



ISLAMIC FINANCIAL SERVICES BOARD

EXPOSURE DRAFT

**GUIDING PRINCIPLES ON GOVERNANCE FOR
ISLAMIC COLLECTIVE INVESTMENT SCHEMES**

*Comments on this Exposure Draft should be sent
to the IFSB Secretariat not later than 10 May 2008
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ABOUT THE ISLAMIC FINANCIAL SERVICES BOARD (IFSB)

The IFSB is an international standard-setting organisation that 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 involves, 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.

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ACRONYMS

BCBS	Basel Committee on Banking Supervision
BOD	Board of Directors/Governors of an ICIS
CIS	Collective investment scheme
GB	ICIS's highest governing body, which exercises the oversight function rather than the management function. Depending on the legal and regulatory framework in the jurisdiction, as well as the structural form adopted by the ICIS, a GB could be the BOD, Investment Committee, Investment Management Committee, etc., or it may be mandated to the custodian, trustee or depository.
IAH	Investment account holder
ICIS	Islamic collective investment scheme
IFSB	Islamic Financial Services Board
IFSB-3	IFSB Guiding Principles for Corporate Governance of institutions offering only Islamic financial services
IFSB-4	IFSB Disclosure to Promote Transparency and Market Discipline for institutions offering only Islamic financial services
IIFS	Institutions offering only Islamic financial services (excluding Islamic insurance/ <i>Takāful</i> institutions and Islamic mutual funds)
IOSCO	International Organisation of Securities Commissions
IRR	Investment risk reserve
NAV	Net asset value
OECD	Organisation for Economic Co-operation and Development
PER	Profit equalisation reserve
SPV	Special purpose vehicle
SRO	Self-regulatory organisation
SSB	<i>Shari`ah</i> Supervisory Board
UCITS	Undertakings for collective investment in transferable securities

INTRODUCTION

1. In December 2006, the Islamic Financial Services Board (IFSB) issued its Guiding Principles for Corporate Governance of institutions offering only Islamic financial services (IIFS) – known as IFSB-3.¹ In order to further strengthen governance in the Islamic financial services industry (IFSI) and promote soundness and stability in the Islamic financial system, the IFSB decided to develop a second tier of its governance standards by focusing on collective investment schemes (CIS) that are claimed to be *Shari'ah* compliant. These schemes are sometimes referred to as Islamic unit trusts, Islamic mutual funds or Islamic investment funds, depending on the jurisdiction.
2. In the interests of clarity, and in accordance with internationally recognised standards for investment funds,² the IFSB has decided that the term “Islamic collective investment scheme” (ICIS) is more appropriate and will be used in this document. In line with this premise, where appropriate, the key terminologies herein are defined and adapted accordingly.³
3. As an ICIS is primarily a capital market instrument, the standard marks a first prudential standard developed by the IFSB in the area of Islamic capital markets. In this respect, the standard has the specific aim of complementing the internationally recognised governance standards, by reinforcing international best practices while addressing the specificities of ICIS. The IFSB recognises that certain governance issues are of equal concern to all CIS, whether Islamic or otherwise. Therefore, this document will not attempt to “reinvent the wheel” by proposing a wholly new governance framework for ICIS. Instead, it will seek to supplement and expand the relevant international standards by focusing on the appropriate best practices identified by the IFSB, particularly with regard to governance issues that are specific to ICIS. In this manner, this document seek to “add value” to the existing international standards.
4. The IFSB has conducted its own survey on ICIS. Its findings are consistent with the surveys conducted by the IOSCO on CIS,⁴ namely, that – regardless of the diverse CIS frameworks applied in different jurisdictions – they still share many similar governance concerns, such as independence of oversight of CIS operators, their conduct and execution of fiduciary duties, the management of conflicts of interest, transparency in disclosures of material information, etc. In the case of ICIS, the requirement to comply with the *Shari'ah* not only reinforces good governance and integrity, but also influences the way governance structures and procedures are implemented. Accordingly, rigorous compliance with internationally accepted governance best practices should be recommended.

¹ IFSB-3 contains seven guiding principles for strengthening corporate governance of IIFS which complement the existing international corporate governance standards set by the Organisation for Economic Co-operation and Development (OECD) and the Basel Committee on Banking Supervision (BCBS). In addition to reinforcing the general importance of good governance practices, IFSB-3 especially focuses on the protection of investment account holders (IAH) and compliance with *Shari'ah* rules and principles, which are two important specificities of IIFS.

