and its implications to the stability of the

[1] Islamic Financial Services Industry Stability Report 2013

Islamic financial services industry. Recognising the importance for these discussions to take place and the need for concerted efforts, the IFSB, together with the IOSCO and SC had jointly organised a high-level Roundtable on *Disclosure Requirements for Islamic Capital Market Products* on 18 September 2012 in Kuala Lumpur, Malaysia. The Roundtable brought together leading practitioners, senior regulators and the academia to present their thoughts and perspectives on issues and challenges in this area.

This publication has been developed from the proceedings of the Roundtable. It is hoped that the proceedings of the Roundtable which has been documented in this publication will help strengthen knowledge in the area of ICM and will also provide stakeholders with a better understanding of issues covering the disclosure requirements for ICM instruments.

The book begins with the Opening Remarks by Mr. Jaseem Ahmed, Secretary-General of the IFSB, Mr. Tajinder Singh, Deputy Secretary-General of the IOSCO, and Mr. Ranjit Ajit Singh, Chairman of the SC.

In Chapter One, Mr. Yeo Wico outlines a summary of the fundamental principles of Islamic finance and its application to the ICM. He underlines the importance of *Sukūk* and discusses the relevance of the International Debt Disclosure Principles.

Chapter Two consists the Issues Paper by Mr. Peter Casey, followed by commentary papers by Mr. Ijlal Ahmed Alvi, Professor Dr. Volker Nienhaus, and Mr. Christopher Lee. Mr. Peter Casey analyses the dominant Islamic financial instruments and the issues arising. He further discusses the *Sukūk* structures and the issues arising from differences in those structures and raises the question whether the IOSCO disclosure standards are sufficient to deal with these issues.

Mr. Ijlal Ahmed Alvi in his commentary paper examines the importance of disclosure and transparency in the development of the ICM. The paper also includes a discussion on the issue of capacity risk and emphasises the need for document and product standardisation. Professor Dr. Volker Nienhaus highlights issues related to disclosure of the reasoning behind a *Fatwa*, as well as disclosure for Islamic funds. The commentary paper by Mr. Christopher Lee discusses disclosures in relation to *Sharī`ah* compliance. He also highlights the issues arising from different *Sukūk* structures and specific risks associated with those differences.

In Chapter Three, Mr. Mohamed Faiz Azmi highlights in his Issues Paper four key foundational attributes for Islamic finance, namely *Sharī`ah* adherence, Taxation neutrality, Accounting consistency and appropriate Regulatory oversight (*STAR*). In particular, he examines the role of accounting and regulation in promoting investor confidence in the ICM. He also discusses issues on *Sharī`ah* non-compliance risks and *Sharī`ah* screening. Building on that paper, Mr. Hooman Sabeti-Rahmati develops the subject further by examining the role of disclosure in regulating *Sharī`ah* compliance, the adequacy of conventional disclosure principles in addressing issues in the Islamic capital market and the need for enhanced *Sukūk* disclosure. The second commentary paper by Mr. Ashraf Mohammed deals with parallelism between the Asian Development Bank's (ADB) policies and transparency disclosures. He also mentions the need for a minimum standard of disclosure requirements and that self regulation is not a viable option. The commentary paper by Mr. Eser Şagar addresses the approaches to *Sharī`ah* adherence in various jurisdictions. He also discusses accounting standards and recommends revisions to address current shortfalls relating to ICM.

The concluding Chapter provides a summary and synthesis of the Roundtable discussion.

The IFSB, the IOSCO, and the SC would like to thank the participants of the Roundtable for their efforts as well as the contributors of this publication for their high quality papers and significant comments and views shared during the Roundtable discussions. It is hoped that the Roundtable will lead to further engagements and collaborations between standard-setting bodies and regulators to encourage the advancement of the Islamic finance industry.

We are also grateful to those who have contributed in making the Roundtable and this publication a success. In this regard, we would like to extend our special thanks to Mr. Jaseem Ahmed, Secretary-General, IFSB, Mr. Abdelilah Belatik, Assistant Secretary-General, IFSB; Mrs. Siham Ismail, Mr. Mustafa Taşdemir, and Ms. Rosmawatie Abdul Halim from the IFSB Secretariat; David Wright, Secretary-General, IOSCO, Tajinder Singh, Deputy Secretary-General, IOSCO, Ms. Isabel Pastor, Senior Policy Advisor and Mr. Cengiz Alp Eroglu, EMC Advisor from the IOSCO Secretariat; and Mr. Ranjit Ajit Singh, Chairman, SC, Mr. Zainal Izlan Zainal Abidin, Executive Director, Ms. Neetasha Rauf, Mr. Badlishah Bashah, Ms. Shireen Kandiah, Mrs. Azmaniza Bidin, and Mr. Mohd Lukman Mahmud from the SC.

The IFSB, IOSCO and SC

September 2013

ABOUT THE CONTRIBUTORS

Ashraf Mohammed is an Assistant General Counsel in the Office of the General Counsel, Asian Development Bank (ADB) and is the Head of the South Asia and Pacific Legal Teams. Mr. Mohammed is a UK-qualified Solicitor with over twenty five years of legal experience. Before joining ADB in 2004, Mr. Mohammed was a European General Counsel for a NASDAQ-listed international telecommunications company where he spent considerable time working on distress sales and debt restructuring in Europe. Mr. Mohammed has also been a partner in two well-known commercial law firms in London, undertaking company and commercial work, corporate finance, and mergers and acquisitions for a wide range of clients including international banks and multinational corporations as well as acting for insolvency practitioners on insolvency matters. In ADB, Mr. Mohammed has worked in many countries across Asia on both private sector and public sector projects and programmes, in numerous development sectors and in financial intermediation. Mr. Mohammed has also worked on *Sharī`ah*-compliant structures and *Sukūk* legal issues for ADB.

Christopher Lee is a partner in Christopher Lee and Co. law firm. Mr. Lee's area of practice includes infrastructure development, utility privatisation, and project financing and in this area he has negotiated and advised on power purchase agreements, concession agreements, EPC contracts, O&M contracts, and financing documentation for projects. Mr. Lee is also active in the debt and capital markets (both in conventional and Islamic financing). He is advising clients on financing raising exercises involving issuance of *Sukūk*, bonds, and other commercial papers. He has also advised and continues to advise on mandatory and voluntary takeover offers, reverse takeovers, mergers, and acquisitions transactions as well as joint ventures. Mr. Lee has been recommended or noted in the *PLC Which lawyer?*, Chambers Asia 2011, and the 2010/2011 Asia Pacific Legal 500.

Eser Şagar is a specialist at the Department of Corporate Finance, Capital Markets Board (CMB) of Turkey. He received his BA degree in Business Administration from Ankara University and holds an MBA from the University of Cambridge Judge Business School. With over ten years of experience in evaluating disclosure requirements regarding capital market instruments, he has been working in regulation and supervision of Turkish structured products and lease certificates (*Ijārah Sukūk*) for the past four years.

Hooman Sabeti-Rahmati joined the International Islamic Liquidity Management Corporation, a supranational *Sukūk* issuer established by a number of central banks and others, as General Counsel. Prior to IILM, he practised law for fifteen years in New York, London and Singapore, most recently as a partner of Allen & Overy. His private legal practice focused on securitisation, capital markets, and Islamic finance. He is named in the usual industry publications as a leading practitioner in these areas. Before practicing law, he worked on early securitisation transactions as a financial analyst. His Islamic finance practice began with advising on the Malaysian and Qatari sovereign *Sukūk*, the first two global *Sukūk*, in 2002 and 2003, respectively. Since then, he has been involved in the Asian, European, and Middle Eastern markets in advising on *Sukūk* and *Sharī`ah*-compliant securitisations, banking transactions, property financings, structured investment products, property and equity funds, and reinsurance schemes. A number of these were widely recognised as innovative or inaugural transactions of their type. Mr. Sabeti-Rahmati studied mathematics at Duke University and law at Tulane University. He is currently a member of the Advisory Board of the Duke University Islamic Studies Centre.

Ijlal Alvi is the Chief Executive Officer and Secretary to the Board of International Islamic Financial Market (IIFM) since mid 2005 where he has been instrumental in initiating standardisation of documentation, products, and related processes in Islamic Capital and Money Market. Mr. Alvi has negotiated and successfully signed several joint cooperation agreements with other trade and standard setting organisations such as Islamic Research & Training Institute (IRTI-IDB), International Swaps & Derivative Association, International Capital Market Association, and Association of Islamic Banks in Malaysia. Mr. Alvi has been involved in several working committees at international level and has provided extensive technical guidance to various Islamic finance committees, forums, and working groups. He currently manages development of a number of IIFM's Global Documentation & Product Standards particularly on Islamic Hedging & Liquidity Management. So far, Mr. Alvi has overseen the development and launch of several documentation and product standards such as the ISDA/IIFM Tahawwut Master Agreement. Under his management, IIFM has received prestigious WIBC Award for "Outstanding Contribution to the Islamic Finance Industry". Mr. Alvi received a Master's in Finance from Golden Gate University, San Francisco, USA.

Mohamed Faiz Azmi is the Global Leader of PricewaterhouseCoopers Global Islamic Finance Team, the Financial Services Leader for SEAPEN, the SE Asia grouping of firms from Vietnam, Cambodia, Laos, Thailand to Malaysia, and the Joint Leader PwC Assurance Practice in Malaysia. He has over 25 years of extensive experience in the audit and business advisory services of financial institutions both in the UK and Malaysia. Mr. Azmi is also a Partner in the Financial Instruments & Treasury, a unit specialising in offering advice on risk management and accounting matters, particularly on special products and transactions. Mr. Azmi is also a regular speaker on banking and Islamic finance seminars and forums, both locally and globally. He is frequently involved in speaking engagements on Corporate Responsibility (CR) to corporate clients and is the SBS Malaysian contact partner in PwC Global SBS Network. Mr. Azmi was educated in Malaysia and the UK. He holds a BA (Hons) Law from the University of Durham, and trained with Touche Ross & Co. London after being called to the English Bar. Mr. Azmi returned home to Malaysia in 1993 to join Price Waterhouse. He was made Partner in 1996 and still remains as a Senior Partner with PricewaterhouseCoopers Malaysia.

Peter Casey recently retired as Senior Director, Policy and Strategy, and Head of Islamic Finance in the Dubai Financial Services Authority. Mr. Casey has been involved in standards development in Islamic finance through membership of the IFSB Technical Committee and several IFSB Working Groups, including those on Special Issues in Capital Adequacy, Governance of *Takāful* Operations, and Solvency Requirements for *Takāful* Operators. He participated in the joint IFSB-IAIS working group on *Takāful*, and in the IOSCO working group, which analysed the application of IOSCO's Objectives and Principles of Securities Regulation to Islamic products. He has also been a member of the Islamic Finance Working Group of the Asian-Oceanian Standard-Setters Group. He has written two book chapters and numerous articles on Islamic finance topics. Before joining the DFSA in 2002, Peter was the Head of the Non-Life Insurance Department of the UK Financial Services Authority. Before that, he held senior regulatory posts in the Treasury, the Department of Trade and Industry and the Office of Fair Trading. He has wide experience of UK Government, having also served in the Cabinet Office and Science

Research Council, and having worked in areas ranging from export promotion to the creation of computer misuse legislation. Mr. Casey was educated at Cambridge University.

Professor Dr. Volker Nienhaus received his doctorate in economics (1979) and his post-doctorate (1985) from the University of Bochum. He was full professor of economics at the German universities of Trier (1989-1990) and Bochum (1990-2004) where he also was director of the Institute of Development Research and Development Policy and vice rector for structure, planning and finance (2000-2003). He was President of the University of Marburg from 2004 to 2010. He holds an honorary professorship of the University of Bochum (since 2004) and an honorary doctorate of the I.M. Sechenov Moscow Medical Academy (since 2009). Since September 2010, he is Visiting Professor at the ICMA Centre, Henley Business School, University of Reading, UK. In addition, he was a Visiting Scholar at the University of Malaya under the Securities Commission Malaysia Islamic Capital Market programme in 2011. In 2011, he also was Visiting Professor at the Faculty of Islamic Studies of Qatar Foundation, Doha. He served as a member of several academic advisory committees and boards in Germany and is a member of the INCEIF Governing Council. He was a consultant to the Islamic Financial Services Board. His recent research interests cover several areas of Islamic finance, and he has published books and articles on Islamic economics and Islamic banking since the 1980s.

Yeo Wico, a Partner in Financial Services, has a well-rounded practice with broad experience in corporate finance, capital markets, Islamic finance, structured finance, derivatives, mergers and acquisitions, joint ventures, restructuring, private equity, and securities regulations. Mr. Wico has advised on landmark transactions including City Developments Limited’s S$1 billion Islamic Trust Certificate Programme (the first Islamic certificate programme in Singapore), which won ALB Debt Market Deal of the Year 2009; Monetary Authority of Singapore’s S$200 million Islamic Trust Certificate (*Sukūk*) Issuance Programme, which won IFN Singapore Deal of the Year 2009; and Danga Capital Berhad’s S$1.5 billion *Sukūk* issue, which won IFN Singapore Deal of the Year 2010, and IFN Corporate Finance Deal of the Year 2010. Mr. Wico is admitted to practice in Singapore, England and Wales, and the State of New York. He was called to the Singapore Bar in 1992. Mr. Wico has been regularly cited as a leading practitioner in The Asia Pacific Legal 500, and *PLC Which lawyer?*. He has been listed as a leading lawyer for Islamic Banking & Finance by IFN Leading Lawyers.

OPENING REMARKS TO THE ROUNDTABLE

Jaseem Ahmed, Secretary-General, Islamic Financial Services Board

It is my pleasure to welcome all of you to the IFSB-IOSCO Roundtable on Disclosure of Islamic Capital Markets Products. On behalf of the Islamic Financial Services Board (IFSB), I would like to first thank the International Organization of Securities Commissions (IOSCO) and the Securities Commission Malaysia (SC) for their commitment and support in co-organising this landmark Roundtable event. My deepest appreciation goes to the speakers and discussants whom I am very sure have invested a lot of time and effort to work on their respective papers and commentaries despite the busy and tight schedules. Last but not least, I would like to thank all the participants who are here today for accepting our invitation to participate in this event.

As you are all aware, this Roundtable is organised as a “by-invitation only” event. The reason for this is to ensure that first priority is given to experts and professionals like you to actively share your views and to provide constructive comments, ideas, and suggestions to further enhance the strength and the resilience of the Islamic capital market segment of the Islamic financial services industry. Therefore, the expectations on your active participation are high, particularly during the question and answer sessions. Judging by the names and faces in the room today, I strongly believe that we will not only achieve, but exceed these expectations, and will thus be able to achieve the objective of our Roundtable today, which is to identify the gaps between disclosure requirements within the conventional and Islamic capital market products.

Overview

Allow me to enlighten you with some background of the IFSB and this initiative. As an international standard-setting body, the IFSB is mandated to promote the development of a prudent and transparent Islamic financial services industry (IFSI) through introducing new, or adapting existing, international standards consistent with *Sharī`ah* principles, and recommending these standards for adoption. In realising this mandate, the IFSB membership comprises stakeholders from different segments of the financial industry. This is in tandem with the mandate of the IFSB to design prudential structures for firms operating not only in the banking sector, but also for the capital markets and insurance (*Takāful*) sectors.

The membership of the IFSB has grown from just nine members (founding members) back in the year 2002 when it was first established to 187 members comprising 52 supervisory authorities from the banking, insurance, and capital markets; eight international inter-governmental organisations; and 127 market players, professional firms, and self-regulatory organisations from 43 jurisdictions. The representation of the different stakeholders from the various segments of the financial industry in our membership, including the international inter-governmental organisations (namely the World Bank, the IMF, BIS, ADB, and IDB), greatly assists the IFSB in adopting an integrated risk approach to the supervision of the IIFS. These members make up the General Assembly of the IFSB. The IFSB Council, which comprises 20 members whom are heads of lead supervisory authorities and the President of the Islamic Development Bank, is currently chaired by the Governor of the Central Bank of Bahrain, who is the chairman for 2012.

In 2007, the IFSB issued IFSB Standard no. 4 – *Disclosures to Promote Transparency and Market Discipline for Institutions offering Islamic Financial Services (IIFS)*. At the time, the principles and practices addressed in the Standard were designed to enable market participants generally, and *Investment Account Holders (IAH)* in particular, to assess key information on (i) the type of IIFS, (ii) the capital structure, (iii) the treatment of investment accounts, (iv) the risk management process, (v) the indicators of risk-sharing with IAH, (vi) the key aspects of general and *Sharī`ah* governance, (vii) the scope of consumer-friendly disclosures concerning such risks and returns, *Sharī`ah* compliance, and investment account products, and (viii) the role of Islamic windows. The scope of IFSB-4, however, does not include Islamic capital market products, for example the Islamic Collective Investment Schemes or *Sukūk*. Given the strong growth of the latter, there is now a dire need to strengthen the regulatory requirements pertaining to disclosures, so as to extend the coverage of our standards and to make it more comprehensive for the industry.

The subject of disclosure and regulatory practices within the Islamic capital market sector has long been a concern among supervisory authorities, in particular, following the global financial crisis. One of the key concerns in Islamic capital market spins around the issue of the utilisation of conventional regulations to govern Islamic capital market products. This is especially true for *Sukūk*, which is said to have reached the issuance volume of USD 66.4 billion in the first half of 2012[2], despite the uncertainty in the global economy. With such a high demand for this type of Islamic capital market product, it is no surprise that many supervisors are finding themselves swarmed with applications by entities wanting to undertake cash-raising exercise via the issuance of *Sukūk*. The stake is therefore high, as any failure or default will have an adverse effect not only on the investors or customers, but also on the reputation of the issuing organisation as well as the Islamic finance industry as a whole. Hence, it is our hope that this event will provide better understanding and clarification to the industry that there are indeed certain specificities in Islamic capital markets that demand additional regulatory and supervisory scope on top of the existing requirements. Key among these specificities relates to the disclosure of such products, which are generally termed either as Islamic capital market products or *Sharī`ah*-compliant financial instruments.

Categories of disclosure

I would like to address this subject matter of disclosure by looking at it in three areas. First is in the area of legal and regulatory disclosure. Currently, the feedback received from supervisors and industry players in meeting this type of disclosure is, by and large, for the purpose of compliance and not disclosure in its true wisdom.

Second is on the area of accounting disclosure, which is perhaps an area that shares the same borderline with the areas of legal and regulatory disclosure. While the issues related to accounting and auditing disclosure in Islamic finance have been covered by the *Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI)*, I am sure that the discussions today will give us a better understanding, as well as the notions of what more needs to be done, to bridge (if not to close) the gaps in accounting and auditing related disclosures that still exist between the Islamic and conventional

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[2] http://www.interaksyon.com/article/41459/islamic-finance-shrugs-off-global-banking-worries

capital market sectors with the hope that it can contribute to a more comprehensive coverage of the prudential and regulatory frameworks by the supervisors.

The final area would be one that is distinct and unique to only Islamic finance, and it is in relation to *Sharī`ah* disclosure. While we acknowledge that some of the areas related to *Sharī`ah* disclosure can be covered through vigorous evaluation of the governance processes and frameworks applied by the institution concerned, there is no guarantee that what is actually practised in reality is within the desired scope of the *Maqāsid al-Sharī`ah* (foundational goal of *Sharī`ah*).

Now what would the impact be to the industry if these were not taken seriously?

Importance of disclosure

Let me highlight to you one example on the importance of providing accurate disclosure on Islamic capital market products. Take a look at a *Sukūk* prospectus. Most likely, it will point you to a list of names of *Sharī`ah* scholars whom had advised the issuer on matters pertaining to, among other things (i) the structure of the *Sukūk*, (ii) the utilisation of the *Sukūk* proceeds, and (iii) the *Sharī`ah* pronouncements (or opinions) issued and signed by these scholars. For general investors, this implies a blanket *Sharī`ah*-compliant status of the *Sukūk*. It gives them an impression that the scholars have actually placed a *"halal"* stamp on the *Sukūk* when the scholars are in fact contractually acting as advisors to the issuer, NOT to the investors. This issue has been well illustrated in the infamous The Investment Dar (TID) vs. BLOM Bank case[3]. From the risk perspective, this lack of appropriate disclosure had opened up a new type of risk that is non-existent in the conventional capital market, namely *Sharī`ah* non-compliance risk. I do not intend to go into detail on this type of risk but I do hope that it gives you a basic idea of the importance of appropriate disclosure practices in Islamic capital market. I am glad that we have with us today experts with vast experience in this field who will be taking us through the specific disclosure issues in their respective papers and commentaries, which will hopefully help us in understanding and deliberating these issues in greater detail.

Developments at the IFSB

May I now take this opportunity to provide you some updates on the developments that are taking place at the IFSB in general, and developments in relation to Islamic capital markets. The Council of the IFSB in its meeting in Bahrain in March 2012 officially approved the issuance of two more Standards namely *IFSB-12: Guiding Principles on Liquidity Risk Management* and *IFSB-13: Guiding Principles on Stress Testing*. Both of these standards however exclude Islamic insurance (*Takāful*) institutions and Islamic collective investment schemes. Nevertheless, in respect of the Islamic capital market, we have issued three standards that can also be adopted by capital market regulators namely *IFSB-6: Guiding Principles on Governance for Islamic Collective Investment Schemes*, *IFSB-9: Guiding Principles on Conduct of Business for Institutions offering Islamic Financial Services*, and *IFSB-10: Guiding Principles on Sharī`ah Governance Systems for Institutions offering Islamic Financial Services.*

[3] TID, in a legal dispute, argued that the deal approved by its own *Sharī`ah* Board ultimately did not comply with the *Sharī`ah* law and the contract between the company and BLOM Bank was therefore void.

In March 2011, we published a book entitled, *Strategies for the development of Islamic capital markets: Infrastructures and legal aspects of Islamic assets securitisation* that was made possible with the Technical Assistance (TA) from Asian Development Bank and Islamic Development Bank. The book comprises chapters written by several distinguished scholars who share their thoughts and experiences on pertinent issues in the industry. Next, in March 2012, the Council of the IFSB approved the *Strategic Performance Plan 2012 – 2015* that includes, among others, a number of projects for the Islamic Capital Market sector, namely *Disclosure requirements for the Islamic Capital Market Products* – the topic of our current roundtable, *Investor protection in Islamic Capital Markets*, *Comparative study on the regulation of the Islamic Collective Scheme (ICIS)*, and *Strategies for the Development of the ICIS*, just to name a few.

In addition to the Standards, we have also been actively conducting our series of workshops on *Facilitating the Implementation of Standards* in our member countries. These workshops are tailor-made for Islamic capital market regulators and other members within the capital markets sector. To date, we have organised these workshops in Hong Kong, Mauritius, South Korea, and Malaysia. *En shā Allah*, we will have two more of these workshops before we close the year.

Closing

In 2010, the IFSB held a Roundtable Discussion with The World Bank in Washington D.C. on *Effective Insolvency Regimes: Institutional, Regulatory and Legal Issues Relating to Islamic Finance.* The result of this Roundtable is a book published in 2011 that aims to enlighten the industry stakeholders and to provide them with a better understanding on the issues surrounding the insolvency regimes that should be developed for the IFSI. I have a strong inclination towards having similar publication following this Roundtable as I believe this will benefit the IFSI in general, and specifically the capital market regulators.

In closing, I would like to emphasise that the IFSB is indeed very grateful that the IOSCO has agreed to support our cause in promoting better understanding and stronger awareness on the issues of disclosure within the capital market sector and we hope to have more collaboration with the IOSCO in the near future. Last but not least, I would also like to express my thanks to you ladies and gentlemen for your support, commitment, and contribution throughout this Roundtable.

With that, I wish you a fruitful and successful discussion.

September, 2012

Tajinder Singh, Deputy Secretary-General, International Organisation of Securities Commission

On behalf of the International Organization of Securities Commissions (IOSCO), I would like to mention that we are very pleased to organise this event jointly with the IFSB and I am personally very delighted to be invited here to address this prestigious gathering of experts on Islamic finance.

As you well know, IOSCO is the leading international policy forum for securities regulators, with a membership of over 120 securities regulators who are responsible for regulating more than 95% of the world's capital markets including the major capital markets of Europe, the Americas and Asia, and we are still growing.

IOSCO is now recognised as the global securities-markets standards-setter by the G20, the FSB, the International Monetary Fund, and the World Bank, along with its banking and insurance counterparts at the Basel Committee on Banking Supervision and the International Association of Insurance Supervisors. This status is reflected in the fact that we now have two seats on the Financial Stability Board (FSB), representing the more developed markets and emerging markets jurisdictions.

The financial crises in the last decade highlighted that disclosure and transparency, and sound financial reporting are critical elements in mitigating systemic risk and in building confidence in financial markets, which would in turn encourage investment in securities markets with the corresponding effects in the economic growth.

Robust disclosure requirements are critical in ensuring investors have access to timely and accurate information material to make informed investment decisions. As an important segment of the global financial markets, the Islamic finance industry, which observed tremendous growth in recent years, also needs, as much as any other traditional part of the financial sector, to be regulated by sound disclosure and transparency requirements.

In Islamic finance, the details or disclosures of *Sharī`ah* requirements are needed to enable investors to make an informed judgment on the level of *Sharī`ah* compliance of the products and services offered. Insufficient disclosures may result in the introduction of non- *Sharī`ah*-compliant structures branded as *Sharī`ah*-compliant products, the utilisation of proceeds for non-compliant activities, legal misinterpretation and disputes, issues relating to the standardisation of documentation, and comparability issues—all of which can be harmful to confidence among investors.

As highlighted in the 2008 IOSCO Report on the *Analysis of the Application of IOSCO's Objectives and Principles of Securities for Islamic Securities Products*, there is globally lack of a uniform approach to Islamic capital markets regulation. A similar difficulty is also inherent in the conventional financial markets in which regulation differs between jurisdictions. Therefore, further information exchange and co-operation between regulators is necessary. In this respect, thematic work on disclosure standards for Islamic funds and *Sukūk* is strongly needed as also highlighted in the 2008 IOSCO Report on the *Analysis of the Application of IOSCO's Objectives and Principles of Securities for Islamic Securities Products*.

Investor confidence is at the core of IOSCO's aims, and we recognise that investor confidence rests to a large extent on integrity and transparency of financial reporting and disclosure requirements. Therefore, it is worth stressing at this point that IOSCO, as the global standard setter in the securities area, is pleased to collaborate with the IFSB in the organisation of this Roundtable, which addresses important disclosure related issues in Islamic capital markets.

