Regulating the Islamic Capital Market

Wan Rizaidy Wan M. Saufi
Assistant Vice President, Islamic Markets
Introduction
Essentials of A Capital Market

INTERMEDIARIES

PRODUCTS

ACTIVITIES

INFRASTRUCTURE

RULES

INVESTORS

INSTITUTIONS

Equity
Bonds
Derivatives

Trading
Investment Management
Corporate Finance
Investment Advisory

Exchanges
Clearing house
Depository

Securities laws
Guidelines
Rules of Exchanges
Introduction

IOSCO’s Core Objectives for Securities Regulation

- Protection from misleading, manipulative or fraudulent practices
- Full and timely disclosure

- Investors Protection
  - Regulation should detect, deter and penalize market manipulation and other unfair trading
  - Regulation should aim to ensure investors are given fair access to market

- Ensuring fair, transparent & efficient market

- Reduction of systemic risk
  - Reduce risk of financial failure of market intermediaries
  - Promote and allow effective risk management
Introduction

Does regulation of ICM differ from the regulation of conventional capital market?

ICM products and services must not compromise the universal goals of securities regulation.

Regulatory Framework that deters the punishes misleading, manipulative and fraudulent practices.

IOSCO’s Objectives and Principles of Securities Regulation.

Economic objectives of securities regulation.
Introduction

Key Characteristics of Islamic Capital Market

Compliance with Shari’ah Requirement

• Prohibition of:
  • Riba
  • Gharar
  • Maisir
  • Production / sales of good & services of *non-halal* items

Structured through underlying exchange contracts

• Must be underlying assets
• Performance of asset as profits’ generator
Malaysian Approach in Regulating the ICM

Two-tier Structure

1st Tier

General Regulatory Requirement

Guidelines on Offering of PDS
Guidelines on REITs
Guidelines on ETFs

Additional Shari’ah criteria

Appointment of Shari’ah Adviser
Approval by Shari’ah Advisory Council

2nd Tier

Specific requirement for Shari’ah compliance

Guidelines on Offering of Islamic Securities
Guidelines on Islamic REITs
Guidelines on Islamic ETFs
Malaysian regulators have been aggressively promoting ICM through facilitative legal and tax framework...

<table>
<thead>
<tr>
<th>Issuance of Islamic Capital Market Guidelines</th>
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<tr>
<td>• Guidelines on Offering of Islamic Securities, 2004</td>
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<td>• Guidelines on Islamic REITs, 2005</td>
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<table>
<thead>
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<th>Addressing regulatory and tax issues</th>
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<tr>
<td>• Deductions given on expenses incurred in the issuance of Islamic securities</td>
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<td>• Tax exemption on interest income derived by non-resident companies from ringgit-denominated Islamic securities and debentures</td>
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<tr>
<td>• Tax neutrality between Islamic and conventional products</td>
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<tr>
<td>• Supranational allowed to issue RM bonds</td>
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<td>• Framework for issuance of foreign currency denominated bonds liberalised</td>
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<th>Shari’ah Framework</th>
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<tr>
<td>• Establishment of the Shari’ah Advisory Council at regulatory level</td>
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<td>• Appointment of qualified Shari’ah advisers at industry level</td>
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<tr>
<td>• Shari’ah screening of listed companies</td>
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Islamic Capital Market
International Regulatory Framework

Developing internationally-compatible Islamic accounting standards
Differentiation from conventional financial system

Promotes and enhances the soundness and stability of the Islamic finance industry

Issuing global standards and guiding principles for the industry, including capital markets

IFSB complements that of the BCBS, IOSC and IAIS

Harmonizing and standardizing Islamic products, documentations and related processes

Unifying Islamic Capital Market and Islamic Money Market segment of IFSI

OIC Fiqh Council
SHARI’AH
Shari’ah Advisers / Committees

AAOIFI
IFSB
IIFM
IOSCO
Two new standards, namely:

**Shari’ah Standards 2010**
- 41 standards covering Gharar in:
- financial transactions, arbitration, Waqf, contingent obligations, credit facilities, and etc.

**Accounting, Auditing & Governance Standards 2010**
- 40 standards
- Covering accounting, auditing, ethics and governance of Islamic financial institution

Source: Malaysian Sukuk: Issues in Accounting Standards
International Regulation
Islamic Financial Services Board

Published standards by IFSB on Islamic Capital Market

- **IFSB - 10**: Guiding Principle on Shari’ah Governance Systems for Institutions Offering Islamic Financial Services
- **IFSB - 9**: Guiding Principle on Conduct of Business for Institutions Offering Islamic Financial Services
- **IFSB - 7**: Capital Adequacy Requirements for Sukuk, Securitization and Real Estate Investment
- **IFSB - 6**: Guiding Principles on Governance for Islamic Collective Investment Scheme

Role of IFSB in maintaining momentum of globalizing ICM instrument

- Demystify Islamic financial terms
- Providing more data on Islamic finance
- Creation of innovative products adaptable to rapid changes to market demands
- Initiate greater collaboration in terms of resources and commitment for effective regulatory and supervisory framework
- Human intellectual capacity building must be accorded with high priority in the development efforts
International Regulation
International Islamic Financial Market