² The International Organization of Securities Commissions (IOSCO) has, among others, established the Principles of Securities Regulation 17-20, which relate to CIS (known as the CIS Core Principles). The European Council has issued directives on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities, better known as the UCITS Directives.

³ In particular, we have used IFSB-3, the IOSCO Public Documents (IOSCOPD), as well as the UCITS Directives as main references. Please refer further to page 22.

⁴ See, for example, IOSCOPD no. 219, *Examination of Governance for CIS Part I – Final Report*, June 2006 and IOSCOPD no. 222, *CIS in Emerging Markets*, July 2006.

Definition of ICIS

5. The diversity of legal requirements and regulatory frameworks around the world, and not least in those jurisdictions offering Islamic financial products, is such that the IFSB has faced a major challenge in arriving at an appropriate definition for ICIS. This problem is exacerbated by the ingenuity of those who engineer financial products. The IFSB recognises the significance of “independence”⁵ of review and oversight, as well as, of course, integrity and transparency, which have been made the cornerstones of the relevant IOSCO recommendations. However, it is felt that the efficacy of the governance systems – and, in particular, the transparency requirements – that are in place cannot be judged solely on the basis of whether the ICIS has been established as a separate legal entity, or on the presence or absence of non-executive directors. At this stage in the development of this type of schemes, it is important that these issues be looked at in the context of the wider picture. A similar concern arises in regard to the definition that the IFSB has adopted for an ICIS. While the diversity of practices and products gives rise to a peculiar degree of complexity, we are concerned specifically with those funds that have been securitised and are dealt with in units.⁶ It is further recognised that some jurisdictions may impose different sets of regulatory requirements depending on whether funds are “private” or “public” – that is, funds offered to institutions and high net worth individuals who are considered to be sophisticated investors, or those offered to the general, retail investing public. While this document does not expressly differentiate between the two, as more often than not they share similar governance concerns, the supervisory authority may wish to exercise its discretion regarding the extent to which these Guiding Principles shall apply to private funds.
6. Consequently, for the purpose of this standard, an ICIS is defined as “any structured financial scheme which, fundamentally, meets ALL the following criteria:
- (i) investors have pooled their capital contributions in a fund (whether that fund is in a separate legal entity, or is held pursuant to a contractual arrangement) by subscribing to units or shares of equal value. Such units or shares constitute, in effect, claims of ownership of the undivided assets of the fund (which can consist of financial or non-financial assets), and give rise to the right or obligation to share in the profits or losses derived from those assets;⁷
 - (ii) the fund is established and managed in accordance with *Shari’ah* rules and principles; and
 - (iii) whether or not the ICIS is managed by the institutions that established or sponsored it, it is separately financially accountable from those institutions (i.e. it has its own asset-and-liabilities profile).⁸

⁵ While the definitions of “independence” for directors, internal auditors and compliance functions, as well as for the *Shari’ah* Supervisory Board (SSB), may vary somewhat across different jurisdictions, and are often reflected in regulations or supervisory standards, the Guiding Principles consider that the key characteristic of independence is the ability to exercise sound judgment after fair consideration of all relevant information and views without undue influence from management or inappropriate outside interests. The extent to which supervisory authorities establish stringent tests of either independence or non-independence for the respective organs of governance may depend, among other things, on the extent to which there is a party or parties who are in a special position to influence the IIFS in an abusive or manipulative manner. See also IFSB-3.

⁶ It is noted that unitization is a key feature that determines the extent of rights and obligations of every investor in the ICIS, including the pricing on which the investor enters or exits from such schemes.

⁷ “Profits” and “losses”, as mentioned here, specifically include “capital” gains and losses due to changes in asset values, rather than just “operating” profits and losses derived from the ICIS.

⁸ Where certain safeguards of investors’ interests may be lacking, as normally can be expected when an ICIS takes the form of a separate legal entity, additional governance structure and process may be required to serve that purpose. In particular, adequate disclosure of financial information about the ICIS should be in place. This will enable ICIS investors to be more aware of issues such as which of the ICIS’s assets are being held in the name of the ICIS sponsor, or to what extent the ICIS’s funds are commingled with the ICIS sponsor’s shareholders’ funds. In addition, independent organs of governance, such as the Audit Committee and Governance Committee (if any), should be expected to exercise more effective oversight in order to monitor and preserve the interests of the ICIS investors. IFSB-3, in particular, provides useful guidance on this.