The importance of disclosure and transparency

At the time that the financial crisis reached its peak in September 2008, when Lehman Brothers collapsed, the key fear that gripped markets was uncertainty – uncertainty about the financial positions of counterparties, uncertainty about future funding lines, and uncertainty about institutions' own financial positions. While the regulated securities markets continued their operations very well under extreme stress conditions, and millions of transaction continued to be made and cleared, there still remained uncertainties about positions with a range of unregulated or OTC products.

As the financial crisis has developed into a crisis of confidence in sovereign debt more recently, again what we can see at the heart of the problem is uncertainty; this time it is about public finances in some countries and the political and regulatory actions that will be taken to address them.

This uncertainty – some would call it fear – is fundamentally caused by a lack of transparency and disclosure. **Transparency and disclosure lie at the very heart of an effective capital market.** With adequate transparency, market participants can accurately assess their risks and act accordingly. Without it, they are forced to act on inadequate information, or perhaps worse, they do not act at all and the system seizes.

For many, financial reporting has played a very significant role in the crisis. Some are of the view that the application of mark-to-market or fair value accounting to impairment losses in distressed markets undermines market confidence, exacerbates risk aversion, and contributes to a pro-cyclical worsening of the crisis. Being inexperienced in the use of fair value accounting and in the implementation of intricate and sophisticated valuation techniques behind the accounting treatment of complex structured financial products and derivatives contributes to investors being misled. Others claim that behind the scenes, there are hidden risks in off-balance sheet structures unfolded in contingent liabilities that reduce the confidence in the soundness of financial institutions. Shortcomings in corporate governance practices and failures in the independence of external auditors also add fuel to the fire.

One of the more positive outcomes from the crisis has been reinforcement of the view that good, high quality financial reporting is crucial to the integrity and proper functioning of financial markets and that adherence to fundamental principles on transparency and disclosure is necessary to restore and maintain investor confidence in capital markets. The recent crisis has underscored the importance of some fundamental principles of disclosure that financial reporting should meet in order to contribute to the efficiency of markets and to fulfill its main role in providing transparent, accurate, and relevant information to investors. These disclosures are not only about the issuer's performance and financial condition, but also about issuer's risks and any other information that might be material to investors and users.

In this context, it is very timely to mention IOSCO's work on disclosure and transparency. IOSCO's Committee 1, which carries out mandates on Multinational Disclosure and Accounting, continues to be influenced by those issues raised by the financial crisis particularly in the areas of improved issuer disclosure, transparency, valuation, and accounting issues. To name a few, IOSCO C1 has been working on IFRS Interpretation and Enforcement Issues; Risk Disclosure: Principles for Ongoing Disclosure of ABS; and Auditing and Auditor Independence. IOSCO C1 also provides input to other Accounting Standard Setters such as the IASB, IFRS Foundation, and IFRIC.

Furthermore, most of the IOSCO's G20/FSB related mandates, which are important pillars in restructuring the global financial regulation, have disclosure and transparency related aspects.

IOSCO's disclosure and transparency objectives

Before moving on to IOSCO's disclosure and transparency objectives, I would like to highlight an important fact that differentiates securities markets from the banking and insurance sectors. This fact probably is another demonstration of the importance of sound disclosure requirements, particularly in the capital markets.

The regulation and supervision of banks and insurance firms are more focused on stability than transparency. By contrast, securities regulation is grounded on the principle of disclosure and transparency. Indeed, disclosure and transparency are in the heart of the three IOSCO core objectives of securities regulation.

In 1998, IOSCO adopted one of the most significant documents in its history, called the *Objectives and Principles of Securities Regulation* or simply the IOSCO Principles. Currently, IOSCO Principles document, which has been updated in 2010 to reflect market developments in the last decade and lessons learned from the crisis, consists of 38 Core Principles of Securities Regulation. The Principles are accompanied by a Methodology and are based upon three key objectives of securities regulation, which are:

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

Currently, eight out of the 38 IOSCO Principles—directly or indirectly—refer to disclosure and transparency related issues highlighting the role they play in the capital markets[4].

[4] Principle 16: There should be full, accurate, and timely disclosure of financial results, risk, and other information, which are material to investors' decisions.
Principle 18: Accounting standards used by issuers to prepare financial statements should be of a high and internationally acceptable quality.
Principle 19: Auditors should be subject to adequate levels of oversight.
Principle 20: Auditors should be independent of the issuing entity that they audit.
Principle 21: Audit standards should be of a high and internationally acceptable quality.
Principle 26: Regulation should require disclosure 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 as set forth under the principles for issuers.
Principle 27: 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.

The IOSCO Principles reflect IOSCO's commitment to the establishment and maintenance of consistently high regulatory standards by securities regulators globally. The Principles are among the key International Standards and Codes that the G20 Leaders have committed to seeing implemented and peer-reviewed through the Financial Sector Assessment Programme. This programme, conducted jointly by the IMF and the World Bank, consists of a comprehensive assessment by international experts of the financial regulatory framework of countries who voluntarily submit to it. Thus, the IOSCO Principles and its related IOSCO Assessment Methodology together provide the benchmark against which the securities sector is assessed.

Previous IOSCO work on the Islamic Capital Market

To date, IOSCO has published two Reports on the Islamic Capital Market. In 2004, the Islamic Capital Market Task Force published an *Islamic Capital Market – Fact Finding Report*, which provides an overview of the development of Islamic capital markets and its fundamentals, as well as an assessment of relevant key issues that affect the development of the Islamic capital market. In 2008, IOSCO published another Report entitled *Analysis of the Application of IOSCO's Objectives and Principles of Securities for Islamic Securities Products*, which assesses the compatibility of IOSCO's Core Principles with the products and practices of Islamic finance.

The findings of the 2008 IOSCO Report are that the IOSCO Core Principles are broadly applicable to Islamic securities markets. The Report however highlights that the implementation of certain IOSCO Principles in the Islamic markets could warrant further consideration, and in particular, recommends thematic work be conducted on disclosure standards for Islamic funds and *Sukūk*, as I mentioned earlier.

The Report notes that additional disclosures would be relevant for investors in Islamic securities, and these might include the composition of the *Sharī`ah* board, how the products comply with *Sharī`ah* requirements, and on-going *Sharī`ah* compliance. It also highlights that the differing risk profiles of Islamic securities may warrant the need for enhanced disclosures of financial and/or legal information.

IOSCO's response to the financial crisis

The financial crisis has laid bare a lot of uncomfortable facts about the global financial system, including gross breaches of conduct of business both to retail customers and professional investors, a lack of transparency in markets that we believe to be well organised, and a massive shift of losses to the public sector.

Following the first effects of the financial crisis, IOSCO embarks on a programme of overhauling securities markets standards including, in particular, those areas highlighted as being problematic or having a contributory factor to the crisis.

In collaboration with the G20, FSB and other global standard setters, IOSCO is well advanced on an ambitious post-crisis work programme to address forward-looking issues affecting the regulation and oversight of securities markets and is at the cutting edge of the development of the necessary standards, where at the heart of all of this work are two core

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[4] Principle 35: Regulation should promote transparency of trading.

pillars of securities regulation that are relevant to the focus of today's conference—disclosure and transparency. Some of the main IOSCO works in this respect are Shadow Banking, OTC Derivatives Markets Reform, External Audit, Issues Related to Emerging Markets, and Developing Economies.

Closing remarks

As in the traditional capital markets, it is important to achieve greater harmonisation with respect to disclosure requirements across jurisdictions where Islamic capital market products are offered. Toward this end, this Roundtable serves for an important purpose. As the global international standards, the IOSCO Principles related to disclosure and the Methodology can serve as an important guideline to achieve this objective.

As IOSCO, we are very glad to collaborate with the IFSB in the organisation of this event, given its experience and technical expertise in the subject matter. The IFSB as the international standards setter for the Islamic financial services industry (including banking, capital market, and insurance) has been active in the development of standards for the Islamic financial services industry, and therefore we see this collaboration as an initiation of future joint efforts and an important first step to contribute to global efforts in convergence of the global financial regulation.

Thank you very much.

September, 2012

Ranjit Ajit Singh, Chairman, Securities Commission Malaysia

Chairman of the Emerging Markets Committee, IOSCO, members of the inaugural IFSB-IOSCO Roundtable, and for those who have come from overseas, it is my pleasure to welcome you to Kuala Lumpur this morning. It is certainly a significant moment for us to be able to have this Roundtable that we have been talking about for a while and finally seeing the fruition of the efforts to have this discussion on a subject that is extremely important in the area of Islamic finance. Once again, it is delightful to have such a high level participation at this Roundtable and I am very grateful for your presence today.

The topic of today's Roundtable, *Disclosure Requirements for Islamic Capital Markets Products*, is certainly a very timely topic in view of the increasing cross-border transactions and activities that are happening in the Islamic capital market space and particularly against a backdrop of significant growth in the last 10 to 15 years which, by all estimates and projections, look like it is going to be sustaining further. Figure for the last decade, which was about 14% average annual growth in the global Islamic finance industry, is expected to record further expansion of about 10 to 15% in the region for the next five years.

In Malaysia, we have been focusing our efforts on developing Islamic finance. More broadly, our own projections of growth in the next phase of the *Capital Market Masterplan 2* also show that we will continue a double-digit growth for the Islamic capital market component. Much of the growth projections are to do with efforts at further internationalisation of the Islamic capital market arising from an expansion of products and services, including enhancement of distribution channels, increasing collaboration with various jurisdictions, and mutual recognition arrangements that we have in place, and of course, from greater international trade and investment flows that are likely to characterise the space in the next few years. Therefore, developments in the area of disclosures will be significant in supporting these internationalisation efforts.

In view of this, and in view of significant developments in the Islamic capital market space globally, there is clearly a strong recognition among stakeholders for more concerted initiatives across jurisdictions to facilitate greater cross-border transactions and activities, while from a regulatory and market stand point ensuring that investors' interests remain well protected. In fact, today's Roundtable has come about from such recognition.

You heared from my colleagues from the Islamic Financial Services Board, Jaseem Ahmed, the Secretary-General, who talked about the work that the IFSB has done and their own aspirations on what the Roundtable is about, as well as from the IOSCO, represented by the Deputy Secretary-General, Tajinder Singh, who shared with us some of the works that IOSCO has conducted.

I would like to make a couple of brief comments, particularly given the Securities Commission's very strong involvement in the Islamic capital market space. In 2004, we chaired the IOSCO's Islamic Capital Market Task Force, which produced the first work that IOSCO had done in this area. The *Islamic Capital Market Fact Finding Report* in 2004 was intended to be an assessment of the landscape with an aim of creating dual objectives. Firstly, it was to create awareness in the developments occurring in the Islamic capital market to the wider community of securities regulators, and secondly, to be able to assess the application of the IOSCO Objectives and Principles, which are the core principles within which securities regulation worldwide is applied, against Islamic finance.

Subsequently, in 2008, IOSCO further looked at the work in this area by having another Report on the *Analysis of the Application of IOSCO Objectives and Principles of Securities Regulation for Islamic Securities Products*. This was an update of the work that was done earlier. The conclusions from both reports affirmed that the IOSCO Principles are generally applicable; however, there are several areas for enhancements among which are the areas related to disclosures, for which we hope that this collaboration will provide specific recommendations that can then be incorporated into the body of work that we have on capital markets.

The IFSB, equivalently, is also to be commended for the continuous work that they do in this area, specifically in the space of disclosure as they have issued standards on disclosures to promote transparency and market discipline. Again, this too provides very specific sets of principles for institutions offering Islamic financial services in making disclosures. So, the challenge for us in moving forward is to bring these two bodies together and look at what can be done in terms of identifying areas for cross-border activity that will provide a framework for market participants in respect of Islamic capital market regulations as well as disclosures.

Let me just finish off by mentioning a little about what the Securities Commission does in its own approach, and to bring the discussion closer to the Commission's efforts in this area. We, of course, have a disclosure-based regime operating in the Malaysian capital market. At the same time, the Securities Commission adopts a two-tier approach in respect of the Islamic capital market. The first tier requirements apply to all Islamic capital market products, regardless of whether they are conventional or Islamic, while the second tier addresses requirements specific to Islamic capital market products. This approach is consistent with the findings in the IOSCO Reports, which provide that the IOSCO Principles are compatible with and can be applied to the Islamic capital market, with certain additions to address issues specific to it.

In this regard, the disclosure requirements and other provisions applicable specifically to Islamic capital market products are either issued as stand-alone guidelines or, in some cases, incorporated into the general guidelines. Either way, the two-tier approach ensures that investors of Islamic capital market products receive the same level of disclosure and protection as those of conventional ones, while at the same time ensuring that there is greater clarity and consistency to market participants.

As the Islamic capital market expands and becomes increasingly global, it is important that the issues surrounding investor protection and market integrity are addressed from a cross-jurisdictional perspective. It is therefore hoped that this first formal collaboration between the IFSB and IOSCO, with your participation, will lead towards strengthening disclosure requirements in the areas unique to the Islamic capital market, and contribute to greater growth in the global Islamic finance space.

Let me finish by thanking you, once again, for being here. I am deeply appreciative on behalf of the Securities Commission for your presence and to provide your valuable time, thought leadership, and contributions. I hope you have a valuable and useful deliberation during the Roundtable and look forward to your insights during the day.

Thank you very much.

September 2012

Chapter One

Comparative Evaluation of Regulatory and Best Practices on Disclosure of Islamic Capital Market Products

ISSUES PAPER

Yeo Wico

Chapter One
Comparative Evaluation of Regulatory and Best Practices on Disclosure of Islamic Capital Market Products

ISSUES PAPER

Yeo Wico

I. Introduction

I am grateful to the organisers of this Roundtable for inviting me to speak. The topics chosen by the organisers of this Roundtable clearly demonstrate their vision and commitment to promote the international development of Islamic capital markets based on globally recognised standards.

Before focusing on the areas of development in the International Organization of Securities Commissions' (IOSCO) *International Disclosure Principles for Cross-Border Offerings and Listings of Debt Securities by Foreign Issuers* (the "**Principles**"), I propose to lay the background by highlighting the fundamental principles of Islamic finance and its application to *Sukūk*, which are the most prevalent type of Islamic capital market instruments.

Fundamental Principles in Islamic Finance

The fundamental principles in Islamic finance could be summarised in the following manner:

- Money is regarded as a measure of value and not an asset in itself.
- Profiting from trade of money is regarded as *Riba* and not permitted.
- Profits cannot accrue from lending money.
- Financiers are required to assume risks related to business or ownership of assets.
- As a general guideline, profits must accrue from:
  - Asset purchase and sale or trading (e.g. *Murābahah* or Commodity *Murābahah*);
  - Leasing (e.g. *Ijārah*); or
  - Investment in *Sharī`ah*-compliant enterprises, real estate or other assets (e.g. *Mushārakah*, *Muḍārabah* or Diminishing *Mushārakah*).
- There are prohibited industries or activities such as gambling, alcohol, pornography, hotel or entertainment business.

The over-arching principle of Islamic commercial law (*Fiqh al-Mu`amalāt*) being:
"All transactions are to be considered lawful so long as they include nothing that is prohibited."

Choice of Governing Law

When we apply fundamental principles of Islamic finance to Islamic capital market instruments, the first key point to establish is the governing law of the Islamic capital market instruments. The choice of governing law is critical because it establishes the rights and obligations of the parties, and the system under which such rights and obligations could be enforced in a lawful manner.

In practice, Islamic finance transactions may be governed by the laws of any jurisdiction. Typically, they are governed by conventional laws (such as Singapore or English law), not *Sharī`ah*. With this as the premise, the legal documents are prepared with the view to reflect compliance with *Sharī`ah*, but they are not governed by *Sharī`ah*.

Enforcement

The approach of an Islamic finance transaction being governed by conventional laws but reflecting *Sharī`ah* compliance has been tested in English courts.

The English Court of Appeal held in *Shamil Bank of Bahrain EC v Beximco Pharmaceuticals Limited & Ors* [2004] EWCA Civ 19 that contractual obligations are based on the conventional banking law regime. Accordingly, the Islamic finance agreement between the parties was held to be valid as a financing transaction and reference to *Sharī`ah* in the governing provision was not enforceable. The court also decided that English courts will not take the place of Islamic scholars in ensuring compliance with *Sharī`ah*.

The current practice is that the documentation for an Islamic finance transaction should reflect the intended *Sharī`ah*-compliant nature of the transaction, although it is not intended that the documentation be governed by *Sharī`ah*. To make this abundantly clear, the market norms for governing law and jurisdiction clauses in Islamic finance documentation is not to make reference to *Sharī`ah*. Instead, the Islamic finance documentation should be structured and prepared to reflect the intention that the transaction is intended to be *Sharī`ah*-compliant.

With this fundamental understanding, we will apply Islamic finance principles to *Sukūk*.

II. *Sukūk*

Sukūk are trust certificates or securities of equal value issued by, or subscribed to in a *Sharī`ah*-compliant investment scheme. *Sukūk* are commonly described as the Islamic equivalent of conventional bonds. There are key differences between *Sukūk* and conventional bonds.

Key Differences between Sukūk and Conventional Bonds

The key differences between *Sukūk* and conventional bonds could be summarised as follows:

- *Sukūk* are asset-based (but not necessarily asset-backed).

- *Sukūk* represent undivided proportionate ownership interest in the underlying asset in the *Sharī`ah*-compliant investment scheme.
- Attached to this ownership interest is the corresponding right to income streams from that asset.
- *Sukūk* cannot be based on a transaction of debt and credit on a future basis (unlike conventional bonds).

These differences arise from the application of Islamic finance principles to *Sukūk*. To better illustrate this point, I turn to a typical structure for a *Sukūk*, described below.

Sukūk Al-Ijārah

A *Sukūk al-Ijārah* is based on an *Ijāra*, which refers to a lease or rental or hire contract whereby the lessor leases out goods, services, assets, real property or equipment to a lessee at an agreed rental fee for a pre-determined lease period.

The characteristics of an *Ijārah* are:

- Lessor holds title to *Ijārah* property and bears responsibility for its upkeep.
- Rentals derived under the *Ijārah* agreement are equivalent to the coupon payable under *Sukūk*.
- Assets sold by SPV issuer to asset originator is pre-agreed and includes:
  - Face amount of the outstanding *Sukūk*; and
  - All other amounts due and owing by asset originator (as lessee) to SPV issuer (as lessor) under the *Ijārah* agreement.

Graphically, the key steps and cash flows of *Sukūk al-Ijārah* are presented below in three phases:

- At inception;
- Periodic payments during the life of the instrument; and
- At maturity or dissolution.

Figure 1: Cash flows in *Sukūk al-Ijārah* – At Inception

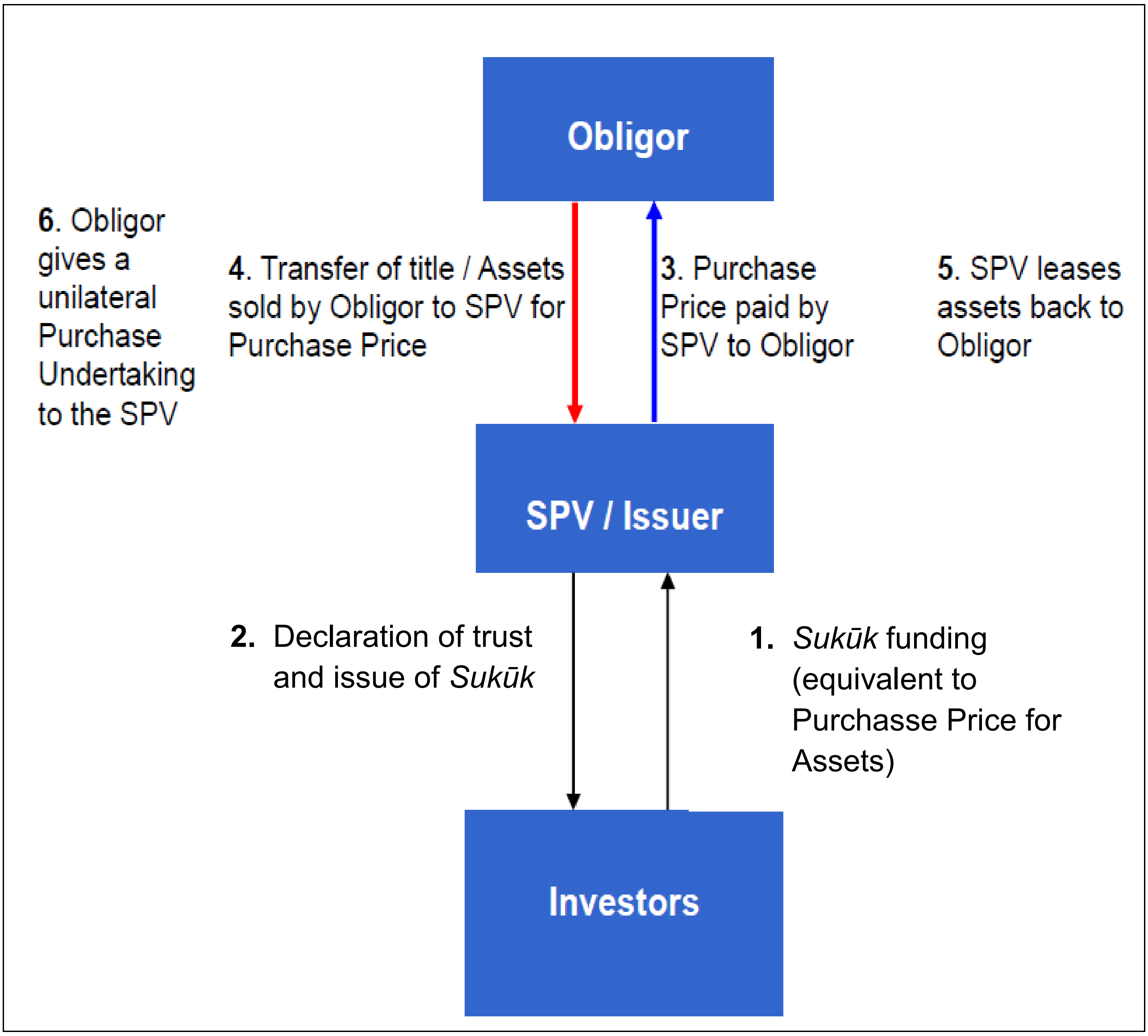


Figure 2: Cash flows in *Sukūk al-Ijārah* – Periodic Payment

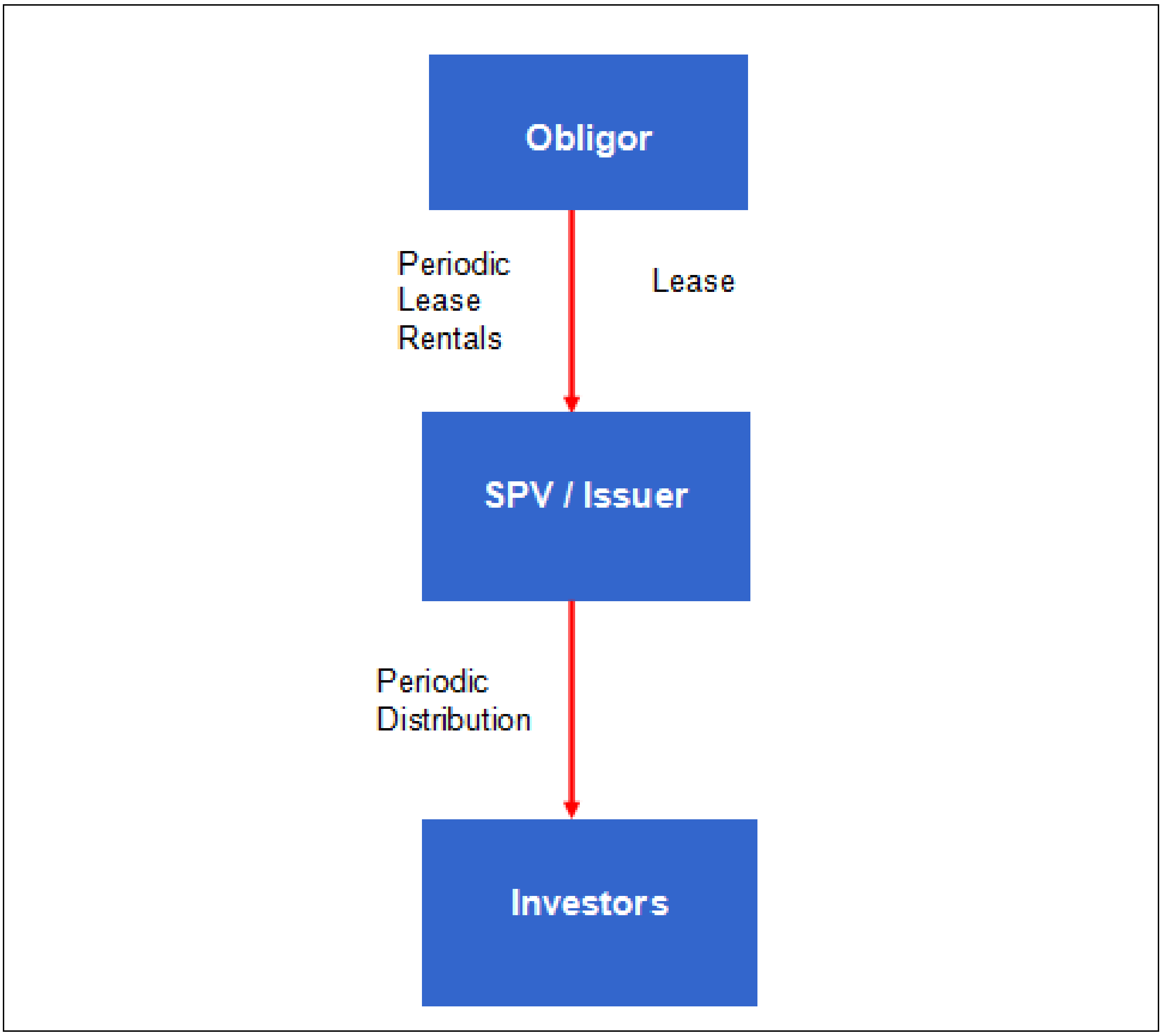
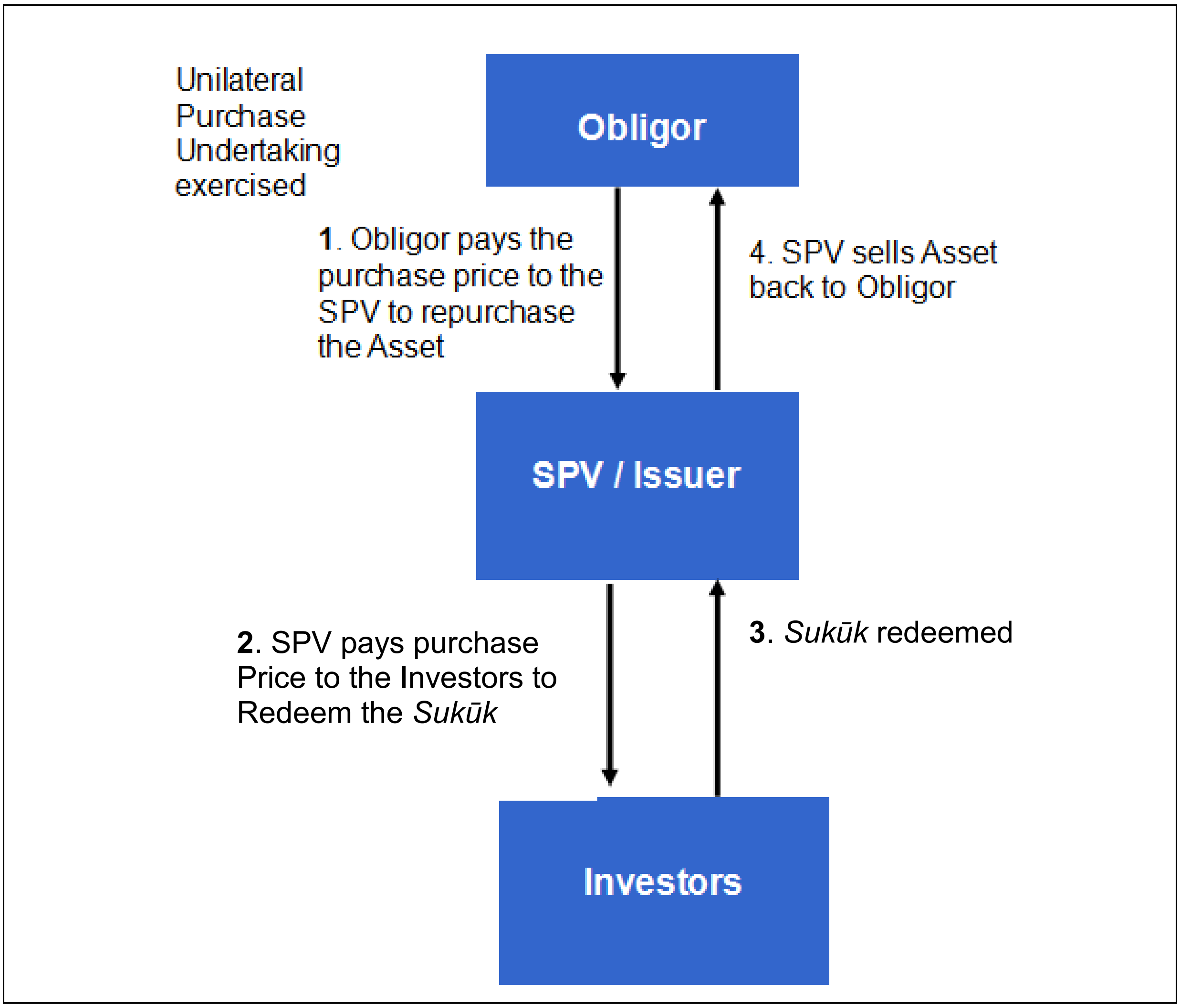


Figure 3: Cash flows in *Sukūk al-Ijārah* – At Maturity/Dissolution



III. International Debt Disclosure Principles

After discussing Islamic finance principles as summarised above and how they could be applied to *Sukūk*, we turn our attention to the Principles.