• Focusing on Shari'ah harmonization / standardization of Islamic products, documentation, and related processes
• Debut initiatives:
  – Shari'ah endorsement and enhancement
  – Cross-border listing and secondary market trading
• Introduction of ISDA/IIFM Tahawut (Hedging) Master Agreement
  – The first Islamic swap & derivatives contracts
  – First globally standardized documentation for privately negotiated Islamic hedging products
  – Applicable across all jurisdiction practicing Islamic finance
• Role of IIFM in harmonizing the Shari'ah standards:

Source: International Islamic Financial Market
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.”
**Regional Development Regulation**

**LUXEMBOURG**
- IFSB member
- Looking forward for dual financial system

**UK & LONDON**
Amendment to FSMA 2000 (Regulated Activities) Order 2001 (S.I 2001/544)

**KAZAKHSTAN**
Amendments & addition - Legislative Act of Republic of Kazakhstan

**FRANCE**
Passed rules to support Islamic finance activities

**SINGAPORE**
- Aspiring to be centre of Islamic finance
- Issued Sukuk

**THAILAND**
Introduction of Sukuk or Islamic bonds issuance under Capital Market Development Master Plan

**AUSTRALIA**
‘Australia as a Financial Centre’, an industry led review document has Islamic finance as key agenda

**CHINA**
Bank Ningxia spearheads Islamic finance

**SOUTH KOREA**
Parliament expected to pass the law related to offering of tax waiver on foreign investors’ interest income from Sukuk

**HONG KONG**
- Aims to become Islamic finance gateway to China
- Plans to issue sovereign Sukuk

**BRUNEI**
Aims to become Islamic financial services hub for Asia

**JAPAN**
Law passed allowing banks to do Islamic finance

**SINGAPORE**
Aspiring to be centre of Islamic finance
Issued Sukuk

**THAILAND**
Introduction of Sukuk or Islamic bonds issuance under Capital Market Development Master Plan
Regional Development
Tax Treatment

**LUXEMBOURG**
- Issuance of new tax circular on Murabahah & Sukuk transactions

**KAZAKHSTAN**
- Changes to tax legislation
- Rules calculating advance payment of corporate tax for non resident entities with PEs

**FRANCE**
- Tax treatment for Murabahah transactions
- Tax treatment on Sukuk and similar indexed financial transactions

**UK**
- Tax law amended in Finance Act 2009 (placing Islamic finance on par with conventional

**INDONESIA**
- Awaiting parliamentary approval to pass amendment on VAT tax laws
- Law No. 42 Year 2009 toward Third Amendment on Law Number 8 / 1983

**SOUTH KOREA**
- Tax treatment for Sukuk issuance and transactions

**JAPAN**
- Law passed allowing banks to do Islamic finance

**THAILAND**
- Tax law amendments hampered by political uncertainty
Thank You

Islamic Markets
Bursa Malaysia Berhad
12th Floor, Exchange Square
Bukit Kewangan
50200 Kuala Lumpur

Tel: +60 3 2034 7000
Fax: +60 3 2732 3310

www.bursamalaysia.com
www.mifc.com
APPENDIX

Regulating the ICM

The Malaysian Approach
Malaysian Financial Regulatory System

Overall Regulatory Framework

Regulators of the Banking & Takaful Sector

Bank Negara Malaysia

Suruhanjaya Sekuriti Securities Commission

Bursa Malaysia

CMSA 2007
SCA 1993
SICDA 1991

Labuan FSA

Labuan Offshore Securities Industry Act 1998

Bursa Malaysia Securities Sdn Bhd

Bursa Malaysia Derivatives Bhd

Bursa Malaysia Depository Sdn Bhd

Bursa Malaysia Derivatives Securities Clearing Sdn Bhd

Bursa Malaysia Bonds Sdn Bhd

Labuan International Financial Exchange Inc.
Malaysian ICM & Securities Commission

Introduction

Objective of Malaysian Capital Market Masterplan

To establish Malaysia as an international Islamic capital market centre

Approaches taken by the SC

- Supplying necessary infrastructure for research, discussion & dialogues
- Undertake specific efforts to develop and strengthen the market

Dual Market System

To establish

Steps taken to establish dual market system

Islamic Capital Market Department (ICMD)

Shari'ah Advisory Council (SAC)

Islamic Instrument Study Group (IISG)
Malaysian ICM & Securities Commission
ICMD & IISG

Conduct R&D of ICM products and analyzing listed companies’ securities
R&D in Equity, Debt and Derivatives sector
Presentation to IISG for Approval
Any development in ICM is subject to IISG’s approval

Centralization of SAC
To ensure implementation of ICM complied with Shari’ah principles
To advise the SC on matters be related to ICM development
To function as a reference centre for all ICM issues

Upgraded to
Islamic Instruments Study Group

Shari’ah Advisory Council
May 16, 1996

To ensure implementation of ICM complied with Shari’ah principles
To advise the SC on matters be related to ICM development
To function as a reference centre for all ICM issues