Although, in principle, *sukūk* schemes fit into the above description, supervisory authorities may wish to prescribe certain economic tests before imposing on them the governance structure and processes under the Guiding Principles, considering that they serve certain economic functions that differ from CIS – that is, fundamentally, they are a *Shari'ah*-compliant alternative to conventional fixed-income instruments.

7. It may be helpful to set out some examples of structured funds that, subject to what we have set out above in paragraph 6, would be included within this definition. Note, however, that these are only examples and that our list is by no means exclusive. Among other forms, an ICIS may take the form of:
 - (i) authorised open-ended funds that will redeem their units or shares, whether on a continuous basis or periodically;
 - (ii) closed-end funds, whether those units or shares are tradable (in regulated or unregulated securities markets) or untradable;
 - (iii) unit investment trusts, whether on a contractual model or that of a European UCITS model;
 - (iv) an individual fund, or an umbrella fund that comprises various sub-funds; or
 - (v) profit-sharing investment accounts (whether restricted or unrestricted) that are pooled in the form of a CIS, and whereby all of the IAH participate in the financial result (whether profit or loss) on a proportional basis pro-rata to their holdings and are generally governed by the same terms and conditions.

8. It is possible to identify funds that would not normally fall within the definition that we have adopted. There is always the possibility, in the complex environment of the financial services industry, of regulatory overlap even within a single jurisdiction. Consequently, for clarity, our definition of ICIS shall exclude:
 - (i) funds that are not pooled in the form of a CIS, such as certain types of investment accounts that are not based on profit-sharing and loss-bearing contracts, but are treated more like capital-guaranteed deposits;⁹
 - (ii) funds established by Islamic insurance/*takāful* operators (if they are attached to any Islamic insurance/*takāful* policy such as retirement or education plans, which are irredeemable until a specified date of maturity), as they constitute a different segment of the Islamic financial services industry and will be addressed by the IFSB in specific standards for Islamic insurance/*takāful* operators;¹⁰
 - (iii) pension funds, as they are arguably a different species from ordinary CIS; and
 - (iv) investment accounts that are not divided into units or shares.¹¹

Scope of ICIS Governance

9. As highlighted by the IOSCO, the operation of CIS potentially involves conflicts between the interests of those who invest in CIS (**CIS Investors**) and those who organise and operate the CIS (**CIS Insiders** or **CIS Operators**).¹² It must be borne in mind that the

⁹ This exception exemplifies how this standard differs from IFSB-3. Although IFSB-3 already contains governance principles that cater for the protection of IAH, it has not covered investment accounts which, when we analyze their fundamentals, clearly operate as ICIS. In other words, IFSB-3 specifically does not cover investment accounts that have elements such as unitized subscriptions, or tradability of those units (whether in regulated or unregulated securities markets), as dealt with in this standard.

¹⁰ However, the Guiding Principles should apply if the funds stand on their own as an investment product, free from any Islamic insurance/*takāful* policy.

¹¹ It is noted that governance of such types of investment accounts would have been covered in IFSB-3 and IFSB-4 (Disclosure to Promote Transparency and Market Discipline for IIFS).

¹² Please refer IOSCOPD-219. Correspondingly, in the ICIS set-up, the main potential conflicts would be between the interests of **ICIS investors** (which include resident and potential investors) and those of **ICIS Insiders** or **ICIS Operators**. For example, ICIS could be subject to the risk that ICIS Insiders, although being legally committed to the fiduciary responsibilities of acting on behalf of the best interests of ICIS investors, will use the ICIS's assets for their own gain, to the detriment of ICIS investors. ICIS Insiders could rid themselves of unattractive securities that they own by dumping them into the ICIS, or obtain rebates from third parties in connection with transactions for the ICIS, or even inaccurately