Essentially, the Principles provide guidance on the following areas of disclosures:

- Identities of parties responsible for the document
- Description of the debt securities
- Risk factors, including those specific to the Issuer and its industry
- Markets
- Information about the public offering
- Taxation
- Selected financial information about the Issuer
- Information about the Issuer
- Operating and financial review and prospects
- Directors, senior management, and employees of the Issuer
- Major shareholders and related party transactions of the Issuer
- Interests of the Issuer's experts and counsel
- Financial information of the Issuer

After reviewing the Principles, I am of the view that there are a few key areas of focus that could advance the development of disclosure standards for international Islamic capital market instruments, using the *Sukūk* structure described above as guidance.

Areas of Focus

The Principles should adopt a new set of principles that are yield-based rather than debt-based. The benefit of this approach is that the focus will be on the income nature of the securities (that is their yield), rather than their classification as debt or otherwise.

The Principles currently refer to "debt securities". However, as demonstrated by the application of Islamic finance principles described above, *Sukūk* (whilst bearing similarities with conventional bonds) differ from conventional bonds. *Sukūk*, unlike conventional bonds, are not based on a transaction of debt and credit on a future basis.

For example, the *Sukūk al-Ijārah* is structured in such a way that holders of *Sukūk* receive payments for the lease of the *Sukūk* asset rather than by way of a debt.

I suggest that the Principles be reviewed to adopt a new set of principles that are yield-based rather than debt-based (the "**New Principles**").

Focus on the Obligor

The Issuer is defined in the Principles as a "company whose debt securities are being offered to the public or listed". Accordingly, the subject matter of the Principles is focused on the Issuer but not the Obligor (which is referred to in the structure above relating to *Sukūk al-Ijārah*).

Holders of *Sukūk* are primarily concerned with the ability of the Obligor to make timely payments. In the New Principles, I would suggest that the focus should be on the Obligor.

Description of the Sukūk

Unlike bondholders, holders of *Sukūk* have undivided proportionate ownership interests in the *Sukūk* asset.

The New Principles should focus on the ownership of the holders of the *Sukūk* and the structure of the particular *Sukūk* and the material risks involved. Clearly, the key terms of the *Sukūk* arrangement should be disclosed, which in the case of *Sukūk al-Ijārah* consists of:

- Acquisition of the *Sukūk* asset from the Obligor;
- Lease of the *Sukūk* asset to the Obligor; and
- Sale of the *Sukūk* asset back to the Obligor.

Sharī`ah Compliance

The New Principles could also provide guidance on *Sharī`ah* compliance being the key aspect of Islamic finance, and how market participants could address it.

In an Islamic finance transaction, the pronouncement or *Fatwa* from *Sharī`ah* advisors inform potential investors that the *Sukūk* is compliant with the principles of *Sharī`ah*.

The issues that could be the subject of further discussion and deliberation in the New Principles may include the following key areas:

- Should the pronouncement or fatwa be disclosed in the offering document?
- Should potential investors rely on the pronouncement or fatwa in deciding to make an investment in the *Sukūk*?
- Should potential investors consult their own *Sharī`ah* advisors before making any investment decision?

IV. Conclusion

By identifying and elaborating on the areas of focus, I hope to contribute towards finding the path forward on these and many other matters to be discussed at the Roundtabl

Chapter Two
Emerging Issues from Inadequate Disclosure Requirements for Islamic Capital Market Products

ISSUES PAPER

Peter Casey

Chapter Two
Emerging Issues from Inadequate Disclosure Requirements for Islamic Capital Market Products

ISSUES PAPER

Peter Casey

I. Introduction

The Islamic capital markets

Islamic capital markets (ICM) are at present dominated by three types of instruments: equities, collective investment funds, and *Sukūk*[5]. Other ICM products are in their infancy, and it is not clear that they will develop beyond it. The basic tenets of Islamic finance make it very difficult, for example, to sell short, to trade in debt other than at par, or to create contracts for differences. Even options over equities are controversial. Some of the limitations can be overcome with some ingenuity, but there is often a price to be paid, for example in terms of tradability. However, ingenious minds are always at work, and it remains possible that we shall in the future see new instruments in the Islamic markets, for which wholly new issues arise.

Even for the three dominant types of instruments, the modern ICM are rather young and volumes are relatively small. Moreover, some of the countries where Islamic finance is prominent are ones in which the tradition is for disputes to be resolved behind closed doors, rather than in courts or by public regulatory interventions. The combined effect of these factors is that there have so far been few disputes or interventions that have been analysed in detail. Although there have been claims that disclosure was inadequate in specific cases, few of them have been subject to rigorous testing, at least in any public forum. It is therefore difficult to argue confidently from practical experience. Nevertheless, I shall draw on the experience of certain *Sukūk* that have been the subject of default or near-default.

This is a paper about disclosure, and in particular about disclosure standards. There are other ICM issues, for example about governance, or the role of ratings agencies, which cannot be covered in detail here. I also do not discuss accounting standards, which are covered in a separate paper.

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[5] There is scope for debate as to what should be treated as a capital markets instrument. For example, a bank loan is certainly part of the market for capital, but is not normally regarded as a capital markets instrument. For the purposes of this paper, I have concentrated on <u>securities</u> markets, i.e., those markets that would be covered by the IOSCO Core Principles. See, for example, the Introduction to the IOSCO Methodology, Section E.

II. The key instruments and issues

Very few practitioners of Islamic finance see any structural problem with normal equities. The issues that concern investors are predominantly whether the underlying activity of the business is acceptable in Islamic law and whether its financing is also acceptable. The normal initial and continuing disclosures associated with equities provide a reasonable basis to answer such questions, and there is no significant body of opinion arguing for anything different. The remainder of this paper will therefore not consider equities (except in relation to collective investment schemes).

For other Islamic capital instruments, the disclosure issues fall into two broad classes. One class concerns the way that instruments or transactions are structured. The second concerns the claim to be compliant with the *Sharī`ah*, the body of Islamic law. Although the structures are chosen to achieve compliance, the two classes of issues are different. It would be possible in principle to have an instrument structured in the same way as a typical *Sukūk*, but making no claim to be Islamic. Such an instrument might, and in my opinion would, raise issues of the first type, but not of the second.

Conversely, Islamic collective investment funds in general raise no structural issues. They can, and generally do, use, one of the structures familiar in conventional finance without modification. They have certain limitations in what they can do, but the structure of a typical fund would be entirely familiar to any conventional regulator[6].

This paper will deal first with the disclosure issues associated with structure, and in that discussion will concentrate on *Sukūk*. It will then discuss the issues of *Sharī`ah* compliance, with particular reference to both *Sukūk* and collective investment funds.

Implicit in any such discussion are two well-established regulatory principles. One is that disclosure is only one of the approaches available to protect investors; product regulation and regulation of the sale process are others, and in practice regulatory regimes have elements of all three. The other principle is that the strength of regulation will depend on the market participants; a true interprofessional market will generally be regulated less heavily than a retail market. This paper cannot discuss all the possible complexities arising here, and implicitly assumes that Islamic instruments are being traded in broadly similar markets to their closest conventional counterparts.

Disclosure issues arising from structure

Sukūk are an established feature of the capital markets. The word "*Sukūk*" is strictly a plural noun meaning something like "certificates", though it is often used as though it were singular.

Sukūk can in principle vary very widely in both form and substance. Modern Islamic finance has in general based itself on the contract forms known in the early Islamic period, and on which substantial jurisprudence has been accumulated. AAOIFI[7] identifies 14 of these contract forms on which *Sukūk* can be based. Admittedly, some of them are fairly obscure agricultural contracts but, on the other hand, *Sukūk* structures are often complex

[6] For this purpose, a Real Estate Investment Trust (REIT) is regarded as one particular type of collective investment fund, as is a private equity fund.

[7] The Accounting and Auditing Organisation for Islamic Financial Institutions

and the base contract may be surrounded with multiple supporting contracts or undertakings that materially affect the nature of the transaction. For example, it would be easy to create a *Sukūk* issue, based on the classical *Ijārah* contract, which looks very much like a real estate investment trust, involving sale and leaseback of one or more properties and with the *Sukūk* holders taking substantial asset risk. But, it would be equally easy – and it has been done many times – to create an *Sukūk Al-Ijārah* that is economically equivalent to a fixed rate corporate note, in which the holders effectively take only the counterparty risk of the originator. So, to call an instrument a *Sukūk* in fact says very little about its economic character, and even to name the contract on which it is based does not necessarily say much more.

In practice, most *Sukūk* are structured to resemble fixed or floating rate bonds over a period of typically 1-7 years. There are a few longer term *Sukūk*, and some shorter "bill-like" ones from governments such as Bahrain, often with limited tradability. However, they almost all have in common an effectively fixed return, or one determined by reference to an external benchmark, with the key risk being the counterparty risk of the originator, or in some cases a guarantor. In 2009, the Dubai International Financial Centre Authority, in conjunction with Clifford Chance, published a book on *Sukūk* structures[8]. For every base contract discussed, the focus of the discussion in that book is how to build around it in such a way as to mimic as closely as possible a conventional debenture.

However, this debenture-like character is by no means inherent in the concept of *Sukūk*. Indeed, many practitioners argue that it is unfortunate, and that Islamic finance should, at its best, be offering instruments with different patterns of risks and returns from those which dominate the conventional markets. It is thus possible that future instruments issued under the name of *Sukūk* will <u>not</u> be designed to mimic conventional debentures, or indeed any other standard conventional instrument. It is, however, unclear whether there is market appetite for some new instrument. The discussion that follows will concentrate on the market as it currently is, i.e., dominated by *Sukūk* economically similar to debentures, but I shall discuss towards the end the possible implications of new types of instruments.

Even where *Sukūk* <u>are</u> designed to mimic in their economic effects a conventional debenture, the aim is typically achieved through moderately complex engineering. Figure 4, for example, is a rather simple real *Sukūk* structure.

It depends on only five transaction documents, but each of these documents is in principle independent. Furthermore, one of the parties (DIFCI) appears in two roles: as *Muḍārib* (managing the money the *Sukūk* holders have invested) and as Obligor (undertaking to buy out from the *Sukūk* holders at the end of the period or if certain events happen).

[8] See: http://www.difc.ae/news/guide-issuing-*sukūk*-difc-published

Figure 4: DIFCI *Sukūk* structure

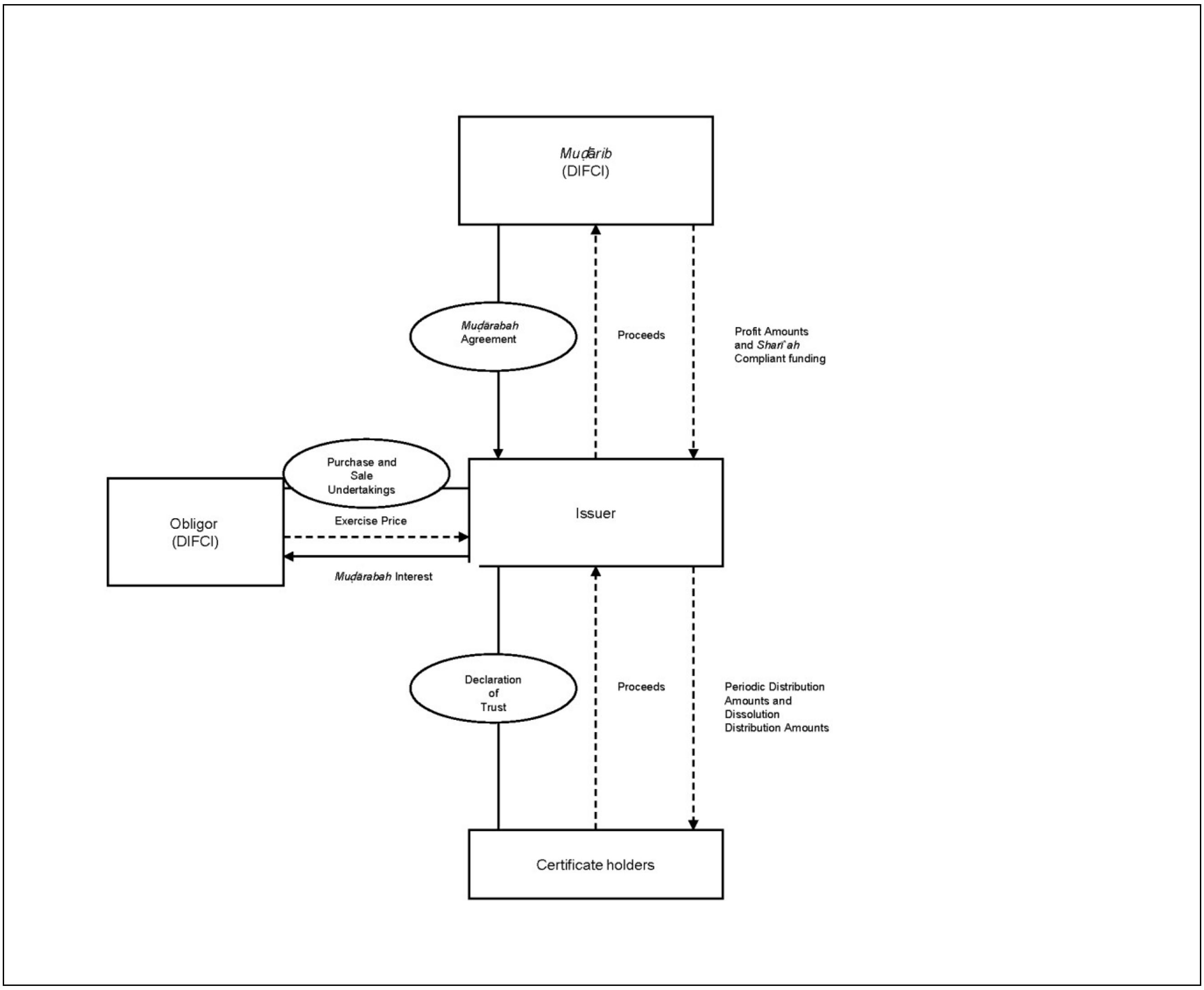
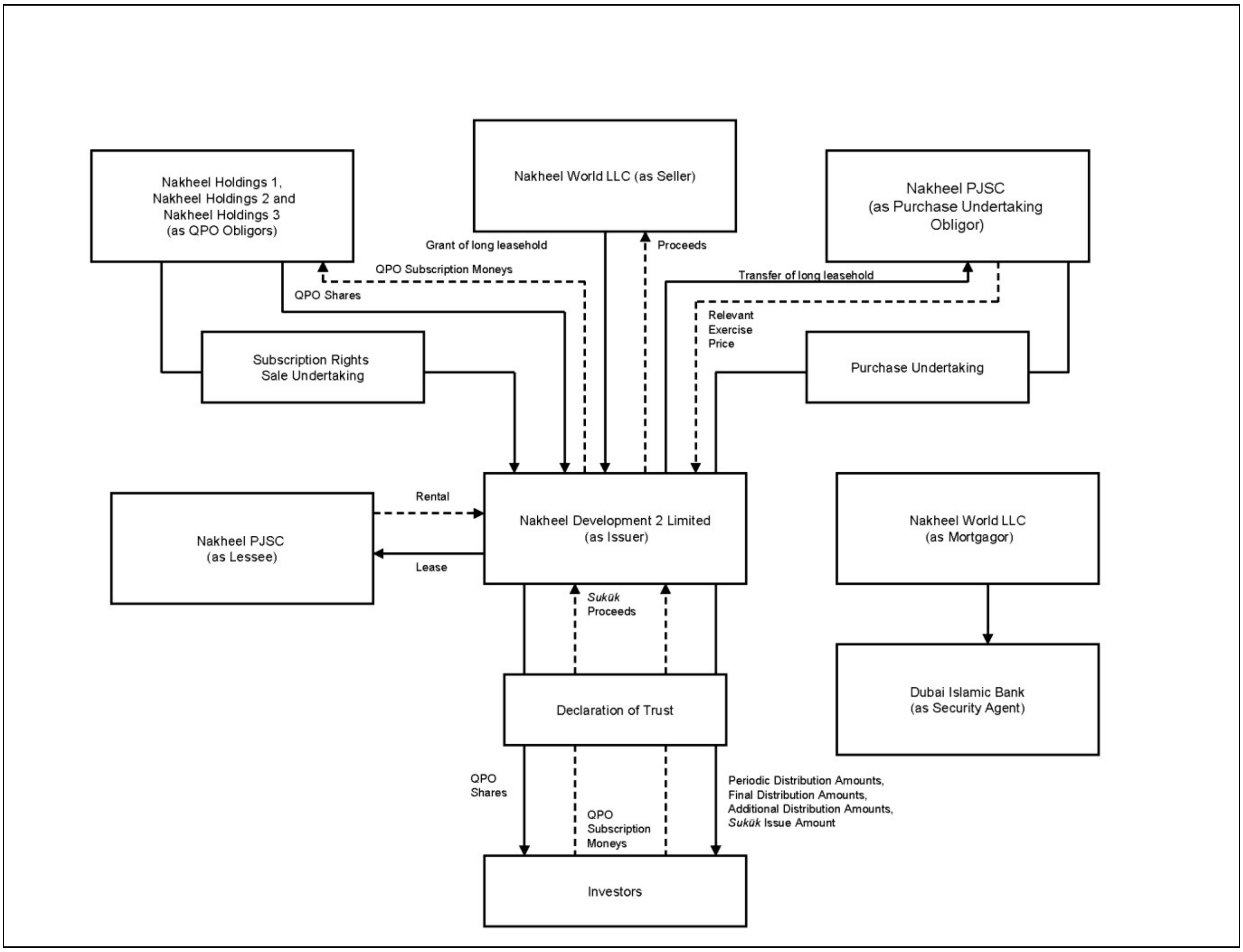


Figure 5 shows a more complex structure than the structure of DIFCI *Sukūk*; more complex because it includes convertibility and some guarantees.

Figure 5: Nakheel *Sukūk* structure



This Nakheel *Sukūk* structure involved 17 different transaction documents, 19 if you count multiple copies of the same document, and the offering circular ran to 254 pages. 6 separate companies in the Nakheel group were involved; two of them in dual roles. The *Sukūk* had some other interesting features, including being based on a 50-year lease of land some of which had yet to be reclaimed from the sea.

Both these *Sukūk* were at certain times thought to be in danger of default, but in fact were paid out in full. They were initially sold to a small number of highly sophisticated investors, though the DIFCI *Sukūk* at least did come to be held more widely[9].

For present purposes, the details of these structures are not important; it is the fact of complexity that is important. Complexity like this inevitably leads to a set of questions

[9] My doctor was among those invested in it.

about disclosure. Fundamentally, did investors in these instruments, both initially and in the secondary market, understand their nature; not only in terms of broad economic effect but also in terms of any additional risks the instruments might carry? Indeed, I would argue that one additional risk arises from their sheer complexity. Any transaction dependent on 17 separate documents depends on those documents working together seamlessly as a matter of law, and not being vulnerable to a legal attack on a single contract by, for example, a vulture fund. A market counterparty investing a large sum in an initial offer should of course be able to analyse the offer circular, but there are real issues if the instruments are offered, or subsequently traded, to less sophisticated investors. Note here that even if the disclosure is notionally full, in the sense that all documents are available, articulating their effect and any legal risks is non-trivial even for professional lawyers[10].

Having discussed the disclosure issues associated with *Sukūk* structures in general terms, I turn to one particular area where the structure may need to be analysed. This is often encapsulated in the phrase "asset-based versus asset-backed", though this is a vast oversimplification. The underlying point here is that, in Islamic finance, money cannot, of itself, generate more money. So, most Islamic finance transactions involve either investment or trading in real assets. It is therefore common for *Sukūk* to be structured around specific assets that are transferred to a special purpose vehicle or to a joint venture structure. The question is then to what extent do the *Sukūk* holders have ownership of the assets and, specifically, can they (or trustees acting on their behalf) under any conditions take active control of the assets and use or dispose of them? Even where the returns are not in practice closely linked to those assets, to what extent can those assets be regarded as effective collateral for the payments due from the ultimate obligor?

One example of the issues that may arise is offered by the now defaulted TID Global *Sukūk*, issued by the Kuwaiti firm, The Investment Dar (TID). The basic structure is a partnership[11], to which the issuing SPV contributes cash and TID contributes assets, in this case leases on 8,328 new and used vehicles, and certain real estate. If TID defaults on its obligations, especially as regards payment of the expected return, this triggers a purchase undertaking, under which it is obliged to buy back the *Sukūk* units on defined terms. If it cannot do this, the holders in principle have access to the assets. But, there is very limited precision in the offering circular as to what the underlying assets actually are. Furthermore, the leases are, it appears, to be granted to the partnership, which may well not have legal personality, and the legal person with responsibility for ensuring the leases are properly granted is the Management Agent for the *Sukūk*, which turns out to be TID itself. In my view, these factors leave considerable uncertainty as to what title the *Sukūk* holders would have, and to what assets, in the event of a default, and this uncertainty is far from clearly articulated in the offer documents. This phenomenon is not particularly unusual in the *Sukūk* world.

The TID issue was marketed only to large investors[12] and it may well be that they scrutinised the documents carefully and concluded that, in the event of problems, they would rather be unsecured creditors of TID than concern themselves with the assets. Even

[10] Legal risks may, as in other areas of Islamic finance, include a lack of certainty about how secular and *Sharī`ah* law will interact within the judicial systems of relevant countries. This is a larger topic than can be discussed in detail in this paper.
[11] *Mushārakah*
[12] The minimum investment was $1million.

if they had legally unimpeachable title to leases over these properties and vehicles, it might be difficult to realise significant value from them.

But, there is on the other side the famous case of the East Cameron *Sukūk*. This US *Sukūk*, which won various awards when launched in 2006, was based on the royalties from certain Louisiana oil and gas concessions. The revenues of the originating company were impacted by hurricanes, and it filed for bankruptcy protection. The company then argued in the bankruptcy court that there had been no real transfer of ownership into the SPV, and the transaction had merely the character of a loan secured on the royalties. *Sukūk* holders argued that the full rights to the royalties had indeed been transferred. After long consideration, the judge ruled against East Cameron on this point, and in favour of the *Sukūk* holders. However, the fact that the point could be raised at all indicates the lack of clarity in characterising *Sukūk* transactions, even well-scrutinised ones in an advanced economy, and in particular the lack of clarity around rights to underlying assets.

How are issues such as these dealt with in the IOSCO standards? The relevant IOSCO core principle is number 16:

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

While this principle clearly covers all relevant issues within the phrase "other information that is material to investors' decisions", it is naturally stated at very high level. The "Key Issues" in the IOSCO Methodology that expand on this principle are set out in Annex 1 to this paper. In this context, they do not take us much further on, and in some respects they seem, naturally enough, to be focused mainly on equity securities.

