

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



OICU-IOSCO

**EXECUTIVE COMMITTEE
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Executive Summary

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

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

Key Findings of the report

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

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

Recommendations

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

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

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

(2) Other recommendations:

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

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

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

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

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

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

Section 1 – Introduction and Overview of the Islamic Securities Market

1.1 Mandate for the report

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

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

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

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

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

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

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

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

1.2 Islamic securities market overview

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

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

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

The growth of the Sukuk market

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

⁶ EurekaHedge: Key Trends in Islamic Funds 2008

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

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

⁸ Wilson (2008)

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

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

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

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

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

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

The Islamic funds industry

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

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

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

¹² IMF Policy Discussion paper PDP/08/03

¹³ Deutsche Bank Global Markets Research, August 2007

¹⁴ Forecasts from Ernst & Young Islamic funds report 2008:

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

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

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

1.3 Current initiatives

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

International Islamic standard-setting bodies

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

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

¹⁶ Failaka funds database: failaka.com

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

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

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

International trade bodies

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

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

Rating Agencies

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

Islamic Indices

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

²⁰ Signed on 30 Jan 2007, see

http://www.icmagroup.org/content/market_practice/regulatory_policy.Par.0007.ParDownloadFile.tmp/ICMA_riegpol_April07.pdf

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

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

1.4 Common products

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

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

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

1.5 Islamic fund structures

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

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

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

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

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

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

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

1.6 Sukuk structures

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

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

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

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

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

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

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

Certain developments in the Sukuk market should be noted:²⁷

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

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

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

Section 2: The IOSCO Objectives and Principles of Securities Regulations

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

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

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

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

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

2.2 Method of analysis

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

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

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

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

The analysis has been divided into five sections:

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

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

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

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

Shariah compliance

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

Profit Sharing Investment Accounts (PSIAs)

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

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