- general goal is not to insulate investors from suffering any market-driven loss, but rather to enable them to understand the risks pertaining to investments in specific CIS. This would reduce the CIS Investors' exposure to any loss due to misleading, manipulative or fraudulent practices, as well as malfeasance or negligence on the part of the CIS Insiders. Indeed, the *Sharī'ah* itself clearly prohibits the abuse of a position of privilege and promotes integrity and fair dealing.
10. Accordingly, **CIS Governance**, which is described in IOSCOPD-219 as "a framework for the organisation and operation of CIS that seeks to ensure that CIS are organised and operated efficiently and exclusively in the interests of CIS Investors (including both resident and potential investors), and not in the interests of CIS Insiders", is expected to reduce the risks associated with conflicts of interest and robustly seeks to ensure that the interests of well-informed investors in CIS are well protected and managed, through appropriate oversight, control and review mechanisms, according to traditional fiduciary standards.
 11. In addition to the above definition, in the context of ICIS, good governance should further encompass:
 - (i) a set of organisational arrangements whereby the actions of the management of CIS Insiders are aligned, as far as possible, with the interests of its stakeholders, including the community (*Ummah*), guided by the objectives (*maqasid*) of the *Sharī'ah*;
 - (ii) provision of proper incentives for the organs of governance – such as the Board of Directors/Governors (BOD), the *Sharī'ah* Supervisory Board (SSB) and management – to pursue objectives that are in the interests of the stakeholders and to facilitate effective monitoring, thereby encouraging ICIS to use resources more efficiently; and
 - (iii) strict compliance with *Sharī'ah* rules and principles.
 12. The IOSCO recognises that, save for minor details, CIS are typically organised under two structures:
 - (i) **contractual model** – whereby the CIS as an investment fund only exists as a trust or contract between the operator and individual investors; and
 - (ii) **corporate model** – whereby the CIS takes the form of an investment company, legally registered as a corporation.

In certain jurisdictions, a CIS that is a hybrid of these two main models may be found; thus, it is prudent to include the **Hybrid Model**.
 13. However, in a number of the IFSB member jurisdictions, it has been observed that the IOSCO's assumptions in terms of management and operation may not necessarily apply in the same manner as in certain more developed jurisdictions. This may be due to varying degrees of clarity and sophistication, especially in the development of fiduciary and trust law.¹³ Among other things, this would have an impact on the framework for independent custodians or trustees, as well as in recognising the status of special-purpose vehicle (SPV) companies.¹⁴ It must always be remembered that ICIS operates within the legal environment, and that much will therefore depend on the development and sophistication of the legal system and, in particular, on the existence of laws

value or inflate their assets in order to avoid showing poor performances. See also paragraph 23 for further clarification as to who might be considered "ICIS Insiders".

¹³ "Fiduciary and trust law" here refers to the imposition of the highest standard of care, whereby a fiduciary or trustee is expected to be extremely loyal to the person to whom they owe the duty (the "principal" or "the beneficiary"): they must not put their personal interests before this duty, and must not profit from their position as a fiduciary or trustee, unless this is permitted by their mandate. A fiduciary relationship is highlighted by good faith, loyalty and trust.

¹⁴ SPVs are commonly used among international ICIS sponsors as a legal strategy to protect the fund's assets and to separate the insolvency risks between the fund itself and its sponsors. However, the lack of legal recognition of SPVs under the insolvency laws of some countries has necessitated ICIS sponsors establishing such entities in other jurisdictions, such as the Bahamas, Cayman Islands and British Virgin Islands.

facilitating the establishment and management of corporations and trusts, and the financial markets as a whole.

14. These and other considerations have led many supervisory authorities to contemplate a CIS regime whereby banks play multiple roles in the operation of the CIS, including sometimes as custodian/trustee of the fund's assets. To mitigate the conflicts of interest in such structures, it is a common practice for an independent party such as a lawyer or public accountant to act as administrator.¹⁵
15. Therefore, depending on the structural form, a number of different entities – such as the regulators, investors, sponsors, managers, auditors, broker-dealers, members of the BOD, trustees and depositories, SSB, self-regulatory organisations (SROs) and insurers – can, and should, play a role in ICIS governance. However, each organ of governance can only be effective if they collectively execute their roles well and recognise the importance of complementing one another. In this respect, ICIS are expected to view compliance with these regulations from a **holistic perspective**.