However, in 2007, IOSCO published its International Debt Disclosure Principles (ISDPs)[13]. Although most *Sukūk* do not create a debt, strictly speaking (and those that do are not considered by most scholars to be tradable other than at par[14]), the ISDPs are the IOSCO standards most applicable to the economic nature of most practical *Sukūk*. They cannot be summarised very briefly, but the topics covered are listed in Annex 2 together with the verbatim text of those principles most relevant to the issues discussed in this paper[15]. The ISDPs can be regarded as the standards around which a high-quality (conventional) regulator can be expected to have structured its regime. The key issues of structure and of rights to assets are not important areas of focus, and in my opinion a good regulator basing its regime on the IOSCO standards would not necessarily have been led to focus on the issues discussed above.

Having concentrated mainly on initial disclosures, I now comment briefly on continuous disclosure. I do not believe that there are fundamental issues here, save perhaps in the *Sharī`ah* areas that I shall come to later. As a matter of practical experience, however, I have noted that bond issuers generally are much less well-attuned

[13] https://www.iosco.org/library/pubdocs/pdf/IOSCOPD242.pdf

[14] This was one of the reasons the recently-proposed Goldman Sachs *sukūk* issue was considered controversial; the instruments were based on a contract which did create debt, but were intended to be listed on an exchange.

[15] In addition, a number of the principles go to the issue of structure, for example in discussing guarantees and the consequences of any failure to make payment. But, they do not quite address the issues of complexity discussed here.

to continuous disclosure than are equity issuers. There are some obvious reasons for this, but it has been a particular regulatory focus during the crisis, when markets have had an enhanced interest in gauging the risk of issuers' defaulting. This is, however, largely a question of enforcement, and Islamic issuers are in principle little different from conventional ones in this respect. One practical point is, however, that *Sukūk* are relatively thinly traded, and where trading does take place, it is usually OTC, even for listed instruments. It seems, again as a matter of practical experience, that some supervisors focus their activity on those instruments that are actively traded on exchange, and may be less assiduous in enforcing continuous disclosure requirements on instruments like *Sukūk* where trading is mainly OTC. This is regrettable, since the whole value of listing, for a little-traded instrument, lies in the implicit assurance that certain regulatory standards are met.

This part of the discussion has been based on the practical reality that the vast majority of *Sukūk* offered in the market are economically similar to a conventional debenture, with a return either fixed or dependent on an external reference (such as LIBOR), and with the dominant risk being the counterparty risk of the ultimate obligor or guarantor. I note again that these features are not inherent in the concept of *Sukūk* and that if instruments emerge offering different patterns of risk and return, then new disclosure issues will emerge. One obvious possible line of development is *Sukūk*, which bear a greater element of asset risk; in that case it might be appropriate to require continuous or periodic disclosure about the performance of the underlying assets. There is also some exploration of debt-equity hybrids which may, depending on their terms, require more equity-like disclosures.

III. *Sharī`ah* related disclosures

I now deal with the second class of issues.

Any claim to be "Islamic", express or implied, by or on behalf of a *Sukūk*, a fund, or any other instrument, is, in effect, a claim that the instrument conforms to the body of Islamic law known as the *Sharī`ah*. What issues of disclosure follow from this claim?

The claim of *Sharī`ah* compliance is clearly an important claim made to investors or potential investors. To assess the claim, it requires in most cases a knowledge of *Sharī`ah* that very few investors will themselves possess, and the standard approach throughout Islamic finance is for the claim to be approved in a *Fatwa* (ruling) given by a panel of *Sharī`ah* scholars. Depending in part on the jurisdiction, this panel (often called a *Sharī`ah* Supervisory Board) may be established by the originator, by one of its advisors[16], or by the regulator. The members will normally be named in the offer document. Even if this is not a regulatory requirement, it will commonly be done as a matter of market practice, because the use of a credible group of scholars lends credibility to the issue[17].

One difficulty is that scholars themselves disagree at certain points about what is permissible under *Sharī`ah*. These disagreements stem in part from the existence of different schools of Islamic jurisprudence, and in part from the fact that modern Islamic finance is relatively new and is still groping towards consensus on some important issues. Some suspect that there are other factors at play, for example the way questions are framed and posed to busy scholars. But, in any event, it is frustratingly common for an

[16] An Islamic bank, for example, can be expected to have such a panel already in place.
[17] Much like having accounts approved by a major accountancy practice.

instrument that has been approved by a group of well-reputed scholars then to be regarded as unacceptable on *Sharī`ah* grounds by major investors – whose *Sharī`ah* Supervisory Boards may even contain some of the same scholars. This is an issue frequently raised by lawyers advising on transaction structures, and is particularly significant for international transactions[18].

This is one illustration of the fact that there are large questions of *Sharī`ah* governance and advice that pervade the whole of Islamic finance. I cannot do anything like justice to them in this paper, and must confine myself to those bearing on disclosure.

The most obvious point is that disclosure of the names of the scholars who have advised on an issue of securities or units in a fund is a basic requirement but, fortunately, one that is consistent with market demands. There is also a significant body of opinion arguing that disclosure should extend further to the reasoning that leads to the fatwa. The direct impact of this on investor protection is a matter for debate. Few investors will be able to read and judge such reasoning themselves, though it is possible that (as with financial data) analysts will emerge to interpret it. It will be more directly useful to those institutional investors who are able to have it reviewed by their own *Sharī`ah* advisors. It can, however, be seen as more significant for the pursuit of convergence in *Sharī`ah* interpretation by exposing the reasoning involved to the judgement of the scholars' peers.

Beyond initial disclosure, the issues diverge for *Sukūk* and funds. For *Sukūk*, the main question of continuing compliance with *Sharī`ah* relates to the activities of the originator, and the uses to which the funds are put. These can in principle change during the lifetime of the *Sukūk* in ways that affect *Sharī`ah* compliance; for example, the originator may buy a brewery, or rent its real estate to a conventional bank. Some have argued that the *Sharī`ah* Supervisory Board that approved the original transaction should remain in existence to oversee continuing compliance. That would, however, involve considerable cost and is arguably not justified given that any change large enough to affect compliance would probably need to be disclosed in any event, under standard principles.[19]

For funds, the issues are subtly different. An issue of *Sukūk* is a one-off transaction, and continuing *Sharī`ah* issues will arise only if the activity of the originator changes significantly. Such changes are relatively rare. But, it is entirely normal for the holdings of a fund, even a straightforward long-only fund, to change frequently as it buys and sells investments. If it is an Islamic fund, its managers will need to decide in each case whether those investments are *Sharī`ah*-compliant. One way to do this is to retain a *Sharī`ah* Supervisory Board to advise on each case; another is to use one of the "*Sharī`ah* screens" operated by any one of several third parties and approved as to their principle by appropriate scholars[20]. Taking equities as a convenient example, they will advise on

[18] Where an issue is purely domestic, there is at least the possibility of a regulator imposing some consistency of interpretation.

[19] There is, incidentally, a continuing debate about the scope of the activity that needs to be compliant. A second issue around the proposed Goldman Sachs *Sukūk* was that, although the funds raised would be used in *Sharī`ah*-compliant activities (commodities trading), the firm as a whole is far from compliant. Some argued that this did not matter, others that it did.

[20] The choice between these will depend in part on the nature of the fund. An actively managed equities fund is likely to make relatively frequent transactions in well-analysed securities, whereas a REIT or a private equity fund will make less frequent transactions in properties or shares, which are unlikely to be covered by one of the standard screens.

whether the issuer is engaged in business that is non-compliant. This will include the nature of its business, for example whether it is involved with alcohol or pornography, but also whether it pays or receives significant sums by way of interest. But, there is by no means full consensus on what is acceptable[21], and there is thus a question whether the screening methodology should itself be disclosed.[22] Furthermore, an investment that was acceptable at one point may become unacceptable at another. For example, a rise in interest rates may increase the proportion of a firm's turnover paid in interest. If this crosses the threshold, should the holding be sold immediately, or should there be some grace period to see whether rates fall again? So, there is a question as to what should be disclosed about the fund's behaviour, and whether this should be at the level of principle (as an initial disclosure) or on a detailed basis, investment by investment (as continuous or periodic disclosure)[23].

Regulatory approaches to *Sharī`ah* issues like these are complicated by the differing extents to which regulators consider they can be involved in *Sharī`ah* matters.[24] They range from being the ultimate arbiter for their jurisdiction, generally by establishing some top-level *Sharī`ah* council, through having systems and controls requirements (including disclosure requirements) but not being an arbiter in disputed areas, to avoiding any reference, express or implied, to religious matters. In this last case, it is difficult to mandate relevant disclosures in any but the most general terms[25]. In such circumstances much will depend on what is done, and what disclosures are enforced, in practice.

Are the IOSCO standards sufficient?

I can now offer my own answer to the question of whether the IOSCO disclosure standards are sufficient for Islamic capital market products. In brief:

- The 2008 IOSCO analysis already cited[26] found that "there are no concerns with respect to the compatibility of the IOSCO Core Principles with the Islamic securities market." Although IOSCO has since revised its Principles, that conclusion is unlikely to be changed by that revision. The report did, however, recognise that "there are certain aspects pertaining to implementation in which further work may be beneficial" and specifically recommended (in para 3.2(1)) thematic work on disclosure standards for Islamic funds and *Sukūk*.
- While other IOSCO standards (e.g. the ISDP) have not been the subject of a similarly detailed analysis, there appear likely to be few, if any, fundamental incompatibilities (though some points where language could helpfully be

[21] For example, the amount of interest that is acceptable as a proportion, say, of turnover.

[22] There can also be differences in other areas. For example, Islamic funds will often not invest in entertainment businesses, because some of their productions may be pornographic. But how far should this principle extend?

[23] For funds not invested in securities, the issues will again be different. In particular, a REIT or other property fund will need to consider the uses to which the underlying properties are put.

[24] See, for example, section 2.3 of the IOSCO report of 2008, *Analysis of The Application of IOSCO's Objectives and Principles of Securities Regulation for Islamic Securities Products*, www.iosco.org/library/pubdocs/pdf/IOSCOPD280.pdf.

[25] Of an "anything that an investor might reasonably need to know" type.

[26] *Analysis of the application of IOSCO's Objectives and Principles of Securities Regulation for Islamic Securities Products*, www.iosco.org/library/pubdocs/pdf/IOSCOPD280.pdf.

amended[27]). There are, however, some points where, at least as regards disclosure, the standards could helpfully be extended.

- For any Islamic capital market product, some disclosures about *Sharī`ah* compliance are needed. The nature may vary. For some products, like *Sukūk*, the disclosures will be predominantly at the initial stage; but for others, like collective investment funds, there may be some relevant continuous or periodic disclosures.
- For *Sukūk* in particular, enhanced disclosures are needed about the structure of the offering, the risks (including legal risks) to which it gives rise, and in particular the rights of the *Sukūk* holders to the underlying assets.
- To the extent that *Sukūk* diverge from the current pattern of being economically similar to debentures, there will be further disclosure needs. It is not possible to generalise about what these may be, but they are likely to relate both to structure and to performance of underlying assets.
- Any substantially new Islamic instruments[28] are likely to be complex in their structure relative to their conventional counterparts (if any), and to require additional disclosures at least about structure.

I note also that disclosures only have regulatory value only if they are comprehensible to investors, to their advisors or, in some situations, to commentators and analysts. It is relatively easy to specify additional disclosures in any regulatory situation, but quite another to ensure that information is provided in a way that is useful in influencing investment decisions. Although this problem is by no means unique to Islamic finance, one of the challenges it does face, particularly but not exclusively in the *Sukūk* market, is whether disclosure-based regimes can be created that will work outside the highest-level interprofessional markets.

IV. Tailpiece: The Limitations of Disclosure

This reinforces the point already made that disclosure is only one of the investor protection tools available to conduct regulators, the others being product regulation, and regulation of the sales process. All three are used, but the balance between them varies with the product and the market. Over the last few decades, the trend has been heavily in favour of disclosure (and away from product regulation), with the weight given to disclosure being greater the better understood the product and the more professional the market. The financial crisis has already led to some soul-searching about whether disclosure can ever be made to work adequately for some products, except perhaps in true interprofessional markets. The implication of such a view would be, of course, that more emphasis has to be placed on product regulation and suitability[29].

Are we reaching a similar point in Islamic finance, especially in the *Sukūk* market? Whereas conventional interest-bearing bonds are regarded as standard and well-understood structures, the additional complexity of *Sukūk*, and the possible legal risks they introduce might lead to that view. If that were the case, one obvious response would be regulatory standardisation of structures, but it is far from clear that this would deal with all

[27] For example, to refer to “return” rather than “interest”.
[28] That is, other than *Sukūk*.
[29] As an indicator of the changing mood, see the UK FSA’s 2011 Discussion Paper on Product Intervention, http://www.fsa.gov.uk/pubs/discussion/dp11_01.pdf; it is almost inconceivable that such a paper might have been issued even 5 years earlier.

the areas of uncertainty. It is one thing to standardise a structure, but another is to know how the structure works under pressure. Furthermore, a young market has more to gain than older ones from creative innovation, which will always be slowed by direct product regulation. In addition, with the exception of some *Sukūk* issued by Governments in their domestic markets, there is at present a limited retail market. It is therefore well worth the effort to try to devise a disclosure regime that is compatible with other parts of the regulatory framework and that will be effective in allowing the Islamic capital markets to develop and grow.

COMMENTARY ONE

Ijlal Ahmed Alvi

COMMENTARY ONE

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I. Introduction

This paper is based on my comments and observations on the article submitted by Mr. Peter Casey entitled, *Emerging Issues from Inadequate Disclosure Requirements for Islamic Capital Market Products* at the IFSB-IOSCO Roundtable held on 18 September 2012.

Disclosure and transparency are critical for the sustainable growth, progress, and innovation in Islamic Capital Market (ICM). Although Islamic banking is over three decades old, the beginning of ICM was effectively in the year 2001 when the 1st International *Sukūk* was issued by Malaysian corporate followed by International *Sukūk* by Government of Malaysia as well as Bahrain and other jurisdictions. The *Fatwa* on *Sukūk* as an investment certificate (fixed profile nature) was issued by OIC Fiqh Academy in 1988 and took more than a decade before *Sukūk* emerged as a major ICM instrument.

II. Observations and Comments

Unlike conventional bonds, *Sukūk* reflects an ownership interest in an underlying asset, transaction or project. It refers to the process of pooling of tangible assets, their usufruct, or beneficial ownership into an entity that issues *Sukūk* certificates reflecting undivided, proportionate ownership.

Presently, efforts are made by several jurisdictions, institutions, and other market participants to further diversify and increase the range of ICM product offerings and products that have great potential for wider market acceptability, such as Islamic Real Estate Investment Trust and Exchange Traded Funds.

I disagree with the author’s pessimistic view that ICM may not develop beyond *Sukūk*. I am of the view that the Islamic financial services industry needs to continue with research, deliberation/consultation with scholars and market participants, and the role of Standard Setting organisations is critical in this process of product development. We also need to work on increasing the disclosure and transparency requirements in ICM products. Furthermore, standardisation in products and documentation will contribute a great deal in developing new ICM products as not only *Sharī`ah* harmonisation is achieved but also wider cross-border market acceptability.

The author has carried out in-depth analysis on transparency with respect to *Sukūk* and his conclusion is that often *Sukūk* structures are complex and involve multiple contracts. As per *Sukūk* research by various service providers including IIFM, *Sukūk* structural concentration is not limited to *Sukūk Al-Ijārah* or *Murābahah* or *Muḍārabah Sukūk* only, but as per IIFM research, 8% of International *Sukūk* were issued as Exchangeable/Convertible *Sukūk*, 14% *Sukūk* as Investment (*Wakālah*), and 8% as Hybrid *Sukūk*.

Often they are not as complex as mentioned in the examples of the DIFC *Sukūk* or Nakheel *Sukūk*. The main issue in *Sukūk* structuring is the use and the transfer of assets. Generally, documentation is now fairly standard but how to ring fence the assets is at times complex and may differ from *Sukūk* issued earlier. This is not a *Sharī`ah* issue but more of a legal and subject to jurisdictional law. For example, the October 2012 perpetual *Sukūk* issuance by Abu Dhabi Islamic Bank, based on *Muḍārabah* contract, is a fairly straightforward structure, not as complex as selected by the author in his examples. Other than that, there are many examples of fairly standard *Sukūk* structures.

The issue of *Sharī`ah* compliance is raised and in this regard I am of the view that scholars when approving *Sukūk* structure always have basis on which they approve the *Sukūk* issuance. Once the *Fatwa* is issued, it stands and any subsequent *Sharī`ah* rulings do not apply to *Sukūk* already approved and issued. 2008 AAOIFI revised ruling particularly for equity-type *Sukūk* is a good example as in that case scholars did not direct to unwind all the outstanding *Sukūk*, which were earlier approved by scholars.

To recap the above point, it is important to be aware that, for example in the case of tradable *Sukūk*, once *Sharī`ah* Board issues a pronouncement and the *Sukūk* is issued, then the *Sharī`ah* ruling is not changed although subsequently scholars of *Sharī`ah* Board may, based on review, decide to change certain aspects of the *Sukūk* structure. But, once the *Sukūk* is issued, then *Sharī`ah* approval stays.

In my opinion, we need to increase the transparency on operational aspects of ICM products as that is where the uncertainty lies.

Another area where proper transparency and disclosure are needed is the use of purchase undertaking particularly in *Mushārakah* and *Muḍārabah Sukūk* and I agree with author's concerns in this regard. Sheikh Taqi Usmani's comment and subsequent declaration by AAOIFI in 2008 on some aspects of mainly partnership-based structures that were being used in the market until early 2008 were unacceptable, particularly when the pricing under the "Purchase Undertaking" is applied. While number of issuances initially declined drastically thereafter, partly due to the credit crunch, there was one *Mushārakah*-based *Sukūk* named "Gulf Holding", which to some extent complied with AAOIFI ruling and the guarantee was issued by a bank though it was a related party bank. In my opinion, this aspect was not fully disclosed. In my view, the use of purchase undertaking in certain *Sukūk* structures requires greater deliberation and transparency is key in removing any doubts.

The author has rightly raised the concern surrounding "asset-based versus asset-backed" *Sukūk*. This is not a *Sharī`ah* issue as *Sukūk* can be issued based on beneficial interest or on transfer of title to *Sukūk* holder. There are several reasons why almost all the *Sukūk* issued so far, which approximate the amount of US$ 472 billion, are based on beneficial interest, i.e., asset-based. Among these reasons are:

- The ownership and title transfer rights in various jurisdictions are either not allowed or limitations
- The *Sukūk* investors generally prefer corporate or sovereign guarantee rather than taking direct risk on asset
- The issuer may find it difficult to transfer title to *Sukūk* holders due to covenants in its other obligations or legal and other reasons.

The author has rightly indicated that often the *Sukūk* profit payments (fixed or floating) are not derived from underlying asset but the source of profit payment could be other alternative available to *Sukūk* issuer. This area definitely requires a great deal of consultation. Transparency on the source of payment will be helpful in removing any doubt. Another related issue raised by the author is that return or profit on *Sukūk* from an economic perspective is similar to conventional debenture and is generally dependent on guarantors or counterparty risk. In my view, this area requires further deliberation and indeed more clarity will be helpful to the further development of ICM including *Sukūk*.

As far as default scenarios are concerned, *Sukūk* are similar to any financing and investment product—Islamic or conventional. Whilst the business causes leading to *Sukūk* default are varied, the ultimate reason for a default is the issuer's failure to pay the *Sukūk* investors their dues in accordance with the terms governing the *Sukūk* issuance, which may lead to the restructuring of the debt or indebtedness restructuring.

However, restructuring of *Sukūk* is not the same as with conventional bonds as this effort poses a number of additional challenges. For example, the nature of *Sukūk* structures is crucial to how they are to be restructured or unwound. Some *Sukūk* are securities that resemble debt obligations with the determinable profit rate, while other *Sukūk* resemble equity-like investments, containing a variable return (largely *Muḍārabah* or *Mushārakah*-based *Sukūk*). Yet, all have different methods or forms of transferring, applying, and dealing with the underlying asset in order to comply with *Sharī`ah*.

Moreover, the *Sukūk* defaults, for example Golden Belt *Sukūk* (a Saudi group) has brought to light once again the problem pointed out by the AAOIFI *Sharī`ah* Board in February 2008, namely the discrepancy between *Sharī`ah* contracts and the governing law of the *Sukūk* in executing and interpreting the transfer of assets to the *Sukūk* holders. As mentioned earlier, *Sharī`ah* accepts the beneficial transfer of interest, hence a large majority of *Sukūk* issuances are based on asset-based or beneficial interest transfer basis. However, another issue is that most of the Islamic jurisdictions including the GCC do not have relevant insolvency, title transfer, and netting law in place, hence legal certainly is not possible.

Islamic contractual obligations are governed by countries governing law as *Sharī`ah* law is not codified. There is a need to unify the governing law for Islamic capital markets. As far as capital or money market products are concerned, the product structures and documentation are reviewed and approved under the guidance of *Sharī`ah* Board and the pronouncement covers the product and documentation issues while transacting institutions may agree to which country's governing law will be applicable.

The point to note is that generally the differences in *Sharī`ah* opinions or interpretations are minimal across most ICM jurisdictions, particularly for products like *Sukūk*; however, the possible change in subsequent *Sharī`ah* rulings due to the development and innovative nature of ICM may lead to capacity investment risk in Islamic products. This is the point highlighted in the case of the Kuwait-based company, TID and BLOM Bank. In this case, when the bank tried to use *Sharī`ah* non-compliance as an excuse not to pay the *Wakālah* placement, the TID *Sharī`ah* Board told the bank that *Sharī`ah* approval was given on the arrangement and it stands and cannot be used as an excuse.

This case, however, highlighted the issue of "Capacity Risk" and has caused Islamic finance institutions to come under scrutiny by rating agencies that are now prompted to evaluate additional risks when assessing such transactions.

As per IIFM research, most of the institutions now include the capacity risk clause as a standard clause in their master agreement.

The proper disclosure of the explicit versus implicit guarantee in cases of quasi-sovereign *Sukūk* is a major issue, as seen in cases of troubled quasi-sovereign *Sukūk* during height of 2008 global financial crisis. In recent times some improvement in the offering documents has been made, for example, in recent Saudi Civil Aviation *Sukūk* issuance. However, further assessment is needed on quasi-sovereign *Sukūk* disclosure requirements.

The author has mentioned that by bringing known scholars as part of the issuers *Sharī`ah* Board provides credibility. In my view, this statement is not necessarily true due to the fact that the Islamic industry has a limited number of senior scholars who have extensive knowledge on investment and banking system. Hence, there is a gap between the understanding and interpretation of *Sharī`ah* rulings versus practical knowledge on modern capital market practices.

As for maintaining compliance, as stated earlier, once the *Sukūk* is issued upon approval of the *Sharī`ah* Board, the ruling are maintained or cannot be changed. Hence, it does not matter whether *Sharī`ah* Board members are maintained or changed. The main issue is how operational aspects are managed, and whether they are *Sharī`ah*-compliant or not. The other issue is to look at the legal implications arising from contractual obligations.

We also have to keep in mind that the Islamic financial services industry is interlinked with the global financial systems. Hence, there is an issue of making certain conventional products *Sharī`ah*-compliant, which may result in the mimicking of conventional products. In my view, not all products can be made *Sharī`ah*-compliant and a good example is conventional Repo, which cannot be structured to give the same result and risk profile.

ICM is evolving and in recent times, not only has the *Sukūk* market witnessed record issuances, but further progress have been made on *Sukūk* funds that lead us to review the disclosure and transparency requirements.

III. Conclusion

Although IOSCO 2008 analysis points out that "there is no concerns with respect to the compatibility of the IOSCO core principles with Islamic securities market", however, considering the unique nature of ICM and its products, I suggest that each disclosure and transparency issue raised in the article and in this paper needs to be separately looked at as there are some major differences between ICM compared to the conventional capital market.

I also suggest that the standardised product and documentation approach can be very effective in improving the transparency and proper disclosure in product offerings. This is the approach preferred by scholars.

I totally agree that a transparency and disclosure regime will greatly assist the orderly and robust development of ICM and I look forward to the initiation of this important task by related development institutions with the cooperation of the industry.

COMMENTARY TWO

Volker Nienhaus

COMMENTARY TWO

Volker Nienhaus

I. Introduction

It is correct that *Sharī`ah*-compliant capital market instruments other than equities, collective investment funds, and *Sukūk* are in their infancy. However, the assumption that the basic tenets of Islamic finance make it very difficult to develop them beyond this point can be challenged. For example, several techniques for short selling and for more complex derivatives have been developed, and it is claimed that they are *Sharī`ah*-compliant. The problem seems to be less to make the contractual structures *Sharī`ah*-compliant than to find a sufficiently large number of other market players who are willing to engage in 'prototypes' of *Sharī`ah*-compliant synthetic products. This reluctance could partially be due to a bias of major market players towards instruments developed by them. But, this reluctance may change, and some basic problems of derivatives could also be discussed.

II. *Sukūk*

It is stated that most *Sukūk* are structured to resemble fixed or floating rate bonds. This statement is factually correct until the mid-2000s, but it seems that there are some changes in recent years.

Structures of fixed rate *Sukūk* have changed after Taqi Usmani's critique and AAOIFI's clarifications in 2007/8. The structures of pre- and post-2007/8 *Sukūk* do not differ in their economic results as functional equivalents to interest-bearing bonds, but in their *Sharī`ah* quality. Seemingly, the older structures had an inherent *Sharī`ah* risk (defect), and some risk elements such as the repurchase guarantee at face value were so obviously not in concordance with the AAOIFI standards that it is astonishing how widely they were used and approved by leading *Sharī`ah* scholars. Purchase undertakings were disclosed in the *Sukūk* documentations, but they were assessed by rating agencies and market players not from their *Sharī`ah* risk dimension, but as elements of the financial structure.

The lesson is the following: Structural elements, which are commonly used in the conventional system and replicated in ICM products without any serious concerns over long periods, can suddenly and unexpectedly become major problems in the Islamic system. The sensitivity for the *Sharī`ah* non-compliance risk was low, although the disconformity of practices with recommended AAOIFI *Sharī`ah* standards was quite obvious.