May 16, 1996
Shari’ah Advisory Council

Approaches in Introducing ICM in Malaysia

Two Approaches applied in introducing Malaysian ICM

- Scrutinizing the validity of conventional instruments in compliance with Shari’ah principles
- Formulating new financial instruments based on Shari’ah principles

Supported by Shari’ah Adviser/committee at operational level

As reference centre for all Shari’ah matters in Islamic finance

Oversees overall Shari’ah compliance

SC’s Shari’ah Advisory Council
Malaysian Islamic Capital Market
Products & Services

- Islamic asset-backed securities
  - Sukuk funds
- Shari’ah-compliant stocks
- Islamic Equity funds
- Islamic REIT
- Islamic Index
- Sukuk
  - Sukuk Ijarah, Musharakah & Mudharabah
- Islamic fixed income securities
- Structured investment
- Equity
- Shari’ah-compliant stocks
- Islamic Equity funds
- Islamic REIT
- Islamic Index
- Shari’ah-compliant trading
- Stockbroking
- Shari’ah-compliant margin financing
- Commodity Murabahah Platform
- Dual Currency structured investment
- Equity-linked structured investment
- Structured Products
- BURSA SUQ AL-SILA’
### Dual Financial System (cont’d) Standards in Malaysia

<table>
<thead>
<tr>
<th>Islamic Financial System</th>
<th>Conventional Financial System</th>
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<tr>
<td>A comprehensive Islamic financial system co-exist with conventional counterpart</td>
<td>Full transformation of financial system in accordance with Shari’ah</td>
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### Legal Framework
- **A dedicated High Court** in the Malaysian court system to sit in judgment on matters relating to ICM
- **Kuala Lumpur Regional Centre for Arbitration** - platform to resolve disputes on ICM transactions

### IBFS Arbitration Rule
- Available for disputes settlement relating to **all sectors in financial system**
- Adopts **UNCITRAL** rules (United Nations Commission on International Trade Law)
- Allows for reference to SAC for ICM transactions, products & services

### Government Support
- First jurisdiction to introduce **tax neutrality for transactions** between Islamic and conventional financial system
Malaysian Islamic finance transactions are in accordance with:

**Accounting Standards**

- **Financial Reporting Standards (FRS)**
  - Adopted by **Malaysian Accounting Standards Board (MASB)**
  - Issued by **International Financial Reporting Standards (IFRS)**

**Shari’ah Standards**

- **CMSA 2007 & Central Banking Act 1958**
  - Respond to Islamic finance dispute effectively
  - As a reference by court on Shari’ah issue
  - Obligation of judge to follow SAC’s opinion

**Parliament**

- Granted approval to **BNM’s & SC’s Shari’ah Advisory Council**
<table>
<thead>
<tr>
<th>Islamic Bonds</th>
<th>Conventional Bonds</th>
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<tbody>
<tr>
<td>Sukuk held for trading</td>
<td>Short term investment</td>
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<tr>
<td>Sukuk held for sale</td>
<td>Long term investment</td>
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<tr>
<td>Sukuk held for maturity</td>
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Case Study #1
Conventional Bonds & Islamic Bonds (Sukuk)

In compliance with Private Debt Securities Guidelines

In compliance with:
• Islamic Securities Guidelines
• Private Debt Securities Guidelines
Case Study #2
Regulation of Islamic ETF in Malaysia

Rules and Guidelines
- CMSA 2007
- Regulations issued under CMSA
- Guidelines on ETF
- Guidelines on Unit Trust Funds
- Prospectus Guidelines for CIS
- Rules of Bursa Malaysia Securities
- Bursa Malaysia Listing Requirement
- Rules of Bursa Malaysia Depository

Securities Commission (SC)

Securities Law & Regulations

Trustee
- Approval from SC to act as Trustee
  - Deed
  - Fund Prospectus
  - Bursa Securities
  - Unit Holders

Manager
- Approval from SC to act as Manager

Trustee
- Approval from SC to act as Shari’ah Adviser

Source: Securities Commission (SC)
Case Study #3
Regulation of Islamic REITs in Malaysia

**Governance Structure :** Al-Aqar KPJ REITs

**Governance Structure of REITs in Malaysia:**

- Relationship between parties are governed by Trust Deed

- REIT must be managed by management companies approved by SC and be subsidiary of:
  - Financial institution; or
  - Property investment company

- Function of Trustee:
  - Trust company;
  - Trust Companies Act 1949 [Act 100]

- SC guidelines for Islamic REITs:
  - REIT Guidelines; and
  - Islamic REIT Guidelines

**Source:** Securities Commission (SC)

**Governance Structure of Al-Aqar KPJ REITs:**

- Shari’ah Adviser
- Unit Holders
- Holding of units
- Dividend
- Custodianship
- Trustee fee
- Net property income
- Management fees
- Maintenance fees
- Management services
- Maintenance & management services

**REIT properties:**

- Specialist Hospital
- Building in:
  1. Damansara
  2. Ampang Puteri
  3. Ipoh
  4. Johor
  5. Selangor
  6. Puteri

**Subsidiaries of KPJ:**

**Source:** Securities Commission (SC)