How to Use the Standard

16. This document contains five guiding principles (hereinafter collectively referred to as the **Guiding Principles**). The Guiding Principles are divided into four parts:
 - (i) Part I relates to the approach to general governance, whereby the adoption of good governance practices as prescribed in other internationally recognised governance standards is reinforced.
 - (ii) Part II, on transparency and disclosure, aims to improve the information environment for ICIS investors and to build on (among other things) the disclosure requirements recommended under IFSB-4.
 - (iii) Part III, on compliance with *Sharī'ah* rules and principles, addresses various specificities of ICIS, which include: (a) the process of portfolio screening by ICIS Operators; (b) the role of *Sharī'ah* scholars in monitoring consistent compliance with the *Sharī'ah*, especially through SSBs; and (c) the process of purification (*tazkiyyah*) of tainted income, that is, income which is contaminated by prohibited (*haram*) elements.
 - (iv) Part IV, on additional protection for ICIS investors, highlights the issues of adequacy of representation for investors in the organs of governance of ICIS, as well as some prevalent practices revealed from the IFSB's survey that require appropriate oversight, such as transfers and commingling of funds, as well as smoothing/stabilising of dividend payments in ICIS.
17. The Guiding Principles provide some examples of current practices that can be considered as best practices. It must be appreciated, however, that this is a dynamic area and that these practices will – and should – change as markets alter and develop, and as technology, financial engineering and improved coordination between supervisory authorities make other strategies available. It is not the purpose of the Guiding Principles to prescribe every possible control procedure. Instead, the IFSB will continue to review and revise these recommendations from time to time.
18. To help illustrate the governance structure of ICIS based on the different corporate and contractual models of the CIS framework, diagrams of five ICIS models are included in the **Appendix**. Hopefully, this will facilitate supervisory authorities in mapping out, reviewing and updating their own ICIS Governance requirements.

¹⁵ Part IV of these Guiding Principles is specifically aimed at addressing some governance issues that typically arise in such models, whereby banks are legally required to wear several hats vis-à-vis the funds that they establish or sponsor.

19. With regard to the disclosure requirements to promote better transparency in ICIS, the Guiding Principles recommend adoption of the “comply or explain” approach. This approach would allow the implementation of these Guiding Principles to accommodate the diverse legal frameworks of the jurisdictions in which the ICIS operates. Furthermore, it would facilitate the adoption of a governance framework that is commensurate and proportionate with the size, complexity and nature of each ICIS.¹⁶

¹⁶ IFSB-3 explains that the “comply or explain” approach builds on the idea of market discipline, whereby stakeholders (including the supervisor) are empowered to react to unsatisfactory governance arrangements or sub-standard disclosures (which can be either false, substantially incomplete or misleading). The stakeholders’ sanctions may range from reputational damage for the ICIS, to loss of trust in the management – forcing some managers to quit, or to take legal actions based on contractual terms. Supervisory authorities particularly should have adequate enforcement mechanisms, ranging from the power to direct necessary disclosures, to imposing reprimands and fines in order to curb deliberate non-compliance.

THE GUIDING PRINCIPLES

Part I – General Governance Approach of ICIS

Principle 1: The ICIS's highest governing body (GB) shall establish a comprehensive governance policy framework that protects the independence and integrity of each organ of governance, and sets out mechanisms for proper control and management of conflicts of interest and duty.

Structure and Process

20. The nature of the relationship between ICIS Insiders and ICIS investors is such that the existence of potential conflicts of interest and duty cannot be ruled out. Therefore, in line with the ICIS Insiders' fiduciary duties to the ICIS investors, and for appropriate risk management, it is pertinent for each of these conflicts to be identified and addressed. Hence, the ICIS's GB (which exercises the oversight function rather than the management function), whether it takes the form or the name of BOD, Investment Committee, Investment Management Committee, etc., or is mandated to the custodian, trustee or depository,¹⁷ shall be responsible for ensuring that appropriate governance structures and processes are in place to meet this objective.
21. The GB shall strive for consistent improvement of its governance by establishing a comprehensive governance policy framework that protects the independence and integrity of each organ of governance and sets out mechanisms for proper control and management of conflicts of interest and duty. At the core of the comprehensive governance policy there must be:
- (i) continuous adoption of international best practices; and
 - (ii) assurance that the ICIS's GB shall be responsible for steering the establishment of the governance policy framework and overseeing its implementation.

Recommended Best Practices

22. The GB of an ICIS shall establish an appropriate code of ethical conduct of business, to be complied with by its members, as well as by the ICIS's officers and employees. There shall be adequate systems in place to monitor compliance with this code, and to ensure that any misbehaviour or misconduct is swiftly and effectively dealt with. While every ICIS Insider has a duty to avoid placing himself or herself in a position where there is, or may be, a substantial risk of their own self-interest conflicting in a material way with that of the ICIS investors, such responsibility should be specifically spelt out in the code of conduct of business applicable to members of the GB, officers and employees. Wherever such a conflict is unavoidable, the code should require those subject to the conflict to declare it in writing to the GB. They must similarly report any such conflict in regard to members of their family, business associates or companies in which they have an interest. Where there is such a conflict of interest, or a duty owed to another party, then they should abstain from participating in the relevant decision or action on behalf of the ICIS. Where a notification is made of a conflict, it should be recorded and retained by a designated officer.¹⁸
23. The GB of an ICIS shall carry out a detailed analysis of the types of situations where conflicts of interest arise in the course of the ICIS's operations and management. Conflicts involving self-interest, direct or indirect, that could undermine the reputation of

¹⁷ The OECD confirms that organs that exercise the oversight function in CIS largely vary from one jurisdiction to another. See "Governance Systems for Collective Investment Schemes in OECD Countries", OECD Occasional Paper no. 1 of April 2001.