As long as *Sukūk* are traded among financial institutions, this may not be a big issue. Institutional investors have their own expert knowledge to assess the financial and *Sharī`ah* qualities as spelled out in lengthy documentations. But, for a future *Sukūk* market that also addresses 'retail' investors, a *Sukūk* prospectus should provide some *Sharī`ah* non-compliance risk information for those who do not have their own *Sharī`ah* experts. For example, it could become a disclosure requirement to document explicitly whether a *Sukūk* observes or departs from *Sharī`ah* recommendations of recognised institutions such as

AAOIFI and the IFSB. Deviations are possible, but they should be explained. Such a comply or explain approach would facilitate better informed choices.

While *Murābahah* or *Sukūk al-Ijārah* represent the partial and temporary (true or beneficial) ownership of a specific asset with predetermined returns, *Muḍārabah* and *Mushārakah Sukūk* are a kind of temporary equity of a joint venture that manages assets (which may change over time) and allocates profits and losses to the *Sukūk* holders. The *Muḍārabah* and *Mushārakah Sukūk* resemble participatory finance structures (although it is possible to eliminate for all practical purposes the participatory features and to create fixed return papers even with this structure). Conceptually, the participatory *Sukūk* have risk profiles very different from the asset-backed *Sukūk*, and this raises new disclosure issues. If participatory *Sukūk* structures would increase in quantity and quality (even if they are just new techniques to mimic interest-bearing bonds), the disclosure requirements must be adjusted because participatory *Sukūk* structures share more structural characteristics with collective investment schemes (funds) than with conventional bonds. The participatory (risk sharing) elements should also be reflected in rating methodologies. The prime focus should not be on the issuer or the obligor or a specific underlying asset, but on the business plan (in particular the cash flow projection) of the newly formed joint venture. This is particularly relevant if third party capital guarantees are not acceptable or non-existent.

A particular concern is the continuous monitoring of the *Sharī`ah* compliance of a participatory *Sukūk* (joint venture). This can be (much) more demanding than the *Sharī`ah* supervision of a *Sukūk* that is based on the valorisation of a specific asset, and it may resemble the *Sharī`ah* supervision of Islamic banks. However, issuers or managers of participatory *Sukūk* are not required to have *Sharī`ah* boards, and even if issuers have a *Sharī`ah* board, they are usually concerned with the issuing, and not the continuous monitoring of a *Sukūk*. A rather strict distinction between *Sukūk* and funds is justified for *Sukūk* of the *Murābahah* and *Ijārah* type (which were tied to a specific asset), but not for participatory *Sukūk* where the demarcation lines become blurred.

III. Disclosure of the Reasoning

The paper assumes that the disclosure of the reasoning, which led to a *Fatwa*, has little to do with investor protection because very few investors will be able to read and judge such reasoning. This position can be challenged and turned around. The disclosure of the reasoning could become an important instrument of investors' protection. There are examples where a weak reasoning was publicly criticised by competent people (e.g. other scholars, media, intellectuals), and where a public debate on the *Sharī`ah* quality helped investors make informed choices. As long as only a few reasonings are available, such debates are somewhat arbitrary and unsystematic, but with a general access to the reasoning, a new information processing and disseminating industry could emerge.

IV. Disclosure for Islamic Funds

Islamic funds should be required to disclose detailed information on their screening methods (e.g. source of data, benchmarks, frequency of screening, exact definitions of 'black list criteria').

Such a comprehensive disclosure requirement is justified by the fact that "*Sharī`ah* compliance" is a major claim and distinguishing feature in the competition with conventional funds. However, there is a considerable vagueness of the meaning of "*Sharī`ah* compliance" in this context.

To start with, the concept of joint investments of (potentially large and anonymous) groups of capital providers in stocks (i.e. partial ownership certificates in legal persons with limited liabilities) does not have a basis in the classic Islamic commercial law. Nevertheless, contemporary *Sharī`ah* scholars have accepted joint stock companies as new business organisations. They can be tolerated from an Islamic perspective, provided their business activities do not violate *Sharī`ah* prohibitions. Unfortunately, nearly all existing joint stock companies violate *Sharī`ah* prohibitions insofar as they pay and receive interest. Therefore, investment in stocks is possible only if the violation of the clear Quranic prohibition of *Riba* (interest) is tolerated for pragmatic reasons such as a lack of sufficiently strict *Riba*-free investment opportunities.

This means – in short – that Islamic equity funds are not primarily based on Islamic law but – to the contrary – on an "exemption clause". It is reasonable to set limits to this exemption. For example, it may be tolerated to invest in a joint stock company if that company is not too heavily dependent on interest financing, and this may be the case when the total interest-bearing debt does not exceed 25% of total assets, or 33% of its market capitalisation. There is nothing in the *Sharī`ah* to justify a specific ratio, neither its numerical value nor its numerator or the denominator. The "tolerance ratios" have been set by *Sharī`ah* opinion leaders for pragmatic reasons, and they have been changed over time and differ in different places. In addition, new screening methods with new criteria have popped up. It is not only that tolerance levels can differ between different institutions or individuals. Depending on the tolerance level, the range of permissible stocks will vary, and the portion of dividend income that has to be cleansed may change. Hence, reference to a *Fatwa* that declares a fund as *Sharī`ah*-compliant without further justification of ratios, screening methods, etc. would hardly provide all the information that investors may consider material for a deliberate decision.

Pragmatic tolerance levels have sometimes been justified as a 'second best' solution in a world of interest-based finance. Muslim individuals and institutions with (large) net savings would not be able to find sufficient profitable outlets for their surplus capital in strictly interest-free assets alone. So, it was declared to be in the interest of the Muslim community (*Maslahah*) to tolerate some participation in conventional capital markets. But, once a second best compromise is widely practised and market players get accustomed to it, the character of an exemption from a superior rule disappears and incentives to strive for a first best solution fade away. Islamic finance claims to be different, and therefore it is reasonable to request the disclosure of information that substantiates this claim.

V. Conclusion

This is all the more justified as the setting of the pragmatic tolerance levels does not require a profound knowledge of *Sharī`ah* but a good understanding of economics, accounting, and balance sheets – all areas where *Sharī`ah* scholars cannot claim a specific competence. The individual investor must make a personal decision either to accept the tolerance levels of *Sharī`ah* opinion leaders or to be more or less restrictive, because in the last instance, he or she will have to bear the consequences in this life and in the hereafter. The regulators should ensure that all relevant information for such a crucial decision is easily accessible to the individual investors.

COMMENTARY THREE

Christopher Lee

COMMENTARY THREE

Christopher Lee

I. Introduction

My comments are made primarily from the perspective of the issue of *Sukūk*; the ICM product with which I have the greatest familiarity. However, I think, they are possibly sufficiently generic to apply across all such products.

I take it to be understood that we are not concerned here with the standards or issues of disclosure generally but more specifically in relation to whether more specific or enhanced disclosures are required as a consequence of the product being Islamic although, seemingly self-evident, that is not always how the issue is addressed. In that context, I would re-cast the examination of the issue in the following terms:

What is it about the product being Sharī`ah-compliant, which may require more specific or enhanced disclosures? Has some element been introduced into the product or is there some feature of the product that creates a risk that calls for the specific or enhanced disclosure?

I would submit that while compliance with the *Sharī`ah* does point to the need for some more specific or enhanced disclosures, there are not really a great many of such disclosure required. More controversially, perhaps, I suggest that it is **not yet appropriate** to mandate disclosure in relation to such matters.

The paper by Peter Casey (the "**Paper**") examines disclosures in two broad classes:

- The way the instruments or transactions are structured; and
- The claim to be compliant with the *Sharī`ah*.

II. Issues Arising from Structuring

With respect to structuring, two points are made, which I would comment on.

The first is the additional risk arising from the complexity of some of the structures and the need for separate documents to work seamlessly together. I would say that while the risks mentioned are undoubtedly true, it is unlikely that they are any different from the risks associated with complex structures used in the case of conventional transactions. Structuring can be found even in conventional transactions, e.g. in securitisations to meet true sale or bankruptcy remoteness requirements or in tax-driven structures. Assuming IOSCO principles are adequate to specify the level of disclosures required for complex conventional structures, it is unlikely that they would need to be supplemented for *Sharī`ah*-compliant structures.

The second point is with regard "asset-based versus asset-backed" products. Again, the point is well made that it is not generally clear to what extent *Sukūk* holders have ownership of the assets and can (or through trustees can) take control of the assets or use or dispose of them. It is not unusual to have what may on the face of the document appear to be conflicting statements as to the rights of the investors. The following excerpts from an offering circular illustrate the point:

Recourse to the Issuer is limited to the Trust Assets

Each Certificate represents solely an undivided beneficial ownership interest in the Trust Assets. Recourse to the Issuer is limited to the Trust Assets and the proceeds of the Trust Assets are the sole source of payments on the Certificates. Upon the occurrence of a Dissolution Event, the only remedy available to the Certificate holders will be to require the Trustee or the Delegate, as the case may be, to serve an Exercise Notice and exercise its option under the Purchase Undertaking to require the Obligor to purchase the Sukūk Assets at the Exercise Price. Certificate holders will otherwise have no recourse to any assets of the Issuer, the Obligor (in each of its respective capacities under the Transaction Documents, to the extent the Obligor fulfils all of its obligations under the Transaction Documents to which it is a party), the Issuer, the Trustee, the Delegate, the Managers, the Agents or any affiliate of any of the foregoing entities in respect of any shortfall in any amounts realised from the Trust Assets.

The Obligor is obliged to make payments under the Transaction Documents to which it is a party directly to the Trustee, and the Trustee or the Delegate, as the case may be, on behalf of the Certificate holders, will have direct recourse against the Obligor to recover payments due to the Trustee from the Obligor pursuant to the Transaction Documents to which the Obligor is a party. There can be no assurance that the net proceeds of the realisation of, or the enforcement with respect to, the Trust Assets will be sufficient to make all payments due in respect of the Certificates. Once the Trust Assets have been realised and applied, each of the Issuer and Trustee shall have no further obligations to the Certificate holders and any outstanding obligations in respect of the Certificates shall be extinguished.

Certificate holders should note that, through a combination of the Lease Agreement, the Purchase Undertaking and the Servicing Agency Agreement (each as defined herein) the ability of the Issuer to pay the amounts due in respect of the Certificates will ultimately be dependent on the Obligor.

However, in fairness, a comprehensive reading of the offering circular does make clear what is intended. Again, it is not a question of a failure of the IOSCO principles to specify what to disclose, but the manner of drafting of the disclosure. In many cases, language is taken from documents for conventional products and then modified as thought appropriate. Sometimes, the substance is lost in translation.

The point I would make is that the *Sharī`ah*-compliant nature of the product in these cases does not drive the requirement for additional or enhanced disclosures. The requirement to be *Sharī`ah*-compliant may add complexity, but the application of the normal standards of disclosure should apply.

In the wake of the financial crisis in the U.S., there are on-going studies as to the robustness and adequacy of current disclosure standards. It would be unsafe to assume that the current standards of disclosure are adequate even for conventional products. Certainly, the manner disclosure is made of complex structures is being questioned. One suggestion that may be considered is the use of "layered" disclosure. "Layered" disclosure involves using a summary document containing key information about an investment product or service. The document is sent or given to the investor and more detailed information is provided online or, upon request, is sent in paper or by e-mail. This approach to disclosure forces a focus on ensuring the summary document does contain all key information.

III. Claim to *Sharī`ah* Compliance

It seems to be unavoidable to recognise that the claim to be *Sharī`ah*-compliant must be paramount. So, the question (which has always been there but generally never squarely faced) is how important is the claim to *Sharī`ah* compliance of the product and to what extent must the 'seller' of such a product demonstrate such compliance? Or, in the context of the issue of disclosure, the questions are:

- Should disclosure be made as to why the product is *Sharī`ah*-compliant?
- Should the text or the sources relied upon as authoritative for the ruling as to *Sharī`ah* compliance be disclosed?

The current practice in relation to *Sharī`ah* compliance is in fact to disclaim liability for *Sharī`ah* compliance and leave it with the investor. Two extracts representative of how this is expressed are:

There is no assurance that the Certificates will be Sharī'ah compliant.

[… Sharī`ah Committee and the Sharī`ah Supervisory Board of …] have each issued a Fatwa in respect of the Certificates and the related structure and mechanism described in the Transaction Documents and their compliance with Sharī`ah principles. However, a Fatwa is only an expression of the view of the respective Sharī`ah Advisors based on its extensive experience in the subject and is not a binding opinion. There can be no assurance as to the Sharī'ah permissibility of the structure of the issue and the trading of the Certificates and none of the Issuer, the obligor, the Trustee, the Delegate or the Managers makes any representation as to the same. Investors are reminded that, as with any Sharī`ah views, differences in opinion are possible. Investors are advised to obtain their own independent Sharī`ah advice as to whether the structure meets their individual standards of compliance and make their own determination as to the future tradability of the Certificates on any secondary market.

There is no assurance that the Trust Certificates will be Sharī`ah-compliant.

On or before the Closing Date, each of the Sharī`ah Advisors issued pronouncements which each state that in their opinion the Trust Certificates, and the structure and mechanism described in the Series Transaction Documents, are Sharī`ah-compliant as at the Closing Date. None of the Issuer, the Obligor or the Joint Lead Managers makes any representation as to the Sharī`ah permissibility of the structure or the issue and trading of the Trust Certificates. Investors are reminded that as with any Sharī`ah views, differences in opinion are possible and opinions may change from time to time. Investors should obtain their own independent Sharī`ah advice as to the Sharī`ah permissibility of the structure, the issue and the trading of the Trust Certificates.

If the Trust Certificates are deemed not to be Sharī`ah compliant by an investor's own standard of Sharī`ah compliance, such investor may be required to sell or otherwise dispose of its Trust Certificates by virtue of its own constitutional restraints or otherwise. Similarly, if the Trust Certificates are deemed not to be Sharī`ah compliant by potential investors' standards of Sharī'ah compliance, they may be prohibited from buying the Trust Certificates by virtue of its own constitutional restraints or otherwise. Accordingly, the liquidity and price of the Trust Certificates in the market may be adversely affected by particular Sharī`ah standards, and interpretation thereof, of existing or potential investors.

*Whilst […Sharī`ah Committee and …], in their capacity as the Sharī`ah Advisors (the "**Sharī`ah Advisors**"), have structured the offering of the Trust Certificates in accordance with the principles of Sharī'ah and executed Fatwas have been issued by each of the Sharī`ah Advisors confirming such compliance, a prospective investor contemplating purchasing the Trust Certificates should make its own independent investigation and determination as to whether the offering and the investment in the Trust Certificates will comply with the principles of Sharī`ah.*

The approach, however, begs the question as to how the investor is to make his/her own decision. The practice I am familiar with is for the *Sharī`ah* advisors to review the documents in their totality before issuing their ruling or pronouncement. An investor, however, will at best be provided a summary of the documentation. Is there here an issue of the sufficiency of the disclosure to the investor given the disclaimer language used above?

The Paper makes the point that disclosure of the reasoning behind the ruling on *Sharī`ah* compliance has little to do with the direct issue of investor protection. Implicit in this statement, however, is the assumption that the claim to compliance of the product with the *Sharī`ah* is beyond challenge. I examine this issue further below but the point here is that if the claim to *Sharī`ah* compliance can be challenged and a claim of non-compliance is successfully made, the consequences to the investor may well be more than just a prohibition against investing in such product.

Reverting to my questions above and considering them in the context of IOSCO standards, which are aimed at investor protection, the issue is whether in the absence of any concern of investor protection—Is there any other compelling reason calling for disclosure into the reasoning and basis for a claim of *Sharī`ah* compliance? One possible reason, although this would be individual to each investor, is where it is necessary for the investor that the product be *Sharī`ah*-compliant. This may be because it is a fund or institution whose constituent documents require it. As indicated above, the current practice is to require investors to satisfy themselves as to *Sharī`ah* compliance. What is required, perhaps, is a survey as to the extent funds or institutions have found that insufficient information has been provided for them to come to a decision on *Sharī`ah* compliance and therefore to pass up an investment opportunity.

I will end this section with two other questions:

- Is this the right time to raise the questions above?

Although it has come a long way, Islamic financing and investing might still be said to be in its infancy. Many products are economically similar to conventional products they mimic. The differences in views on the *Sharī`ah* are only beginning to grope to a consensus. A debate on *Sharī`ah* compliance may not necessarily achieve the objectives to be aimed at in requiring greater disclosure.

As indicated by the extracts above, the necessary warnings are given and, arguably, it should be left to the market as to whether the disclosure is acceptable or sufficient. Surely, if funds and institutions find such disclaimers unacceptable, they will seek a change in the market practice accordingly.

The current market practice of warning an investor that it needs to make its own decision as to *Sharī`ah* compliance is simply a recognition of the practice that an investor buying the product because it is *Sharī`ah*-compliant has to comply with its own standards and requirements for *Sharī`ah* compliance. The practice gives recognition to the fact that scholars may be and are divided in some instances as to what is to be considered *Sharī`ah*-compliant. An issuer or seller of an Islamic product is therefore simply making a statement as to what has been found acceptable to it for *Sharī`ah* purposes. But, it is not inviting a debate as to its views. It is seeking like-minded investors and not to influence views on what is *Sharī`ah*-compliant. Disclosing the basis for the claim to being *Sharī`ah*-compliant therefore serves no purpose. Even if the basis for the claim is disclosed, the potential investor will still need to get or take its own advice (or internal approval) as to *Sharī`ah* compliance.

- Is it even necessary or appropriate to address the issue in a prospectus or information memorandum?

The point arises because in the marketing of a conventional product, the question never arises as to whether disclosure should be made as to why some product might be compliant with its governing law or even how such claim of compliance might or must be demonstrated. Would requiring such disclosures simply make it more onerous to market Islamic products without any attendant benefits?

Specific disclosures

In addition to structuring and the claim to be compliant with the *Sharī`ah*, the areas I would say where additional or enhanced disclosures are required and which arise from the *Sharī`ah*-compliant nature of the product would be with respect to:

- Legal risks; and
- Tax risks.

Legal risks

There is a reference in footnote 6 in the Paper to one aspect of legal risk, i.e., how secular law and the *Sharī`ah* interact, that in my opinion deserves closer examination. There are at least five questions that lawyers struggle with and the question is whether disclosure should be made of what is thought to be the answer to these questions. The questions are:

- What law governs the construction and validity of the transaction documents?
- If, as is usual, the choice of governing law is that of a common law or civil law system, can that choice be displaced so as to make *Sharī`ah* the governing law?

- Can the question of whether there has been compliance with the *Sharī`ah* be raised under the common law or civil law system so as to affect the validity of the transaction documents?
- Which courts will have jurisdiction in respect of any disputes arising out of or under the transaction documents?
- Will the transaction documents be given effect to in accordance with their terms or are they liable to be set aside as a sham in other words, is there a risk of re-characterisation e.g. a sale and leaseback being held to be a 'secured' loan?

Case law to date has established that, where the transaction documents are expressed to be governed by a common law or civil law system, the question of *Sharī`ah* compliance is not an issue for the courts. Subject to there having been a pronouncement as to *Sharī`ah* compliance, the courts will enforce the documents in accordance with their terms. No issuer or seller of an Islamic product, who has held out a product to be *Sharī`ah*-compliant, has to date, although there have been attempts, succeeded in pleading a right to avoid its obligations on the basis of a subsequent claim that the transaction was or is not in fact *Sharī`ah*-compliant. Although the position cannot be stated with absolute certainty, the risks associated with an issuer or seller of an Islamic product disclaiming *Sharī`ah* compliance can be said to be minimal.

Tax risks

Tax risks are no less difficult. However, it is necessary to ask more general questions in the case of tax. The questions I would pose are:

- What tax issues were considered in the structuring of the product?
- What was the tax advice obtained on these issues?
- Are there thought to be other tax issues that might require consideration?

The main consideration with respect to tax is whether some aspect of the transaction might incur a tax liability and, if so, whether provision has been made for such liability. If no provision has been made for an unexpected tax liability, that liability may have to be met out of trust or collective investment assets and go in reduction of funds available to investors.

IV. Concluding Comments

Disclosure in our particular context serves two purposes:

- To enable an understanding of the nature of the investment; and
- To enable an appreciation of the risks and rewards of the investment.

The Paper and my comments above would suggest that there are ways in which current disclosure standards adopted for *Sharī`ah*-compliant products fail to meet the above objectives of disclosure.

However, it is always important to ask whether regulatory intervention is, at this time, desirable or even necessary. I would suggest not and offer the following reasons:

- It is not clear that the market demands it. There may be some view advocating greater disclosure on the grounds that the current level of disclosure is resulting in some foregone investment opportunities because a class of investors considers the current disclosures as inadequate. But, this is speculation as to what is required with regards to *Sharī`ah* compliance. Certainly the market has been able to function quite successfully at its current levels of disclosure.
- It is not clear exactly what should be mandated. I have made some suggestions above but I would hesitate to suggest that I have got it correct.
- The requirement to disclose is more likely to result in negative statements indicating that answers are not available or as clear cut as one might wish. So, we will get a lawyer's paradise of more risk factors without any greater clarity.
- The current expectation is that new products will develop out of existing ones. These may no longer mimic conventional products and have their own particular aspects requiring enhanced disclosure. It is best to leave the general principles to be applicable for now and wait until it is clear that more specific requirements should apply.
- There are likely to be costs associated with enhanced disclosures. The disclosures referred to above relate mainly to advice of professionals. Requiring their views to be explicitly made clear and therefore implying some acknowledgment that reliance may be placed on them by investors is a risk. There may be a cost to asking advisors to bear this risk.

Chapter Three
The Importance of Strong Disclosure Regime in Facilitating Cross-Border Investments and Development of Islamic Capital Market Products and Services

ISSUES PAPER

Mohamed Faiz Azmi

Chapter Three
The Importance of Strong Disclosure Regime in Facilitating Cross-Border Investments and Development of Islamic Capital Market Products and Services

ISSUES PAPER

Mohamed Faiz Azmi

I. Introduction

Islamic finance is one of the fastest growing segments of international finance. Although a relatively new area, it has achieved impressive global reach and has recorded double digit growth rates over the last decade. In our view however, Islamic finance needs a proper foundation in each jurisdiction to flourish. A term we sometimes use to summarise the foundational attributes needed is STAR, which encapsulates the four key infrastructure needs being *Sharī`ah* adherence, Taxation neutrality, Accounting consistency and appropriate Regulatory oversight. One aspect this paper will look at is the roles Accounting and Regulation play in providing confidence to investors in the ICM and it seeks to explore some current issues and possible solutions to them. Please note that the views expressed below are mine and not PwC International and should not be relied upon in any specific jurisdiction given the general nature of the comments.

Background

To put the growth into perspective, below are some statistics and charts to underscore why it is an area that even non-Muslim countries will need to take seriously.

Some recent global statistics on Islamic finance:

- Total *Sharī`ah*-compliant banking assets exceeded USD1 trillion in 2011.
- Estimated around 2 billion Muslims worldwide by year 2020.
- The number of Islamic financial institutions has proliferated to over 600 in more than 75 countries in 2011.[30]
- Market Capitalisation of Dow Jones Islamic Market World Index reached US$14.5 trillion in September 2012.[31]

In 2011, total global *Sukūk* issuance amounted to USD85 billion. Chart 1 shows the 2011 global *Sukūk* issuance by country, with Malaysia accounting for 71.6% issuance.

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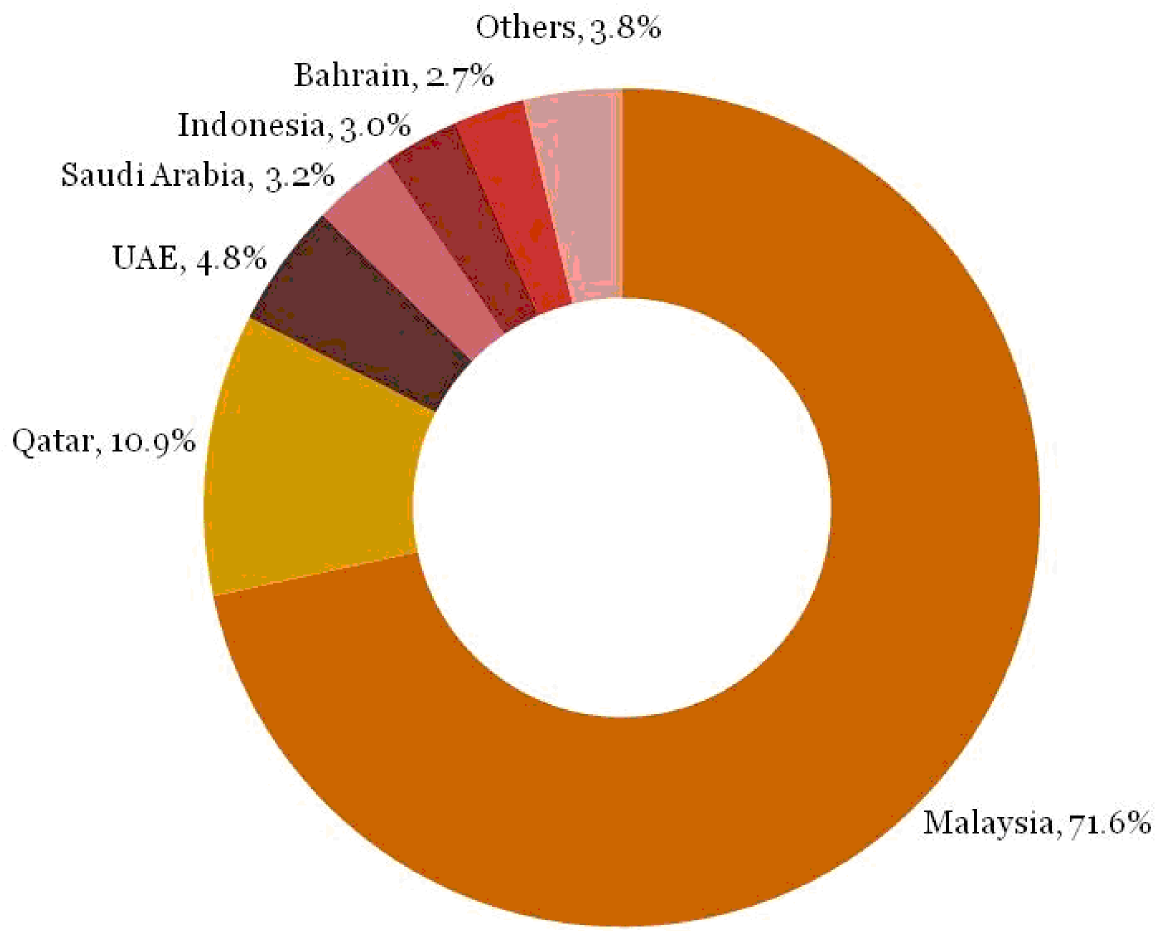
[30] http://www.mifc.com/sift_09/newsletter/SEPT-2011/index.html
[31] Bloomberg

Chart 1: Global *Sukūk* Issuance by Country, 2011



Source: IFSI, Bloomberg, Zawya, KFHR

Taking a closer a look at Malaysia's ICM in Chart 2, it is estimated that market capitalisation of *Sharī`ah*-compliant companies will reach RM1.55 trillion by year 2020. *Sukūk* issuance is estimated to continue its double-digit growth of 16.3% in CAGR from 2010 to 2020 (22.2% CAGR from 2001 to 2010).

Chart 2: Malaysia's Islamic Capital Market

Growth prospects for Malaysia Islamic capital market to 2020

Market segments	2000 (RM bln)	2010 (RM bln)	2020 (RM bln)	CAGR % (2000-2010)	CAGR % (2000-2010)
Market cap of *Sharī`ah*-compliant companies	254.1	756.1	1,551.1	11.5	7.4
Sukūk	39.6	294.0	1,331.5	22.2	16.3
Total ICM	293.7	1,050.1	2,882.6	13.6	10.6
Sharī`ah-compliant unit trust NAV	1.7	24.0	158.0	30.3	20.7

Source: Securities Commission Malaysia estimates

The evidence from the market would suggest that there are a number of drivers of this growth. In some jurisdictions, it is a consumer-led demand forcing existing financial institutions to evolve offerings or set up new institutions to cater for this demand. In Muslim-minority countries, the demand is more from the need to diversify their base of funding by creating new asset classes attractive to Muslim investors, particularly foreign ones. Given the current state of the global economy, there are also indications that funding pools are drying up around the world that makes the oil-rich Muslim countries a key source of new capital. Hardly a day goes by without some mention of a Middle East Sovereign Wealth fund acquiring stakes in foreign companies or looking at some form of investments globally. Some of these cash-rich investors in the Middle East are asking for their investments to be done in a *Sharī`ah*-compliant way. There are also some interesting new trends. There are now more affluent middle-class Muslims emerging in different countries that are seeking to protect their wealth and are seeking more diverse sets of *Sharī`ah*-compliant asset classes to invest in. Other than that, there are the unintended consequences of the new Basel III rules. These rules are curtailing bank lending and will encourage corporates to seek capital market products to fill the funding gap left by the banks.

Different Expectations

Investors are generally a pampered lot. They seek a risk-free high-return product with little capital outlay. The reality is there is no return without risk taking and indeed it is one of the central attributes encouraged by *Sharī`ah* law that investors should take some risk for their reward. So, what are the questions investors generally want to know more about? Generally, they are:

- What am I investing in?
- What return can I expect?
- What risk am I taking?
- When can I get my money back?

However, when it comes to Muslim investors, there is another key question, which is:

- How is it *Sharī`ah*-compliant and will it continue to be so during the duration of my investment?

This last question is critical to such investors as it goes to the heart of why they should invest in these types of instruments. It also creates a fiduciary relationship based on the representations made, that a product is, and continues to be, *Sharī`ah*-compliant. So, if some regulators are reluctant to regulate *Sharī`ah* compliance and the minimum processes to undertake, the question is whether such a policy approach is appropriate given the fundamental expectation of the investor and secondly whether disclosure can be an adequate substitute to regulation.

II. Disclosure Regimes and Considerations

Having discussed the need for disclosure as a substitute for regulation, it is worth exploring what the current position is with regards to disclosure frameworks.

Cross border activities and disclosure frameworks

One of the key objectives of any capital market activity is to ensure that the products are acceptable not just to their own nationals but also to those global investors. Global investing activities are very beneficial to a country's economic growth so anything that makes investors more comfortable, such as the standardisation of products, terms, and disclosure, must all be good. Indeed, as an illustration, without the standardisation of things such as the HTTP protocol or shipping containers sizes, the Internet and movement of goods would not have become as global as it is today.

Currently there are two frameworks that disclosures of ICM products are subject to—the regulatory disclosure and the accounting frameworks.

For regulatory matters, we have to look at international backers such as IOSCO. The IOSCO commissioned a report in 2004 to do a fact finding study on the ICM and again in 2008 to confirm that the IOSCO principles of Securities Regulation were equally applicable to Islamic securities products. One of their observations in the 2008 report was that the Regulators appeared to have a very wide spectrum of regulatory styles to accommodate Islamic securities. This ranges from requiring a centralised approach where *Sharī`ah* compliance is spelt out and regulated to one which generally does not mandate any policy for *Sharī`ah* compliance other than generic requirements of needing to disclose material information to investors. The conclusion of the IOSCO was to recommend that "securities regulators may wish to consider the effectiveness of their disclosure regimes and ensure that customers of *Sharī`ah*-compliant products are able to access the relevant information they require to make a decision. This is particularly important in jurisdictions where the *Sharī`ah* compliance of a product is not directly regulated".

This clearly articulates the case that the disclosure regime has an important part to play particularly in the ICM and given the diverse regulatory approaches such a regime would also facilitate cross-border activities and the development of the global ICM by helping to standardise and make the benefits and risks of such products transparent.

The IOSCO report in 2008 does encourage regulators to consider "that a level of uniformity in regulation and practices of this market sector would need to be achieved to provide further clarity to market practitioners and to allow investor demands to be met effectively". Moreover, "the availability of information on investable products on a wider basis, as well as the credibility and quality of the information provided".

Clearly, regulators should do more both on regulating market practices, particularly on matters relating to *Sharī`ah* compliance. They should also look at disseminating such information to investors. From a brief review of some of the key ICMs, we can see that since the 2008 report, some regulators have been progressively improving regulations in this area but overall, we are still a long way from achieving uniformity of regulation particularly on *Sharī`ah* compliance. This is particularly evident in the lack of mandating disclosures of what *Sharī`ah* adherence there is and what the underlying process should be.

On the accounting framework, there are really two competing models relevant to Islamic securities—the accounting standards issued by the AAOIFI and those standards issued by IASB. These frameworks are in some ways complementary and in some ways contradictory. AAOIFI standards are based on the old international IAS or current IFRS standards but are amended to suit the specificities of the AAOIFI *Sharī`ah* Boards views and are very product-centric. IFRS, which are issued by the IASB, are largely based on conceptual models and principles that are neither industry- nor product-centric. So, AAOIFI standards are complementary to the extent it follows IAS's and IFRS's but departs in some key areas of principle.

As far as disclosures go, AAOIFI standards are quite explicit on disclosures relating to how the issuer or product operates and, as they are largely based on IFRS's, are quite comprehensive. However, AAOIFI standards are largely used by mainly OIC capital markets and not by all jurisdictions. This is because the AAOIFI standards do contradict the IFRS's in key areas. Moreover, as they were designed to be complementary with and to enforce AAOIFI *Sharī`ah* standards, they would not be appropriate in countries that do not subscribe to all their *Sharī`ah* viewpoints.

IASB's IFRS standards are not written with Islamic securities in mind but do generally meet the expectations of the IOSCO principles in terms of given transparency on certain key investor demanded information. However, any reference to *Sharī`ah* compliance appears more driven by local regulatory reasons rather than being mandated by IFRS. This is somewhat surprising since much of the IFRS literature talk about the need to explain material business transactions and about financial risks. Arguably, based on our audit experience, *Sharī`ah* non-compliance can result in financial loss and it is surprising that not all entities conducting transactions in Islamic securities disclose their risk mitigation and how they comply with *Sharī`ah* law.

Of the two frameworks, the ability to achieve uniformity is easier if one was to choose adopting IFRS as the accounting framework of choice. There seems to be a continuing global trend to adopt IFRS as the accounting framework of choice. This is borne out by the AOSSG survey done in 2011, which attempted to assess the extent of Islamic finance transactions in the Asian environment and to see if IASB needed to consider a response to such transactions in their standards. What the survey indicated was the lack of uniformity of accounting treatments in countries that were currently doing Islamic securities. Overwhelmingly, the majority of respondents thought that having separate Islamic standards would be incompatible with IFRS convergence and most were reconsidering their use of Islamic standards. It was also noted that many countries surveyed in Asia were not already IFRS converged. As an example, Malaysia, which converged with IFRS's in 2012, does not have separate Islamic standards and applies IFRS to Islamic finance transactions without amendment. The experience in Malaysia is that, while recognition and measurement principles are adhered to, the disclosures have been amended to reflect the nature of the contractual basis rather than the more generic conventional descriptions. This approach would seem to be an acceptable one from an IFRS perspective.

Another interesting viewpoint was in the IOSCO 2004 report where their recommendation was that "Accounting disclosures should be based on internationally acceptable standards (such as IFRS). Regulators, in considering their accounting requirements, should give due regards to the specific characteristics of Islamic securities. Standard setting bodies such as IASB may wish to consider the application of IFRS with regard to Islamic financial instruments with other bodies (such as AAOIFI)".

The current status is that IASB has indeed been reaching out to Islamic stakeholders over the last few years to understand the industry and announced in March 2012 that they plan to set up a *Sharī`ah* Law Advisory group with a view to advising the IASB on how IFRS can accommodate the specificities of *Sharī`ah*-based transactions. It is hoped that by IASB being more open to discuss how IFRS can accommodate *Sharī`ah* based transactions, we may be able to encourage adoption of IFRS's by all jurisdictions, including ones with a significant ICM. This would certainly help the development of ICM by providing a degree of consistency.

III. Accounting Disclosure of *Sharī`ah* Risk

Having explored the relevant frameworks, it is worth considering what areas disclosure should cover. In our view, there should be sufficient disclosure to reassure the investor as to the *Sharī`ah* adherence:

- *A description of how Sharī`ah compliance was established*
- *A description of the processes to ensure continuing Sharī`ah compliance during the life of the investment*

Previously, it was mentioned that IFRS's does already require disclosures that may address some of these *Sharī`ah* compliance needs. For example, IFRS 7 para 33 requires that, for financial instruments, an entity shall disclose the exposures to risk and how they arise and its objective, policies and procedures, and processes for managing the risk and the methods used to measure the risk. Applying this to the issuer of a *Sharī`ah* instrument, it would imply that, if material, those financial statements should already be describing how *Sharī`ah* compliance was established, given it is a feature of the financial instrument that has material operational and financial risks and how these risks were mitigated.

A cursory review of issuer's financial statements in the Middle East and in Malaysia would suggest that globally, there is not a consistent level of disclosure. More specific issues are highlighted later in this paper but the better ones state which *Sharī`ah* scholars were used in arriving at the conclusion it met *Sharī`ah* principles, what the scope of their work or internal audit was in ensuring compliance, key terms of Islamic instruments that may trigger default and how the financial risk of *Sharī`ah* compliance is mitigated. At the other end of the spectrum, there is little or no disclosure. This is something that local regulators need to consider given the importance of the representation that such an instrument is *Sharī`ah*-compatible.

Difference in Sharī`ah views

One aspect of *Sharī`ah* instruments that investors want to know more about is, specifically, what was the basis and who was the expert who opined that such an instrument was in fact *Sharī`ah*-compliant? While the need for such disclosure is not spelt out in most regulatory frameworks, it is interesting to see how little disclosure there is about the *Sharī`ah* opinion itself.

The need for this becomes more evident when one considers the diversity of views and interpretations that *Sharī`ah* scholars have on the subject and this creates some issues. First, there is a question on the expertise of the scholars or the credibility of the scholars' opinion. Generally, there are two bases for challenging a *Sharī`ah Fatwa*, one being the credibility or qualification of the experts themselves. Regulators have either licensed or defined the qualification of such *Sharī`ah* scholars or have left it to the market to decide. In the latter case, even if the market was left to decide on the suitability of the experts used, it is not clear whether that has been clear disclosures relating to the qualification of the scholars in the term sheets or financial statement disclosures. The second base for challenging the opinion is whether the correct process was performed in arriving at the *Sharī`ah* opinion conclusion. Short of full disclosure of the *Sharī`ah* opinion, it would be very difficult for the investors or their advisors to be able to understand whether such a *Sharī`ah* opinion is appropriate.

The second issue is the extent of the *Sharī`ah* scholars' role in the matter. Was it limited to the instruments terms or do they have a continuing obligation to check on compliance throughout the life of the instruments? There is not much consistency on this by issuers either. Another concern is the legal relationship between the *Sharī`ah* scholars and the issuers. Is there any overarching framework over the *Sharī`ah* scholars' work regarding their roles, conflicts of interest, and remuneration?

Finally there is the question of certainty in disputes. There are a number of cases where *Sharī`ah* views have been disputed and it is not always clear in these disputes as to which authority the parties had agreed to refer to in order to clarify *Sharī`ah* viewpoints. This is particularly an issue in jurisdictions where *Sharī`ah* law is not considered national law and enforceable in disputes. Regulators can play a role in mandating a need for clarity as to whom has the final say in the event of a dispute and it should not be left to the vagaries of legal systems to work out.

Some of the matters described above may well have been given to the regulators at the point of approval. However, some information parity is needed between the regulators and investors.

IV. Issues Relating to Collective Investment Schemes (CIS) and *Sukūk*

Having explored some of the generic issues, let us examine how they relate to some common instruments used in the Islamic capital markets. There are two asset classes that make up the bulk of *Sharī`ah*-compliant investment, which are (1) equity funds both in the asset managed and collective investment schemes and (2) tradable bonds or *Sukūk*.

- Equity funds disclosure issues
- *Sharī`ah* screening issue

A common issue faced by *Sharī`ah*-compliant equity funds is to know which stocks and shares are considered *Sharī`ah*-compliant, what criteria are used, and finally what happens if they may fall out of *Sharī`ah* compliance.

Generally, most equity funds do not rely on their own criteria for screening but use one of these local or third-party screening services. Currently, this need is met by a combination of local bourse initiatives to classify their stock and shares as *Sharī`ah*-compliant or on third-party providers like Dow Jones or S&P.

The screening process is generally well disclosed in the equity funds but leaves the specific disclosures on how and what *Sharī`ah* criteria are used more to the screeners. The screeners identify the *Sharī`ah* scholars used and the criteria applied. Where the issue arises is the coverage of stocks and shares by the screeners, the availability of information available from the financial statements or public sources, and the acceptability or completeness of the screening criteria.

The issue of coverage refers to whether all potential *Sharī`ah*-listed stocks and shares are reviewed by the screeners or just a selection. Generally, most third-party screeners do selections that are biased towards larger, more liquid counters. This could be because of the tradability criteria some use but is probably more to do with the fact that screening is a continuous and expensive process so they tend to focus on what foreign investors themselves prefers. This may have the negative consequence of limiting investments to larger companies and neglecting the small and medium enterprises (SME) market. Another area that could be improved is to have local bourses playing a more active role in helping investors look at not just listed stock and shares in their jurisdiction but also more regionally. This could encourage Muslim minority jurisdictions to take more interest in encouraging foreign *Sharī`ah*-compliant investment in their jurisdiction and to provide them with some access to skill sets they do not possess.

The criteria used to screen are generally decided by the *Sharī`ah* scholars and cover aspects like the absence of *Harām* factors, acceptable levels of interest bearing instruments, and some ethical criteria and financial ratios. Most of this information is derived from financial statements or public information. There are issues over the timeliness of relying on public information as the screeners need the full financial statements and some quarterly information. Concerns have also been expressed that issuers do not provide enough information on their business activities that may lead to inappropriate classifications. This could be mitigated by regulating or encouraging issuers to provide information relevant to the *Sharī`ah* screeners as part of their investor outreach.

Again, voluntary disclosures are not that helpful without some consistent and timely disclosure from the issuers, which really should be mandated. Finally, there are differences between screener's criteria, for example in the use of financial ratios, which complicate comparability.

It is sometimes raised as to what accounting standard setters should be doing in this area. For example, should there be segmental information or a specific set of disclosures that could assist the *Sharī`ah* screener. This is something that can be explored further as many international bourses are moving towards mandating financial statements to be disclosed in XBRL (eXtensible Business Reporting Language)[32] formats, which will enable analyst to deep dive into the details of a compan's financial numbers. As XBRLs taxonomy is based on IFRS, the IASB should be encouraged to see if *Sharī`ah*-relevant information can be extracted using existing IFRS requirements. Such a development may also be seen as consistent with current discussions about having better disclosure in Financial Statements over ethical and sustainability factors. As *Sharī`ah*-compliant investments are arguably ethical ones, it would strengthen the case to do so.

Operational issues relating to Sharī`ah risks

Earlier it has been mentioned that there is a specific need to continue monitoring the status of *Sharī`ah* counters given that some companies may materially change their business models or fall foul of deteriorating financial ratios. A common *Sharī`ah* risk to manage is how to deal with income from a previously permissible stock and share and what are the policies relating to the disposal of this now inappropriate investment. This is sometimes described as the cleansing mechanisms.

Generally, there are disclosures in *Sharī`ah*-compliant funds on these cleansing mechanisms but practices do vary. However, most disclosures are generally adequate. What could be improved is having a more explicit financial disclosure, unless immaterial, of what were the financial impacts of such mechanism being applied to the fund as usually, cleansing involves a payment out of the fund, which reduces the value to investors. Another disclosure that could be useful is to whom such payments are made to as it is a form of donation, and some degree of transparency to the investor is needed as to the quantum and policy for selection of the recipients.

***Sukūk* disclosure issues**

Another important ICM instrument is the *Sukūk*, which are widely used globally given the similar but not exactly the same characteristics *Sukūk* have with fixed income bonds. Investors too seek to have sufficient information to be able to make decisions, but currently the bulk of the investors are commercial and not retail customers. This to some extent explains the lesser public disclosures and the reliance on advisors and private information.

[32] More information at www.xbrl.org.

***Sharī`ah* acceptability**

As discussed above, investors, in addition to financial considerations, do need to be comforted that the financial instrument is *Sharī`ah*-compliant. The current method involves issuers hiring *Sharī`ah* scholars to examine and opine on whether the instruments meet certain *Sharī`ah* criteria. This opinion is not shared publicly but is provided privately to interested investors advisors. There is usually some disclosure in the issuers term sheets and financial statements about the *Sharī`ah* scholars involved and some basic data around the *Sharī`ah* features of the instrument.

There is also the issue of continuing compliance. Few issuers describe in the financial statements how they manage this, and therefore to investors, there is a risk that representations made at inception may not be monitored or audited by an independent party. If one were to look at Islamic banking or *Takāful* institutions, they would usually have a permanent set of *Sharī`ah* scholars on board and one of their roles is to monitor the institutions compliance with *Sharī`ah*. This is sometimes explicitly seen where a formal statement of compliance is disclosed in the financial statement.

Both the disclosures described above are not always consistent or public and it should be an area for regulators to consider mandating in order to provide meaningful information for investors.

***Sukūk* valuation**

One of the features of *Sukūk* is the fact that they are similar to fixed income instruments, are generally rated and therefore with some additional information, can be valued using DCF (Discounted Cash Flow) techniques. As issuers, generally these instruments are treated as liabilities and are carried at cost. In rare circumstances, they may be carried at fair value under IFRS and then the issue of value arises. This does not appear to be a major issue to bond pricing agencies and to market players as there are usually enough traded prices on OTC exchanges or enough data from the financial statements to be able to use DCF or similar models.

For investors, similarly they should be able to identify market prices to trade or to value these instruments. In either issuers' or investors' financial statements, the IFRS does spell out a need for market values to be disclosed so there is usually some attempt to arrive at market values at reporting dates. Other than that, IFRS 13 para 93 spells out the need for details of the valuation inputs and data in Tier 2 or Tier 3 situations (less active trading markets), which may be difficult to do and hence may lead to pricing haircuts.

Where issues arise is perhaps the fact that these instruments are generally in short supply or are held to maturity so there are concerns over the liquidity discounts that are needed to price thinly traded *Sukūk*. Another concern moving forward is the Regulatory rules coming in globally that penalise instruments not traded on exchanges but are purely OTC. This will impact *Sukūk* and there is a need for jurisdictions to consider moving such *Sukūk* trading to more organised exchanges, and to also encourage independent pricing of *Sukūk* to ensure a deeper and more liquid market.

There is sometimes concern expressed that DCF valuations may not be appropriate given the use of interest or that for particularly *Sukūk al-Ijārah*, they be valued by reference to the asset and not to the cash flows generated. These views are not always shared as commentators have made the point that DCF is only one of many models to value liabilities and also the use of interest is only as a reference to market prices in order to price *Sukūk*. The value of the asset as an alternative could be relevant in true asset-backed *Sukūk*, but these are in the minority as most modern *Sukūk al-Ijārah* have a "put back clause", which means the asset is not available to investors in the event of a default and consequently for such valuations, the cash flows are more relevant.

V. Conclusion

The ICM is growing extremely fast. As an asset class, products that are *Sharī`ah*-compliant are seen as new and dynamic and have much growth potential. There are also a number of trending indicators showing expected sustained growth. For a capital market to embrace Islamic products, an enabling environment should look at *Sharī`ah*, Taxation, Accounting, and Regulatory aspects.

On examining the accounting and regulatory aspects of certain *Sharī`ah*-compliant instruments, given that some regulators are reluctant to legislate on matters relating to a religion, a strong disclosure regime is crucial to providing an important alternative for investors to have reasonable and relevant information not only to assess the financial implications but also *Sharī`ah* ones in order to make an informed investment decision. An area of improvement to consider is improving international accounting standards like the IFRS to cater for *Sharī`ah*-compliant instruments and to mandate relevant disclosures. Regulators should consider setting additional regulations to set a minimum framework for *Sharī`ah* scholars, disclosures surrounding the *Sharī`ah* opinion, and monitoring of risks as well as to ensure that market liquidity measures are applied in order to improve the tradability of these instruments. Clearly then, better disclosure is an important prerequisite to a healthy market for ICM products but it is no substitute for more direct regulations.

COMMENTARY ONE

Hooman Sabeti-Rahmati

COMMENTARY ONE

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I. Introduction

In these remarks, I will generally consider the issues raised in the subject paper from a legal perspective, and I will confine myself to address three questions:

- What role should disclosure have in regulation of *Sharī`ah* compliance?
- Do conventional disclosure principles adequately address the issues in the ICM?
- What might be part of a robust disclosure regime for the principal ICM, *Sukūk*?

Two relevant documents for this discussion, as mentioned in the subject paper, are IOSCO's *Islamic Capital Market Fact Finding Report* (2004) and IOSCO's *Analysis of the Application of IOSCO's Objectives and Principles of Securities Regulation for Islamic Securities Products* (2008). In the 2004 IOSCO paper, the tentative view appeared to be that the conventional securities regulation framework and principles equally apply to the Islamic capital market, with perhaps the addition of some form of disclosure on the *Sharī`ah* approval or certification process. This was during the early days of cross-border *Sukūk*, the first one having been issued only in 2002.

In the 2008 IOSCO paper, the view seemed to have evolved to be that there may be room for some further work on disclosure in the context of ICM products. This was in the context of several dozen cross-border issuances having been concluded, and some notable twists in the market such as a perceived change in *Sharī`ah* permissibility of purchase undertakings, arising from some statements made by well-known AAOIFI *Sharī`ah* board scholars.

Since the development of these reports, the market disruptions and failures leading to and causing the global financial crisis have taken place. This crisis was an event of a type and scale that has in the past caused a rethinking of market regulation. While the crisis affected ICMs less and in different ways than it affected the conventional markets, this was not because of any inherently greater strength of ICMs or their disclosure approach. Many lessons have been derived by market participants and regulators from the crisis, and it behoves us to view *Sharī`ah* compliance, *Sharī`ah*-compliant transactions, and their disclosure in light of this learning. It is generally less costly to learn from others' mistakes than one's own.

II. What role should disclosure have in regulation of *Sharī`ah* compliance?

The subject paper asks whether disclosure could be a substitute for regulation of *Sharī`ah* compliance. Whatever approach to regulation is taken, a focus on disclosure must be a part of regulation. This is because markets run on confidence, and the cornerstones of confidence are clear and complete investor understanding of the securities offered, through appropriate disclosure, and predictable outcomes that match investor expectations. We do not always have that in ICM today. What we saw post 2008 was that outcomes did not always match expectations for investors in the case of *Sukūk*. This may have been because some investors misread or misunderstood the disclosure, or because the disclosure was insufficiently clear, or because the financial press misunderstood and incorrectly described and propagated the workings of *Sukūk*. But, in any event, the result was that outcomes did not match expectations for a number of investors and overall confidence was diminished.

Looking at IOSCO's objectives for securities regulation, we might observe that each of them is implicated in current ICMs disclosure approaches, but also not met in some ways:

- The protection of investors is frustrated in a number of ways. Investors do not always receive equal or complete information as to *Sharī`ah* matters and therefore cannot make fully informed decisions. For example, some investors might receive a copy of the transaction fatwa while others do not, depending on significance of the investor, closeness to issuer or arrangers and whether they ask. As another example, disclosure is sometimes incomplete or unclear as to the nature of the *Sharī`ah* review process. Moreover, disclosure as to the nature of recourse can be quite unclear even to seasoned investors.
- The aim of ensuring that markets are fair, efficient, and transparent is not entirely met under current disclosure approaches relating to Islamic capital markets. This is because there is lingering confusion as to the internal mechanics of a *Sukūk* structure, the means of interpretation of the contracts, the mode of dispute resolution, the nature of available recourse, and the mechanism for enforcement.
- The reduction of systemic risk is implicated, too. Some systemic risk that could be reduced persists as a consequence of the market confusion and unclear or incomplete disclosure. It appeared that investors stayed away from *Sukūk* as a class in the aftermath of the defaults and restructurings, which affected some GCC *Sukūk* on the theory that there were problems that infected all *Sukūk*. This should be of concern from a regulatory perspective, because the manageable problem of disclosure, if not properly addressed, can result in much less manageable systemic problems.

III. Do conventional disclosure principles adequately address the issues in the Islamic capital markets?

Here I will focus on *Sukūk* rather than *Sharī`ah*-compliant company shares, because the issues are more numerous and significant with *Sukūk*. The differences between *Sharī`ah*-compliant shares and shares generally arise from the nature of the underlying company's business, financial condition, and financial arrangements. There is, however, no structural or legal difference between the two types of shares. On the other hand, there are significant structural and legal differences between *Sukūk* and conventional bonds.