¹⁸ Reference should also be made to IFSB-4, which adopts IAS24 on related party transactions, and to the forthcoming IFSB ED on Conduct of Business.

the ICIS and its fair dealing with investors require particular and careful attention. In the business world it is not possible (or perhaps even desirable) to seek to eradicate all conceivable conflicts of interest or of duty. However, members of the GB have a personal responsibility to ensure that such conflicts, when identified, do not give rise to abuse, and that integrity can be demonstrated.¹⁹ It is necessary for a system to be developed to evaluate and monitor the level of conflicts of interest, and to provide adequate guidance in order to determine whether an ICIS Insider should be:

- (i) strictly prohibited from subscribing to the ICIS;
- (ii) allowed to subscribe to the ICIS, but must either:
 - (a) disclose the subscription in the prospectus;
 - (b) hold on to the investment (being prohibited from disposing of it) for a specific length of time; or
 - (c) only dispose of the investment subject to prior disclosure of the subscriber's transactions/interests and with adequate time for ICIS investors or supervisory authorities to object to such disposal.

This should cover all ICIS Insiders, including the sponsors, managers, auditors, broker-dealers, GB, trustees/custodians, depositories/administrators, as well as the SSB. In the case of any doubt, it is appropriate for an individual, rather than just corporate bodies, to be included within the scope of these provisions.

24. As much as possible, the GB shall strengthen the independence and integrity of the ICIS's organs of governance through legal, financial, managerial and administrative separation and procedures. Physical and procedural firewalls, including different office premises for each of the ICIS Insiders, restrictions and controls over the handling and communication of market-sensitive information, and progressive independent reviews – for example, by the auditors and in-house compliance officers – will be useful in creating an atmosphere of strong independence and integrity among the ICIS Insiders.
25. If the ICIS enters into an arrangement to delegate or outsource any of the functions of an organ of governance to external parties, the GB shall – by contract or otherwise – take reasonable steps to ensure that it implements and maintains systems and controls to monitor the party carrying out the relevant activity or function. This includes, at least every six months, a progressive review of the carrying out of the relevant activities or functions. Immediate action shall be taken to remedy any non-compliance with the terms and conditions of the delegation or outsourcing arrangement, and the supervisory authorities should be notified in case of any major non-compliance.²⁰
26. Furthermore, the GB shall facilitate – and, as far as is appropriate, protect – any ICIS Insiders who wish to report or highlight incidents of malpractice within the ICIS or otherwise perpetrated by the ICIS. “Whistle-blowers”, as these informants are often called, play a very important role in checking and inhibiting unethical and unlawful

¹⁹ The following practices are usually considered unethical, or even unlawful, in the management of CIS in most jurisdictions, thus requiring the GB of an ICIS to be diligent in opposing them:

- “Front running”: whereby, for example, an ICIS employee, having inside information on the investment strategy of the ICIS, purchases a security for himself immediately before the ICIS makes a purchase of the same security.
- Insider dealing: whereby, for example, an ICIS employee, knowing some price-sensitive information about the ICIS before it is publicly disclosed, uses that information to trade personally on advantageous terms.
- “Warehousing”: whereby, for example, rather than using cash from the ICIS sponsor/manager's own funds to purchase shares in a target company, the sponsor/manager uses the cash from the funds of the ICIS under management to gain control of the target company without any cost or risks to the sponsor/manager.
- “Rat trading”: whereby, for example, an ICIS sponsor/manager purchases a large block of shares on behalf of itself and a number of funds under the same management, and allocates the shares to the respective parties only some time after the deal (thus allowing the ICIS sponsor/manager to allocate shares showing profits to its own account and the shares showing a loss to the ICIS's account).
- “Dustbin”: whereby, for example, when new securities are underwritten by an entity affiliated to the ICIS sponsor/manager, that entity may instruct the sponsor/manager to subscribe on behalf of the ICIS to the underwritten shares which they fail to sell, thus transferring any loss to the ICIS investors.

²⁰ Please also refer to Part II, particularly paragraph 35 regarding disclosure requirements.

practices that can damage the reputation and standing of the ICIS and undermine investor and regulatory confidence. In particular, ICIS shall adopt as a matter of policy that whistle-blowers be permitted to report irregularities directly to supervisory authorities without any adverse employer actions or victimisation.

27. It would be helpful if the GB were to establish and facilitate adequate channels for stakeholders, especially ICIS investors, to seek clarification or to convey their concerns to the GB. While some jurisdictions require the holding of general meetings of ICIS investors for these purposes, a more flexible and less formal system – such as that which allows e-mail inquiries – may well be sufficient and efficacious.

Part II – Transparency in Disclosure

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

Structure and Process

28. Financial reporting is a critical component of good governance. Those overseeing or involved in the financial reporting process have unique responsibilities because financial reporting is a public interest activity. ICIS investors, just as shareholders who commit their funds to companies rely, in part, on the management's representations and on the auditor's opinion that a particular company's financial statements fairly reflect its financial position and results. If ICIS investors cannot rely on the quality of information provided to them, this will undermine their investment decisions.
29. Although, in practice, the ICIS investors may not intervene in the management of the investments made on their behalf, it does not mean they should not have access to appropriate information in order to monitor the performance of the ICIS and protect their investment. Without adequate disclosure, it would even be impossible for ICIS investors to know when to "vote with their feet" and simply withdraw their investments. It goes without saying that accuracy and timeliness of disclosures play a significant role in ensuring market discipline and efficiency. In this respect, it is the duty of ICIS Insiders to present ICIS investors with information that appropriately reflects the investment profile of the ICIS, as well as the associated risks. Insiders must be fully aware of their legal responsibilities in the provision of such information and ensure that it meets the requisite legal, regulatory and professional standards in terms of accuracy, topicality, clarity and comprehensibility.²¹
30. It has been argued that information asymmetries effectively increase the cost of capital. Past scandals have taught us that when investors question the integrity of financial information, they become risk averse or risk avoiding, often to the detriment of the local economy. This is particularly true of financial institutions. When markets lose confidence in the integrity of financial information, or when they can no longer trust the issuer of financial information, the negative effects can be dramatic. Furthermore, effective and timely disclosure reduces the opportunities for certain forms of misconduct, market abuse and, in particular, insider dealing.
31. Therefore, it is appropriate that ICIS Insiders recognise their responsibility to the investors and the markets. This will increase market confidence in ICIS. The key issues for those involved in the financial reporting process may include the following:
 - (i) ICIS managers must ensure that the financial statements provide a true and fair view of the ICIS's financial position and results, reflecting economic reality and in full compliance with the applicable accounting and financial reporting standards. This is in the best interests of the ICIS and investors, because transparency has a direct impact on the cost of capital and standing of reputation.
 - (ii) Auditors must follow applicable auditing standards, act with competence and integrity, and provide a truly independent and diligent audit opinion.
 - (iii) The SSB must highlight any *Shari'ah* issues that might impact on the financial position of the ICIS.²²

²¹ Hence, in addition to some of the disclosure best practices recommended in this Part II, reference should also be made to IFSB-4.

²² Please refer to Part IV with regard to internal and external *Shari'ah* compliance review processes.

- (iv) Regulators must design sound regulatory mechanisms, assess compliance with appropriate standards, and have effective enforcement mechanisms that are proportionate and reasonable to the risks.
 - (v) Trustees, the SSB and other ICIS Insiders must in general ensure compliance with the *Shari'ah*, and in particular observe that conflicts of interest are well managed and addressed, and that integrity is advanced and maintained.
32. It follows that the methods of disclosure can be divided into three categories:
- (i) disclosure at the offering or promotional stage of the investment (this takes the form of a prospectus, placement memorandum, etc.), which is a mixture of integrity and investment-related disclosure;
 - (ii) periodic and progressive disclosure (which takes the form of quarterly reports, semi-annual reports and annual reports); and
 - (iii) timely or continuous disclosure (which sometimes may be a non-financial disclosure relating to significant events) that affects the governance evaluation of the ICIS.²³
33. In addition, the GB of an ICIS shall include in its disclosure to the supervisory authorities and the ICIS investors the status of its compliance with this standard in two components:
- (i) In the first component, the GB shall report how it applies these Guiding Principles. The GB may determine by itself the form and content of its disclosure based on its own governance policies in the light of the Guiding Principles, including any special circumstances applying to it which might have led to a particular approach.
 - (ii) In the second component, the GB shall either confirm that the ICIS complies with the provisions of these Guiding Principles, or, where it does not so confirm, provide a clear and adequate explanation of the reasons for non-compliance.
- Effective and efficient continuous and timely disclosure not only empowers the ICIS investors to make informed investment decisions, but also lends credibility and cost effectiveness to the ICIS sponsors.