In my view, conventional disclosure approaches as applied today do not sufficiently handle *Sukūk* disclosure. I say 'as applied today' because if one were to apply the general securities disclosure principle that investors should have in hand all information material to an investment decision at the time they make that decision, then by definition sufficient disclosure would be forthcoming. But, like much else in the capital markets, actual market practice is the initial point of reference for practitioners, who generally take the view that practice must already be reflecting the principle. There are also disincentives from departing from practice: it might suggest to investors that something about the offering is different from other offerings (when the only difference is the approach to disclosure); or issuers, arrangers, and their counsel may want to avoid the suggestion that previous disclosure they had a hand in was not as complete as current disclosure.

There are other reasons to think that conventional bond disclosure approaches are insufficient. *Sukūk* are fundamentally structured transactions, compared to straight bonds, which are from a legal perspective simple repayment promises. There is not much to disclose about a plain vanilla bond beside its financial terms and the credit quality of the obligor, which is the fundamental dependency. But, with *Sukūk*, there are more and different things to disclose because it is an instrument with a legal structure that constrains investors' rights in important ways through an enforcement mechanism, which is limited and unusual. *Sukūk* structures have features that courts have not had occasion to interpret and address. One could also observe that the disclosure approaches applied so far have not succeeded on some fronts. For instance, there is a perception of unequal disclosure, as regards *Sharī`ah* aspects and *Fatwa*. There are clearly basic legal aspects of *Sukūk* structures that different investors understand differently, meaning at least some must be misunderstanding things.

If conventional bond disclosure approaches are insufficient for *Sukūk*, should we leave it to the market to develop a better approach? I would argue not for various reasons. The *Sukūk* market is both relatively new and quickly evolving. The first cross-border *Sukūk* were issued in 2001. In recent years, the most commonly used structure has become the recently developed (in 2008) *Wakālah* structure. There is insufficient expertise amongst private players in the ICM to leave disclosure norms to be worked out by the market. One may also observe that the level of market player discourse is not always sophisticated, in particular with regards to cross-border instruments. This is in contrast with the conventional market, which is larger and more populated with seasoned participants. Because the *Sukūk* market is still developing and still in a seasoning stage, I believe there is room for guidance from or orchestrated by regulatory or industry bodies on the important issue of disclosure.

I believe it is timely to turn to refining disclosure now. There is now enough maturity and experience that we can begin to distil these into some market guidance. At the time of the 2004 IOSCO paper, there had only been a handful of cross-border *Sukūk* issued. By 2008, the global financial crisis and the spate of *Sukūk* defaults had not yet unfolded. But, since then, there have been some significant adverse experiences in connection with the Dubai restructurings and indeed some outright defaults. It is appropriate to conduct a post-mortem and derive some learning from these. There have been tremendous efforts to look at what was wrong in the conventional system following the global financial crisis, but I am not aware that there has been a serious, harmonised, cross-border effort to learn from the global financial crisis in the ICMs. It is a matter of time before a significant adverse event, like an insolvency of a major bank or a major unexpected *Sukūk* default, afflicts the Islamic capital markets. If by then we had not processed the lessons we are now able to process, we would have been remiss.

We should also be mindful of a financial stability issue here. If investors run away from *Sukūk* on the basis that they do not really understand how *Sukūk* work in distress or enforcement scenarios, inadequate or unclear disclosure will have led to a stability risk. We observed that the aftermath of *Sukūk* defaults a few years ago was generalised confusion. In addition to the stability risk, this confusion and uncertainty can impose a cost on investors and on market efficiency. Islamic products today often cost more; they are less available and different investors have different understandings of how some of their very basic features work. In the face of such levels of misunderstanding or hesitation to invest, regulators should consider acting in concert.

IV. What might be part of a robust disclosure regime for the principal Islamic capital market product, *Sukūk*?

Here, I will highlight some of the areas where a rethinking of *Sukūk* disclosure and mechanisms may be warranted, because the disclosure is rarely clear and often nonexistent. This is meant to be a suggestive rather than exhaustive listing, to give a sense of where some of the gaps lie today.

- The actual use of proceeds raised from *Sukūk* and the source of payments on *Sukūk* not disclosed as a routine matter. One could argue that if there were disclosure standards on this, we could have avoided the problems that afflicted, for example, the Goldman Sachs *Sukūk*, which was misunderstood and misinterpreted and caused damage in credibility to scholars, institutions, and the market.
- The terminology used in describing the nature of recourse in *Sukūk* is fundamentally insufficient and misleading. The terms "asset-backed" and "asset-based" represent a poor choice of terms. There is a reason those terms are rarely, if ever, included in a legal or offering document: one would be hard-pressed to make a plain-meaning distinction between those to a judge or jury. These poor terminologies have become embedded in the market. What would be useful, rather than misleading, is if we describe clearly the nature of available investor recourse, by stating whether there is recourse to an obligor, recourse to an asset, or recourse to both. There are conventional instruments such as covered bonds where there is recourse to both assets and an obligor. Would covered bonds be considered "asset-backed" or "asset-based" under the (confusing) *Sukūk* market terminology? The (confusing) answer is: both.
- *Sukūk* documentation contains limited recourse wording, which has been borrowed from language developed well before *Sukūk* for conventional asset-backed securities (ABS). This language has been included from the beginning of the cross-border *Sukūk* market. In ABS, the limited recourse language explains that there is recourse only to the specified assets, which do include income-producing financial assets the ownership of which has been absolutely transferred. In *Sukūk*, the limited recourse language states that there is recourse only to the specified assets, which in the great majority of *Sukūk* do not include income-producing financial assets that have been absolutely transferred from the obligor.
- Similarly, *Sukūk* disclosure usually provides something to the effect that: Proceeds of the "Trust Assets" are the sole source of payments on the *Sukūk*. In an *Sukūk al-Ijārah*, the Trust Assets would include the physical property. This suggests (though this is a suggestion and not a strict logical deduction) that proceeds of the property are actually available for *Sukūk* payments, though they are generally available only with the significant limitation that the property may not be freely disposed in enforcement; this limitation usually appears elsewhere. It also deflects focus from the fact that any payments on the Trust Assets are

strictly a function of the creditworthiness of the obligor, not any inherent quality of the Trust Assets.

- *Sukūk* disclosure generally does not mention whether or not the obligor's *Sukūk* and its conventional obligations are cross-defaulted. If they are not so linked in either direction, the economic consequences for *Sukūk* holders in a restructuring can be significant.
- One important rationale behind purchase undertakings in *Sukūk* is that they are expected to replicate for *Sukūk* holders the insolvency position of conventional bond holders. There is generally no disclosure as to whether there are risks that the SPV issuing the *Sukūk*, as a *Sharī`ah*-compliant entity might face *Sharī`ah* constraints in participating in an insolvency or accepting distributions from the insolvency estate.
- Similarly, there is no statement as to whether a restructuring of a *Sukūk* could be done in a compliant or non-compliant matter, or how compliant holders who may not want to participate in a non-compliant restructuring would be treated. After a default or restructuring, it may be the case that only a money claim is left, which would leave compliant investors constrained in their ability to sell their *Sukūk* at negotiated prices.
- *Sukūk* disclosure does not usually mention what role *Sharī`ah* would play in the interpretation of the *Sukūk* contracts or in disputes. But, this could well be implicated, for instance in modifications or restructuring, given that the *Sukūk* issuer must remain compliant. *Sukūk* contracts generally have no mechanism to involve *Sharī`ah* scholars after the issuance in any questions that may arise in connection with a modification, default, restructuring, etc. Arguably, some provision should be made or the need to rely on ad hoc mechanisms, and the possible consequences, should be disclosed as an investment consideration.

In addition to these *Sukūk* disclosure items, it is necessary to consider disclosures relating to the *Sharī`ah* process. This has been quite appropriately discussed in the subject paper, and I would like to amplify and add some thoughts. The *Sharī`ah* vetting process, which leads to a conclusion of compliance and culminates in a fatwa, is of course existentially important to *Sukūk*. But, it is barely discussed in *Sukūk* offering documents, largely because of liability considerations as issuers and arrangers are concerned that they might be viewed as representing compliance, which is subject to determination by individual scholars and not in the hands of any institution. As a result, there is very little information about a matter that is centrally significant to many *Sukūk* investors. This is an area where regulatory or industry body express guidance can make a real contribution, by giving issuers and arrangers the security of following a sanctioned form of disclosure and allowing all investors (not just some, as is the case today) to receive information relevant to their investment decision. The disclosure that might be provided could include, as an illustration:

- The scholars' names and their relationship with the issuer or arranger (e.g. internally employed or externally engaged).
- The scholars' credentials, the disclosure of which can help focus investors on credentials not just names. This could broaden the scholar pool, which today is a bottleneck. Can it really be that there are so few scholars today versed in Islamic commercial law and capable of analysing capital markets arrangements?
- What the *Sharī`ah* review process consisted of and what documents (e.g. term sheets, drafts, final documents) the scholars reviewed.

- How far into the structure and its collateral arrangements the *Sharī`ah* review were extended, and whether there were external or collateral arrangements that were not considered.
- The *Sharī`ah* basis/analysis backing the conclusion of compliance, so that other scholars can consider and understand it and general sophistication in the market can improve. Most *Fatāwa* are very light on analysis, and only describe the structure and state the conclusion of compliance with limited reasoning.
- Whether the scholars are aware of a diversity of opinion on any significant points. If there is a serious diversity of views on an important legal point that is fundamental to the structure of a conventional capital markets product, this would usually be disclosed. This is not the case with *Sukūk*.

V. Conclusion

How do we go about creating and implementing a more refined approach to *Sukūk* disclosure? It can only happen in a market as diffuse as the ICM through an orchestrating body, whether it is IOSCO or the IFSB or another body, that leads the way in convening an appropriate group of people to think about the issues, solicit views, and put forth proposals. There is a window of opportunity to do this now. There will be stress times ahead; we may be heading into iterations of sovereign debt and banking crises. Some years down the road, we will be looking back to this time and asking whether enough has been done.

COMMENTARY TWO

Ashraf Mohammed

COMMENTARY TWO

Ashraf Mohammed

I. Introduction

The initial discussion on the IOSCO studies and reports is a useful beginning for our discussions on this important topic and it is helpful of Mr. Azmi to remind us of IOSCO's findings and recommendations. We need to remember that indeed, regulators appear to have a wide spectrum of regulatory styles to accommodate Islamic securities. The relatively infancy of Islamic securities in the market proves to be challenging when discussing standards and mandatory disclosure requirements.

The Paper's emphasis on the significance of the disclosure regime in diverse regulatory environments is very much appreciated. I agree that an effective disclosure regime would facilitate cross-border activities and promote transparency in the benefits and risks of Islamic financial products. The Asian Development Bank (ADB) has always believed in the need for transparent disclosures. In its Public Communications Policy, initially released in 2005 and reviewed earlier this year after two years of wide public consultation, the ADB considers qualitative and relevant disclosure of information as a standard operating procedure for all ADB projects. The reference to transparency is consistent with ADB's policy to be proactive in disclosure and to promote transparency, accountability, and participatory development.

Disclosure requirements are paramount to maintaining investor confidence and the investors' ability to make informed decisions. As cross-border transactions increase, with the differences between regulatory regimes, the importance of effective disclosure requirements cannot be over-emphasised.

The discussion in the Paper of accounting frameworks, which would be relevant to Islamic securities, is also appreciated. It is interesting to learn the differences between the accounting standards issued by the AAOIFI and those issued by IASB. The IOSCO 2004 recommendation that "the accounting disclosures should be based on internationally acceptable standards, but that regulators should give due regards to specific characteristics of Islamic securities" is something to be considered by current regulators.

The Paper correctly identifies some of the issues currently facing the ICM, such as difference in valuation techniques, non-uniformity of standards, how to ensure *Sharī`ah* compliance, and the reliability of local bourse classifications. I agree that in the absence of a uniform regulatory framework, a strong disclosure regime would act as a good substitute. Some discussion on how the differences between the AAOIFI standards and IASB may be addressed would be welcome.

However, it could be argued that the Paper relies too heavily on the IOSCO report in making its case for the importance of robust disclosure regimes. Other sources of information, supporting the importance of robust regulation, do not appear to have been referenced. I would also suggest that the Paper would benefit from (a) an in-depth analysis of the current regulatory regimes in the various ICMs and how robust disclosure regimes could be substituted to bridge the shortcomings in existing regulatory regimes; (b) the advantages and disadvantages of the various disclosure regimes currently enforced; and (c) the manner in which standardisation of the disclosure regime would improve ICMs. In addition to the IOSCO report, other relevant sources should also be discussed in order to provide a more balanced view on the need for robust and effective disclosure regimes in ICMs.

The Paper would also benefit from a more in-depth analysis of proposed disclosure requirements and how a global standardised disclosure regime may be implemented. Some questions that the Paper could consider include:

- What should be the minimum disclosure requirements? Can there be a case of over-disclosure, i.e., information overload, which would actually be detrimental for ICM transactions?
- Who should be responsible to prepare these minimum disclosure requirements? For instance, would it be possible for the IFSB and AAOIFI to collectively produce a set of disclosure requirements to be applied uniformly across the ICM. This would be beneficial to ensure that all Islamic capital market products are subject to the same level of scrutiny irrespective of the jurisdiction in which the market is situated, and avoid, or at least minimise, disclosure forum shopping.
- How can regulators be required to adopt these minimum disclosure requirements? Does self-regulation remain a viable alternative?
- What are the next steps towards creating and implementing a global ICM disclosure regime?

II. Minimum Disclosure Requirements

In 2007, the IFSB issued a Paper entitled *Disclosures to Promote Transparency and Market Discipline for Institutions Offering Islamic Financial Services* (IFSB Disclosure Standards), which were issued for the benefit of Institutions offering Islamic Financial Services (IIFS), their supervisory authorities, and other relevant policy-makers.[33] Section 6 of the IFSB Disclosure Standards sets out the disclosures designed to provide information on governance in an IIFS and transparency regarding *Sharī`ah* compliance. These disclosures are divided into General Governance and *Sharī`ah* Governance Disclosures.

The 2007 IFSB Disclosure Standards could be a good place to start in coming up with “minimum disclosures”, but as Islamic finance is rapidly evolving, a number of issues have arisen in the recent years. A continuing issue is *Sharī`ah* compliance. According to the Paper, there should be sufficient disclosure to reassure the investor as to *Sharī`ah* adherence with regard to (i) a description of how *Sharī`ah* compliance was established and (ii) a description of the processes to ensure continuing compliance during the life of investment. The Paper also notes that the *Sharī`ah* scholars have a diversity of views and interpretations on the subject of *Sharī`ah* compliance of investments and this raises the question on the expertise of the scholar or the credibility or qualification of the expert himself. This was particularly true in the DSM in 2006, which led to an Islamic scholar, Sheikh Mohamed Al Tamimi emphasising the significance of specialisation and the need for Islamic scholars who are familiar with Islamic economics and finance and the nuances

[33] IFSB, *Disclosures to Promote Transparency and Market Discipline for Institutions Offering Islamic Financial Services*, Section 1.

of stock trading.[34] This sentiment was echoed by another Islamic scholar, Alu Mohiuddin Al Qurradaghi from Qatar University, when he opined that a *Fatwa* committee should have Islamic scholars specialising in Islamic economics and finance, legal experts, and economists being members.[35] On the other hand, requiring disclosure of who the *Sharī`ah* experts are may make the whole process appear as a popularity contest. Will we end up with different leagues of scholars such as the English Football Leagues? Will investors then base their investments as to which scholar has the better credentials and which league he or she is in?

The Paper also considers the issue of how to ensure that the correct process is performed in arriving at the *Sharī`ah* opinion, and states that "short of full disclosure of the opinion, it would be very difficult for investors or their advisors to understand whether a *Sharī`ah* opinion is appropriate". This appears to suggest that disclosure of the *Fatwa* itself would be beneficial. But we have to step back to consider whether it really would be? Or would this lead to over-disclosure? Would disclosure of entire *Fatāwa* result in inundating the markets with volumes of unnecessary information that would be difficult to sift through in the first place? This is especially true for retail investors who might not have their own advisors to delegate the sifting through of information. Instead of transparency, the existence of too much information may only end up in confusion. In this respect, extensive disclosure may be counter-productive. In this context, the Paper may consider examining the disclosure requirements in the more established ICMs in order to get a better understanding of the pros and cons of certain disclosure requirements and whether such requirements should be included as part of a more extensive disclosure regime.

With regard to the process of ensuring compliance during the life of an investment, Professor Rodney Wilson of the IOSCO task force on ICM, added as disclosure requirements, an indication of whether *Sharī`ah* advisors are reactive or proactive, and information on the frequency of monitoring by *Sharī`ah* committees. Again, these would require a subjective assessment of the competence and working style of the *Sharī`ah* advisors. Should such subjective disclosures form part of the minimum disclosure requirements?

I would also support the Paper's contention that there is a need for a generally acceptable standard of level of disclosure and methodology in the screening of *Sharī`ah*-compliant equities. Moreover, support the need not only for disclosure of description of cleansing mechanisms undertaken to deal with income from investments that have become inappropriate or a source of income from a *Harām* source, but also the financial impact of such mechanisms on the fund or investment. This would be particularly important to non-Muslim investors who may not be familiar with the concepts of cleansing.

These questions cannot be answered in this session, but the need for a thorough discussion on this matter in the Paper and amongst the Islamic finance community has become very apparent. There is also a need to move boldly in this direction and incite an exchange of ideas, discussions, and debates. Stakeholders, including representatives from global markets, investors, and *Sharī`ah* scholars should come together to flesh out the issues that have arisen and, ideally, come out with the minimum disclosure requirements, which would promote investor confidence in Islamic finance.

[34] http://archive.thepeninsulaqatar.com/component/content/article/349-qatar-newsarchive/116433.html
[35] http://archive.thepeninsulaqatar.com/component/content/article/349-qatar-newsarchive/116433.html

III. Enforceability

As observed by the IFSB in the IFSB Disclosure Standards, various corporate and *Sharī`ah* governance practices are adopted by different IIFS in different countries. Compliance with the IFSB's standards remains largely voluntary on IIFS, their supervisory authorities, and other relevant policy makers. Furthermore, as the IFSB has no oversight function, adherence to the Standards cannot be enforced through the IFSB and compliance can be ensured only through local regulatory agencies. However, as noted in the Paper, some regulators are reluctant to legislate on matters relating to a religion.

A consistent, stronger accounting framework, as discussed by Mr. Azmi, could provide a partial solution to the cross-border situation. The universal adoption of the IFRS but with due regard to specific characteristics of Islamic securities could be the springboard to standardising disclosure requirements. Given the continuous growth of the ICMs, it would be worth recommending to the IASB, an issuance of IFRS standards designed specifically with Islamic securities in mind. But, a uniform accounting framework solves only part of the problem as they would cover only disclosure requirements associated with periodic financial reporting. There are issues on the timeliness of public information presented in financial statements. There is also an issue as to how to require timely disclosures with regard to other material events such as related party transactions.

This leads us to the Paper's conclusion, that there is no substitute for direct regulation. There can be no enforceability without direct regulations. In terms of promoting a level of consistency and certainty, self-regulation would not be a viable option. The IOSCO or the IFSB (or both) should come out with an official issuance setting forth the Minimum Disclosure Requirements for IIFS and Islamic products, and which, similar to a treaty, each regulator should agree to consciously adopt. Regulators who fail to adopt Minimum Disclosure Requirements may be soft-sanctioned by way of a published list. Inclusion of a particular market in the published list may be interpreted by investors that securities traded therein do not follow the standard Minimum Disclosure Requirements agreed upon by experts and stakeholders.

IV. Moving Forward

Disclosure requirements are integral to maintaining investor confidence but their effectiveness requires complementary direct regulations, and the next step that should be taken should be a step in this direction.

COMMENTARY THREE

Eser Şagar

COMMENTARY THREE

Eser Şagar

I. Introduction

As the world gets more interconnected and globalised, capital markets including the Islamic ones also tend to develop in tandem with the global economy. Investors located in an economy with capital surpluses are looking to invest in assets in another country whereas the deal itself is structured yet in another jurisdiction for legal purposes. The combination of these factors poses different challenges to cross-border ICM deals.

This commentary is prepared in accordance with the IFSB-IOSCO Roundtable on Disclosure Requirements for ICM products. The report prepared by Mr. Mohammed Faiz Azmi accurately sets out key issues surrounding the disclosure regime in facilitating cross-border investments and developments of ICM products and services. This commentary will be geared towards cross-border *Sukūk* issuances from the viewpoint of a jurisdiction where both conventional and Islamic finance products and services are used. The views expressed are of the commentator's only and do not reflect the views of the Capital Markets Board of Turkey.

Sharī`ah **adherence**

As discussed in the paper, Islamic Finance is rapidly gaining ground in countries with Muslim minorities and even in countries with no Muslim population. Compared with conventional finance, Islamic finance has a unique selling point for all jurisdictions mainly because ICM products and services are selective in nature but not exclusive to Muslims. The unique feature of *Sharī`ah* compliance, however, is dealt with a number of different ways in jurisdictions where Islamic finance is practised.

- In some jurisdictions, there are national *Sharī`ah* boards that ensure *Sharī`ah* adherence;
- In others, there are clear regulations on how *Sharī`ah* adherence is secured; and
- In some others, *Sharī`ah* adherence is left to the industry via initial and ongoing disclosure mechanisms.

Each jurisdiction has its own solution on how compliance is achieved depending mainly on how sophisticated and developed their ICM is.

On the other hand, disclosure requirements on *Sharī`ah* compliance may be harmonised with regard to same asset classes, products or services especially for cross-border activities. Therefore, a solution may be developing a benchmark Standard (similar to IFSB-4: Disclosures to Promote Transparency and Market Discipline for Institutions offering Islamic Financial Services) regarding ICM products, or the *Sukūk* in particular. This Standard should be diverse enough to cater all different approaches by stating the minimum disclosure requirements.

II. Accounting framework choice

The value proposition of creating an "International Accounting Standards set" was to decrease the overall cost to issuers and to facilitate cross-border issuances by using the same language across countries in terms of financial reporting.

The existence of two competing sets of standards will no doubt hinder the growth of ICM products and services as demand and supply side of the capital markets will not be using the same language. IFRS is increasingly becoming the dominant standard set used globally as more and more countries adopt IFRS as their national accounting framework. According to the numbers, IFRS may serve as the ideal platform to achieve unity in the industry. However, IFRS as it currently stands may not provide the best solution to the needs of Islamic financial institutions.

An example for inconsistency may be explained by an asset-backed *Sukūk Al-Ijārah* transaction. According to IFRS, the sale of and leasing back the assets to the SPV may result in the originator keeping the assets on its balance sheet after the sale of the *Sukūk*, thus confusing the investors on whether the investors have or do not have an undivided ownership interest in the underlying assets through the SPV.

Therefore, an ideal approach may be converging towards IFRS with revisions to address shortfalls regarding ICM products and services.

Perfecting transactions in cross-border *Sukūk* deals

Cross-border *Sukūk* deals become complicated when underlying assets are held in a country and governing law and jurisdiction for contracts of the *Sukūk* issuance is set as another country's law and jurisdiction. This is especially of importance in the case of asset-backed *Sukūk al-Ijārah* mainly because the transfer of property and real estate are subject to local procedure.

The enforceability of court orders of a jurisdiction in another jurisdiction should be carefully examined by lawyers in both jurisdictions and their opinions or a joint opinion regarding enforceability should be clearly stated in prospectuses or other relevant issuance documents. This issue has recently been addressed in Turkey by the requirement of a legal opinion on whether the issuance constitutes legal risk for cross-border *Sukūk* applications.

Civil law countries, which aim to develop ICM in their own jurisdictions, typically face legal issues when regulating ICM products and services. While not exclusive to ICM products and services, issuers in common law countries can make use of agreement-based capital market product and services including securitisation deals easier than issuers in civil law countries can. Regarding ICM products and services, contracts defined in the civil law of a country and Islamic contracts underlying the ICM products in services should ideally be compatible. Major differences between these contracts may bring up the enforceability issue and can potentially harm the industry. For example, there may be local procedures on establishment or enforceability of usufruct in a civil law jurisdiction, which might make some *Sukūk Al-Ijārah* transactions more costly compared to the ones structured in common law countries.

Yet, another challenge for civil law countries is the regulation of the notion of fiduciary ownership, which is required for the creation of SPVs in *Sukūk* transactions. Regulation of such a notion may require constitutional arrangements or major changes in basic laws at the least. In such jurisdictions, fund structures used in conventional capital markets may also be used as SPVs for *Sukūk* issuances, although the challenge of taking legislative action will be required.

Information on whether ICM product or service carries legal risk or how this risk is mitigated should be disclosed in cross-border deals.

III. Disclosures related to *Sukūk al-Ijārah*

As it is mentioned in the report, the *Sukūk* market is mostly a commercial or qualified investor's market. From a regulator's point of view, qualified investors have more purchasing power that enables them to seek information from issuers where retail investors would struggle to obtain. In theory, they are also capable of conducting due diligence before purchasing ICM products. However, insight from industry practitioners suggests that this is not always the case. Investors are prone to carry out a light due diligence and some may not know whether the *Sukūk al-Ijārah* they purchase is asset-backed or asset-based (or in other words whether there is recourse to the underlying assets or not). While most *Sukūk al-Ijārah* on the market is asset-based, the need to distinguish between them is very crucial. The rating of the *Sukūk al-Ijārah* and the credit risk of the security will be dependent on this distinction. On the other hand, depending on the underlying assets and structuring of the *Sukūk al-Ijārah*, in some instances, it may not be clear whether investors have a recourse to the *Sukūk* assets or not. Investors' access to the underlying assets may be extremely conditional, making the *Sukūk* assets non-recourse. Therefore, requiring issuers to disclose the following items as a single page document to accompany prospectuses and other issuing documents may be a solution to better address this information gap:

- The product structure.
- Categorisation of the *Sukūk al-Ijārah* as asset-backed or asset-based.
- The conditions for investors to have recourse to the underlying assets in a case of default.

Recent *Sukūk* regulation in Turkey directs the issuer to disclose whether investors have or do not have recourse to the *Sukūk* assets. The issuer is also required to substantiate his recourse claim in formal writing to the regulator along with supporting documents.

IV. Conclusion

The availability of a strong disclosure regime on ICM products and services is essential in tackling challenges discussed in the Roundtable. Disclosure requirements on *Sharī`ah* compliance may be harmonised with regard to ICM products and services through the establishment of a disclosure standard. Regarding the availability of two competing accounting standard sets, an ideal approach may be directing the related international organisations' efforts to have their members support the convergence towards IFRS with revisions to address current shortfalls regarding ICM products and services. Enforceability of the ICM product and services in cross-border deals is an important issue that needs to be scrutinised before the regulator's approval and disclosed in the issuance documents in detail. Another outstanding issue is the vagueness around investors' recourse rights on the underlying assets in *Sukūk* issuances. This challenge may also be addressed by regulatory scrutiny before the approval stage as well as clear disclosure of the terms and conditions affecting the recourse rights.

Chapter Four
SUMMARY AND CONCLUSION OF THE ROUNDTABLE

Chapter Four
Summary and Conclusion of the Roundtable

The publication of the proceedings of the Roundtable highlighting the inherent issues relating to disclosure requirements for the ICM represents an important joint initiative by the IFSB, IOSCO, and SC Malaysia. The insightful comments and recommendations highlighted by speakers and discussants can help strengthen the disclosure regime for the ICM and promote overall investor confidence in this increasingly important segment of the global financial system.

The IFSB-IOSCO Roundtable was held at an optimal time in view of the growing cross-border transactions and activities in the ICM, which have called for some degree of standardisation, including disclosure requirements. The IFSB, as the international standard-setting organisation for the Islamic financial services industry, is focused on strengthening the regulatory requirements relating to disclosure to make it more comprehensive for the industry. There is also growing interest on the part of the IOSCO as the global standard-setter for securities regulation to follow-through on its earlier ICM initiatives. These initiatives have led to the issuance of the *Islamic Capital Market Fact Finding Report* in 2004 and the *Analysis of the Application of IOSCO's Objectives and Principles of Securities Regulation for Islamic Securities Products* in 2008. The earlier report concluded that the IOSCO Core Principles of Securities Regulation would apply equally to the ICM, a view that was supported in the 2008 report with recommendations, among others, for further thematic work on disclosure standards.

This Chapter seeks to provide a summary of the discussions at the Roundtable, highlighting the need for specific disclosures for ICM products, focusing on *Sukūk* and CIS.

Session 1 - Comparative Evaluation of Regulatory and Best Practices on Disclosure of Islamic Capital Market Products

Bonds, along with other money market instruments, are important instruments for banks in providing liquidity as well as meeting regulatory requirements. What the Islamic markets lack is a viable *Sukūk* market, and for this reason, institutions offering Islamic financial services tend to suffer from a lack of liquidity. This poses one of the greatest challenges for institutions offering Islamic financial services.

A fundamental principle in Islamic finance is that money is regarded as a measure of value and not an asset in itself. Therefore, money cannot be lent out and be repaid in greater amounts (i.e., paid with interest). As a general rule, monetary gains must be derived from transactions like trading, leasing and other investment activities. Bonds that represent monetary indebtedness cannot be exchanged for money. In accordance with *Sharī`ah* principles, financiers are required to assume risks related to the business or ownership of assets. Therefore, *Sukūk* cannot be structured on the basis of an interest-bearing instrument, but rather, structured in such a way that its income stream derives from the transactions based on trades, rentals or investments, e.g. *Murābahah*, *Ijārah* or *Mushārakah.*

In order to achieve *Sharī`ah*-compliance, *Sukūk* are structured as "asset-based" or "asset-backed" – terms to describe the involvement of assets in the structures. It has nevertheless been noted that many of the *Sukūk* issuances are asset-based. *Sukūk* also represent undivided proportionate beneficial ownership in the underlying asset. Attached to this ownership interest is the corresponding right to income streams from the assets. In the case of asset-based structures, they give rise to issues of misconception and legal clarity, which was deliberated in Session 2 of the Roundtable.

It is important to note that conventional law is applied, and not the *Sharī`ah*, when drawing up Islamic finance contracts. As such, legal documents are drafted with a view to reflect compliance with *Sharī`ah*, but they are not governed by *Sharī`ah*, as there are either no *Sharī`ah* courts or the *Sharī`ah* courts are not empowered to deal with commercial matters. Any dispute would eventually be dealt with in courts using the laws, which are commonly civil laws, as described in the legal documents.

Areas of Focus

While the international debt disclosure principles (Principles) and guidelines have adequately covered disclosures for bonds, there still appears to be some gaps when applied to *Sukūk*. Addressing the gaps in these areas would advance the development of disclosure standards for international ICM instruments.

As mentioned, *Sukūk* are not based on a transaction of loan or credit, and therefore the Principles' reference to debt securities do not entirely apply to *Sukūk*. Therefore, a new set of disclosure principles should be developed and adopted to appropriately reflect the nature and characteristics of *Sukūk*.

Focus on the Obligor

Under the Principles, the Issuer is defined as a "company whose debt securities are being offered to the public or listed". Accordingly, the subject matter of the Principles is focused on the Issuer, but not the Obligor (the actual borrower in the case of *Sukūk*). Holders of *Sukūk* are primarily concerned with the ability of the Obligor to make timely payments, as the issuer, in the case of *Sukūk*, is merely a special-purpose company. In the new set of principles referred as to the above, the focus should be on the Obligor.

Description of the Sukūk

Unlike bondholders, *Sukūk* holders have undivided proportionate ownership interests in the *Sukūk* asset. The new set of principles should focus on the ownership of the assets by *Sukūk* holders and the structure of the particular *Sukūk* and the material risks involved. Clearly, the key terms of the *Sukūk* arrangement should be disclosed, highlighting the following:

- Acquisition of the *Sukūk* asset from the Obligor;
- Type of transaction of the *Sukūk* asset to the Obligor; and
- Sale of the *Sukūk* asset back to the Obligor.

Sharī`ah compliance

The new set of principles should also focus on *Sharī`ah* compliance, which is a key aspect of Islamic finance. In Islamic finance transactions, the *Sharī`ah* ruling[36] of the *Sharī`ah* advisors[37] informs potential investors that the *Sukūk* is compliant with the principles of *Sharī`ah*. The issues that will be the subject of further discussion in the new set of principles include whether the *Sharī`ah* rulings should be disclosed in the offering document; whether potential investors can rely on the rulings when making the decision to invest in the *Sukūk*; and whether potential investors should consult their own *Sharī`ah* advisors before making any investment decision.

Session 2 - Emerging Issues from Inadequate Disclosure Requirements for Islamic Capital Market Products

The major ICM asset classes are equities, CIS and *Sukūk*. Two issues have emerged arising from inadequate disclosure requirements for ICM products, namely the way instruments are structured and the *Sharī`ah*-compliant status of the instruments. The current way *Sukūk* are structured to meet *Sharī`ah* requirement has led to legal, tax, and *Sharī`ah* disclosure issues. ICIS on the other hand have none of these issues, save for continued *Sharī`ah* disclosures, as funds using *Wakālah*[38] or *Muḍārabah*[39] structures are no different from conventional funds.

Initial disclosure issues arising from structure of Sukūk

Sukūk attempt to replicate the economic effect of bonds by putting in place several transactions including tangible and intangible assets depending on the *Sharī`ah* principles applied. It is the complexity of the transactions and the nexus that are important because they lead to a set of questions about disclosure such as whether the investors of those instruments understand the nature and peculiar risks of *Sukūk*. The often used terminology in *Sukūk* is “asset-based” or “asset-backed”, denoting that the *Sukūk* are an outcome of several transactions involving asset. Investors would be under the impression that they have recourse to the assets as well as to the issuer/obligor, when in reality,in the case of “asset-based” structures, there are no recourse tosuch assets.

In the case of equity-based *Sukūk*, of which there are presently not many in the market, the usual *Sukūk* investors, e.g. treasury dealers will most likely assume that such *Sukūk* are no different from other fixed income instruments when the actual fact is that this particular type of *Sukūk* has no capital protection at all and that the investors’ legal right is equivalent to that of an equity investor.

The lack of such disclosure and awareness becomes a risk. Perhaps the risks are even greater considering that *Sukūk* are generally offered in the over-the-counter (OTC) market where disclosures are less exhaustive than public offering disclosures. Hence, regulations must look into requiring adequate disclosure to ensure investor protection.

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[36]To also mean *Fatāwa*, pronouncement, opinion, ruling.
[37]To also mean *Sharī`ah* committee or scholar.
[38]The *Wakālah* being fee-based.
[39]Funds using true profit sharing structures and therefore do not have the complexities of “asset-based” issues.

Sharī`ah related disclosure

Investors seeking *Sharī`ah*-compliant products rely on the endorsement by *Sharī`ah* advisors. However, unlike standards, *Sharī`ah* rulings are subjected to various interpretations due to the different schools of jurisprudence. This further complicates the way Islamic instruments are structured. *Sharī`ah* rulings are also dependant on *Ijtihād*. In addition, the nature, complexity, structure or intended outcome of the instruments may be beyond the total comprehension of the *Sharī`ah* advisors.

The process of how *Sharī`ah* rulings are derived is the area that needs to be enhanced. Some *Sharī`ah* advisors are over-burdened with mandates and there are concerns that the cases may not have been examined thoroughly before deriving at the respective rulings. In many cases, *Sharī`ah* advisors do not engage directly with the obligor but they go through the lawyers or arrangers. The reliability of the information becomes an issue, as how much and how clearly has information been communicated (or perhaps not been communicated) to the *Sharī`ah* advisors. This has been known to happen.

Compliance with the *Sharī`ah* must subsist during the life-cycle of the instrument and currently, in most instances, it is unclear who should be responsible for this. For *Sharī`ah* advisors, they give their endorsement based on the structure at the onset, and continued compliance is typically not within the ambit of the work.

A proper *Sharī`ah* governance framework and product compliant guidelines would certainly alleviate the problems where there are requirements for more accountability, responsibility and fiduciary duties. This may come under one of the broad principles or prudential standards.

There are differing views on whether additional *Sharī`ah* disclosure is a necessity. A discussant held forth that the concern is not in relation to standards or issues of general disclosure, but more in relation to whether specific or enhanced disclosures are required as a consequence of the product being *Sharī`ah*-compliant.

While compliance with *Sharī`ah* does point to the need for more specific or enhanced disclosures, there are really not that many such disclosures required. If the claim to be *Sharī`ah*-compliant is paramount, then the issuer or seller of such a product must be able to demonstrate such compliance. The *Sharī`ah* advisor should then disclose how and why the product is *Sharī`ah*-compliant. Nevertheless, there are disclaimers in offering documents stating that the *Sharī`ah* ruling is only an expression of the view of the respective *Sharī`ah* advisors and is not a binding opinion, that there can be no assurance as to *Sharī`ah* permissibility of the structure of the *Sukūk* issued, the trading of certificates or the continued compliance of funds. Neither does the obligor, issuer, trustee nor managers make any representation on the same.

Investors are reminded to make their own independent investigation as to whether the offering and the investment in the trust certificates would comply with *Sharī`ah* principles. Thus, the intended disclosure does not seem to serve its purpose, but instead makes it more onerous to market Islamic products without any attendant benefits.

This view should be taken into consideration when deliberating further on this subject.

Are the IOSCO disclosure standards sufficient?

For ICM products, some disclosures about *Sharī`ah* compliance are certainly needed. In the case of *Sukūk*, enhanced disclosures are required on the structure of the offering, the legal and tax risks to which it gives rise, and in particular, to the rights of the *Sukūk* holders to the underlying assets. Depending on the extent the *Sukūk* diverge from the current pattern of being economically similar to debentures, further disclosure would be required. Any substantially new Islamic instruments are likely to be complex in their structure, relative to their conventional counterparts (if any), and would require additional disclosures about their structure, at the very least.

Disclosures only have regulatory value if they are comprehensible to investors, so the disclosure of ICM products should be provided in a way that would be useful in making investment decisions. The intended information should not be lost amid the peculiarity of the structure.

Session 3 - The Importance of Strong Disclosure Regime in Facilitating Cross-Border Investments and Development of Islamic Capital Market Products and Services

For a capital market to embrace Islamic products, the environment must be conducive and enabling towards *Sharī`ah* adherence, accounting consistency, and regulatory oversight aspects. Currently, disclosures of ICM products are subjected only to regulatory disclosure and the accounting framework. Generally, *Sharī`ah* adherence is not subjected to regulatory disclosures and in cases where it is, it is due to the regulator's own initiative as opposed to requirements of the international principles.

Sharī`ah adherence

There should be sufficient disclosure to reassure the investor as to the level of *Sharī`ah* adherence of a product. The areas of disclosure should cover the description of how *Sharī`ah* compliance was established and the processes to ensure continued *Sharī`ah* compliance during the life of the investment.

The second issue is the extent of *Sharī`ah* scholars' roles in the matter, whether there are limitations to the instruments' pre-disbursement terms (as in the case of *Sukūk*) or continious obligation to check on compliance throughout the life cycle of the instruments (in the case of funds). One of the suggestions was that additional disclosure is required, as this would indicate whether *Sharī`ah* advisors are reactive or proactive in monitoring the product.

Finally, there is the question of certainty in disputes. There are a number of cases where *Sharī`ah* views have been disputed and it was not always clear as to which authority the parties had agreed to refer to, in order to clarify *Sharī`ah* viewpoints. This is particularly an issue in jurisdictions where *Sharī`ah* law is not considered national law and hence may not be enforceable in disputes. Regulators can play a role in mandating the need for clarity and who has the final say in the event of a dispute, and not leaving such issues for the legal systems to work out.

Accounting consistency

The IFRS already requires disclosures that include and address some of these *Sharī`ah* compliance needs.

For ICM products, there are two models which are being referred to: the accounting standards issued by AAOIFI and standards issued by IASB. IFRS, issued by the IASB, are largely based on conceptual models and principles. The AAOIFI standards have to meet *Sharī`ah* requirements and tend to be industry- and product-centric. The IFRS generally meet the expectations of the IOSCO principles, in terms of transparency to enable investment decisions on certain key information usually demanded by investors.

Although the IFRS is more widely applied by Islamic financial institutions, it may not be able to provide the best solution to meet their specific needs. Instead, a more pragmatic approach may be initiating harmonisation between the AAOIFI accounting standards and the IFRS.

Regulatory oversight

From the 2008 document, the IOSCO recommends that securities regulators consider the effectiveness of their disclosure regime and ensure that customers of *Sharī`ah*-compliant products are able to access relevant information to make a decision. This is especially important in jurisdictions where the *Sharī`ah* compliance of a product is not directly regulated.

There was a recommendation put forward for the IOSCO or the IFSB (or both) to come out with an official issuance, setting forth the Minimum Disclosure Requirements for institutions offering Islamic financial services and Islamic products. Going along this line, regulators could establish a group who would adopt these minimum disclosure requirements. Countries in this group will be listed as markets that follow the standard minimum disclosure requirements as agreed upon by experts and stakeholders. That would be a positive indicator to investors that securities traded in such markets have complied with the aforesaid requirements.

A strong disclosure regime is a crucial alternative for investors to have reasonable and relevant information, to assess financial and *Sharī`ah* implications in order to make an informed investment decision. Some areas of improvement to consider include enhancing international accounting standards like the IFRS to cater for *Sharī`ah*-compliant instruments and to mandate relevant disclosures. The authorities should consider setting additional regulations for a minimum framework for *Sharī`ah* scholars, disclosures surrounding the *Sharī`ah* opinion and monitoring of risks, as well as ensure that market liquidity measures are applied to facilitate the tradability of these instruments. Hence, sufficient disclosure is an important prerequisite for a healthy ICM but it is no substitute for more direct regulation, as there can be no enforceability without direct regulation. Disclosure requirements are integral to maintaining investor confidence but their effectiveness requires complementary direct regulation, which would be the next step in this direction.

The Way Forward

The Roundtable has generated several issues that may require further study to strengthen the framework for disclosure requirements for ICM products. Greater collaboration and cooperation among international standard setters and regulatory authorities will also facilitate a better understanding of the challenges arising from inadequate disclosures, and the importance of a strong disclosure regime in encouraging cross-border activities in the ICM.

Introducing disclosure requirements specific to ICM will help close the gaps that currently exist in the offering of related products and services, and achieve overall transparency in this market segment. Standardised disclosures across jurisdictions where ICM products and services are offered can also help reduce systemic risks and strengthen confidence in the market. The initiative by the IFSB and IOSCO in collaboration with the SC to identify issues in this area is a significant step forward in contributing to the overall development of the ICM. The views and recommendations during the Roundtable can potentially guide international regulators in strengthening the effectiveness of their disclosure regimes and ensure investors in the respective markets have relevant information to make informed decisions. This would include, among others, having greater legal and regulatory clarity and transparency of *Sharī`ah* rulings.

It is observed that while the IOSCO Principles of Securities Regulation were drafted with conventional securities markets in mind, they are seen to be broadly applicable to the ICM. This may be addressed via the issuance of separate Reports, Recommendations or Guidance Notes by relevant standard-setters where the implementation of existing international standards may benefit from further consideration or guidance due to the specific nature and characteristics of ICM products.

Recognising the need to complement the increasing internationalisation of ICM with a conducive regulatory environment, this collaboration between the IFSB, IOSCO and the SC represents a significant step forward in strengthening the relevant disclosure requirements. This joint initiative will further underscore the importance of ICM within the global financial landscape and reinforce the importance of issues surrounding investor protection and market integrity from cross-jurisdictional perspectives.

GLOSSARY OF ARABIC TERMS

Commodity Murābahah	*A Murābahah-based* purchase and sale transaction of *Sharī`ah*-compliant commodities, whereby the buyer purchases the commodities on a deferred payment basis and subsequently sells them to a third party on a cash payment basis.
Diminishing *Mushārakah*	Diminishing *Mushārakah or Mushārakah Mutanaqisah* is a form of partnership in which one of the partners (customer) promises to buy the equity share of the other partner (financier) gradually until the title to the equity is completely transferred to the buying partner. The transaction starts with the formation of a partnership, followed by the financier leasing his equity share to the customer throughout the tenure of the lease, the customer will gradually buy the other financier's share at market value or the price agreed upon at the time of entering into the contract. The "buying and selling" contract is independent from the partnership contract and should not be stipulated in the partnership contract since the buying partner is only allowed to give only a promise to buy. It is also not permitted that one contract be entered into as a condition for concluding the other.
Fatāwa ***(sing. Fatwa)***	A juristic opinion or pronouncement of facts given by the *Sharī`ah* board, a *Mufti*, or a *Faqīh* on any matter pertinent to *Sharī`ah* issues, based on the appropriate methodology.
Fiqh	Knowledge of the legal rulings pertaining to conduct, which has been acquired from specific evidence in the *Sharī`ah*.
Ijārah	An *Ijārah* contract refers to an agreement made by an institution offering Islamic financial services to lease to a customer an asset specified by the customer for an agreed period against specified instalments of lease rental. An *Ijārah* contract commences with a promise to lease that is binding on the part of the potential lessee prior to entering the *Ijārah* contract.
Islamic window	Islamic window is part of a conventional financial institution (which may be a branch or a dedicated unit of that institution) that provides both fund management (investment accounts) and financing and investment that are *Sharī`ah*-compliant.
Muḍārabah	A *Muḍārabah* is a contract between the capital provider and a skilled entrepreneur whereby the capital provider would contribute capital to an enterprise or activity, which is to be managed, by the entrepreneur as the *Muḍārib* (or labour provider). Profits generated by that enterprise or activity are shared in accordance with the terms of the *Muḍārabah* agreement whilst losses are to

	borne solely by the capital provider unless the losses are due to the *Muḍārib*'s misconduct, negligence or breach of contracted terms.
Murābahah	A *Murābahah* contract refers to a sale contract whereby the institution offering Islamic financial services sells to a customer a specified kind of asset that is already in their possession at cost plus an agreed profit margin (selling price).
Mushārakah	A *Mushārakah* is a contract between the institution offering Islamic financial services and a customer to contribute capital to an enterprise, whether existing or new, or to own a real estate or moveable asset, either on a temporary or permanent basis. Profits generated by that enterprise or real estate/asset are shared in accordance with the terms of *Mushārakah* agreement whilst losses are shared in proportion to each partner's share of capital.
Riba	Any excess or profit on a loan for a deferred payment when the borrower is unable to repay it after the fixed period and similarly any excess or profit on a loan at the time of contract.
Sharī`ah	Divine Islamic law that encompasses all aspects of human life as revealed in the Quran and the Sunnah.
Sharī`ah supervisory board	A specific body set up or engaged by the institution offering Islamic financial services to supervise its *Sharī`ah* compliance and governance system.
Sukūk* (sing. *Sakk)	*Sukūk* (certificates) each of which represents the holder's proportionate ownership in an undivided part of an underlying asset where the holder assumes all rights and obligations to such an asset.
Takāful	*Takāful* is derived from an Arabic word that means solidarity, whereby a group of participants agree among themselves to support one another jointly against a specified loss. In a *Takāful* arrangement, the participants contribute a sum of money as *Tabarru'* (donation) into a common fund, which will be used for mutual assistance of the members against specified loss or damage.
Wakālah	An agency contract where the customer (principal) appoints the institution offering Islamic financial services as an agent (*wakīl)* to carry out business on their behalf.

ANNEXES

Annex 1

KEY ISSUES FOR IOSCO CORE PRINCIPLE 16

1. The regulatory framework should ensure full, timely, and accurate disclosure of risks, financial results, and other information that is material to investors making informed investment decisions on an ongoing basis.
2. Disclosure rules should include rules about the following (with the list being illustrative):
   (a) The conditions applicable to an offering of securities for public sale.
   (b) The content and distribution of prospectuses, listing particulars documents or other offering documents.
   (c) Supplementary documents prepared in the offering.
   (d) Advertising in connection with the offering of securities.
   (e) Information about those who have a significant interest in an issuer.
   (f) Information about those who seek control of an issuer (discussed in greater detail below).
   (g) Information material to the price, or value, of a security.
   (h) Periodic reports.
   (i) Shareholder voting decisions.
   (j) Material related party transactions and transactions including transactions involving directors and senior managers of the issuer.
   (k) Periodic disclosure of information about director and senior management compensation and risk management practices.
   (l) The most significant risks material to the offering.
3. Specific disclosure requirements should be augmented by a general disclosure requirement.
4. Disclosure should be accurate, sufficiently clear and comprehensive, and reasonably specific and timely.
5. Regulation should ensure that proper responsibility is taken for the content of information and, depending on the circumstances, those persons who take liability for such disclosures may include the issuer, underwriters, promoters, directors, authorising officers of the issuer, experts and advisors who consent to be named in the documentation or provide advice.
6. The circumstances under which derogation from full and timely disclosure is permitted should be limited and the safeguards that apply in such circumstance should be clear.

Annex 2

COVERAGE OF THE IOSCO INTERNATIONAL DEBT DISCLOSURE PRINCIPLES

I. Identity of parties responsible for the document

A. Directors and Senior Management
B. Advisors or Other Parties
C. Auditors

II. Description of the debt securities

A. Economic Terms of the Debt Securities
B. Covenants Relating to the Issuance of the Debt Securities
C. Guarantees
D. Liens

In some cases, a Company may issue debt securities that are secured, in which the Debt Security holders have a claim against the Company's Collateral if the Company is unable to make payments on the debt securities. The kind and priority of any lien securing the issue, as well as the principal properties or assets subject to the lien, would be highly relevant to investors. Holders of secured, as compared to unsecured, Debt Securities have a stronger bargaining position relative to other creditors in case a default occurs. Information about liens enables investors to assess the likelihood that they can recoup their investment in debt securities.

E. Subordination and Limitation of Rights
F. Default
G. Consequences of a Failure to Make Payments
H. Representation of Debt Security Holders
I. (Through Trustees or Any Other Representative of the Debt Security Holders)
J. Meeting of Debt Security Holders
K. Modification of Terms
L. Paying Agent
M. Credit Rating
N. Applicable Law

III. Risk factors

IV. Markets

A. Identity of Exchanges and Regulated Markets
B. Entities Providing Liquidity

V. Information about the public offering

A. Offer Statistics
B. Pricing
C. Method and Expected Timetable
D. Underwriting Arrangements
E. Targeted Investors
F. Expenses of the Issue
G. Reasons for the Offer and Use of Proceeds

Disclosure of the Issuer's expected use of the proceeds from the public offering provides investors with an indication of the Issuer's proposed use of funds, which may help them assess the Issuer's ability to make payments on the debt securities. Investors may also find it useful to ascertain whether the stated purpose is consistent with the general business purpose of the Issuer as described elsewhere in the Document. Relevant disclosures include the estimated net amount of the proceeds, broken down into each principal intended use. If the expected proceeds will be insufficient to fund all of the proposed purposes, an indication of the order of priority for each purpose identified, including the amount and sources of other funds that would be needed, would help investors assess the Issuer's ability to meet its financing objectives. If the Issuer has no specific plans for the offering proceeds, a discussion of the principal reasons for the offering would still be useful.

More detailed disclosure of certain types of proposed uses can be particularly helpful for investors. If the proceeds are being used directly or indirectly by the Issuer to acquire assets, other than in the ordinary course of business, the Document could describe these assets and their costs. Information about whether the proceeds will be used to acquire assets from related parties, as well as whether the acquisition will be transacted on an arm's-length basis, would be viewed as highly relevant information for investors. If the Issuer intends to use any material part of the proceeds to discharge, reduce or retire other indebtedness, information about the interest rate and maturity of that indebtedness could also be useful. The Document may also contain disclosure about whether the proceeds will be used by other entities within the Issuer's group. For indebtedness incurred within the past year, an indication of how the proceeds of that indebtedness were applied helps investors assess the Issuer's funding priorities.

On occasion, the Issuer may be planning to use the offering proceeds to finance the acquisitions of other businesses. The risk profile of the acquired businesses may affect the risk profile of the Issuer overall, as well as its future ability to make payments on the Debt Securities. As a result, if the Issuer intends to use the proceeds to finance acquisitions of other businesses, information about the businesses and the status of the acquisitions would be very relevant, unless the acquisition is not yet probable and the Issuer reasonably determines that public disclosure would jeopardise the acquisition.

H. Resales by Selling Security Holders

VI. Taxation

VII. Selected financial information

A. Selected Financial Data
B. Capitalisation and Indebtedness

VIII. Information about the issuer
A. General Information About the Issuer
B. History and Development of the Issuer
C. Legal Proceedings
D. Business Overview
E. Group Structure
F. Property, Plants, and Equipment
G. Patents, Licenses or Contracts
H. Research and Development

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B. Compensation
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D. Employees
E. Share Ownership

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A. Major Shareholders
B. Related Party Transactions

XII. Interests of experts and counsel

XIII. Financial information
A. Consolidated Statements and Other Financial Information
B. Significant Changes

XIV. Additional information
A. Memorandum and Articles of Association
B. Material Contracts
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Statement by Experts

ISBN 978-967-5687-30-3