Recommended Best Practices

34. Emphasis should be given to providing relevant and reliable information that is material to the ICIS investors in understanding and properly evaluating how their *Shari'ah*-compliant investments are managed. "Relevant" and "material" are key aspects here, as the objective of transparency would not simply be achieved by disclosing as much information as possible, since inundating the ICIS investors with too much information could well result in confusion and misunderstandings. Disclosure must be efficient and cost effective. However, in situations of doubt, it is always better to err on the side of disclosing, rather than withholding, the relevant information.
35. It is recommended that, in addition to the prospectus requirements as may be applicable to the ICIS in its jurisdictions, ICIS sponsors should ensure the disclosure of the following information in its prospectus (or similar offering document):
- (i) information about the GB – including its size, membership, selection process, qualifications, criteria for independence, material interests in the transaction or matters affecting the ICIS, bylaws, and other directorships (if any);
 - (ii) the senior management, particularly those involved in making investment/divestment decisions on a day-to-day basis, including their responsibilities, reporting lines, qualifications and experiences;
 - (iii) basic ownership structure – for example, major share ownership and voting rights, beneficial owners, major unit holders' participation on the GB or in senior management positions, unit holders' meetings;

²³ Please also refer to IFSB-4.

- (iv) organisational structure – for example, general organisational chart, business lines, subsidiaries and affiliates, management committees (if any);
 - (v) information about the incentive structure of the ICIS Insiders from the GB and senior management down to the SSB, trustee/custodian, and depository/administrator, and in particular any payments charged from or linked to the ICIS assets – for example, the remuneration and compensation schemes, bonus, options, fees, etc. (if any), and the basis for each of them;
 - (vi) the code or policy of business conduct and/or ethics imposed upon the top-level employees of the ICIS Insiders (including any waivers, if applicable), as well as any applicable governance structures or policies (in particular, the content of any governance code or policy and the process by which it is implemented, as well as a self-assessment by the GB of its performance relative to this code or policy);
 - (vii) the ICIS's policies related to conflict of interest, as well as the nature and extent of transactions with affiliates and related parties (which may be in aggregate form for routine financing facility to employees), including any ICIS matters for which members of the GB or senior management may have material interests either directly, indirectly or on behalf of third parties;
 - (viii) the financial administration of the ICIS, including methods of profit calculation and distribution, asset allocation and movement, investment strategies and mechanics of smoothing the returns (if any, including any deviation from the original formula that may happen from time to time);
 - (ix) information about the *Sharī`ah* governance system – including identity of the *Sharī`ah* scholars or *Sharī`ah* advisory firm (as the case may be), their terms of reference, reporting lines, qualifications and experiences, associations with other ICIS or competing businesses (if any), as well as their fees; and
 - (x) tenure of the ICIS, and events that may call for early retirement of the ICIS (if any).
36. In the case of an ICIS that is not a separate legal entity from its sponsor or manager, disclosures relating only to the sponsor/manager may be insufficient to give a clear picture of the above issues as they relate to the ICIS itself. For example, the incentive structure provided by the ICIS for its Insiders may not be identical to that provided by the sponsor/manager to its employees. Similarly, aspects such as the code of ethics and conduct applicable to employees, policies on managing conflicts, or even financial administration, may be less transparent than in cases where there is legal separation. Therefore, the GB of the ICIS shall ensure appropriate disclosure in the offer documents to ensure that potential investors are provided with clear information on the points set out in paragraph 35 as they apply specifically to the ICIS. Further, any changes to this information should be communicated to the ICIS investors through timely reports.
37. Sometimes (especially in the case of ICIS in the form of profit-sharing investment accounts offered by IIFS), financial reporting and audit processes are carried out only at the level of the ICIS sponsor/manager, and not on the ICIS itself. This may happen especially in respect of restricted investment accounts that are treated as off-balance sheet items. As a result, there is a lack of scrutiny and monitoring of the actual financial status of an ICIS, which may raise genuine concerns over the legal, economic and reputational risks involved. Therefore, supervisory authorities should be especially careful to ensure that no form of ICIS escapes the appropriate levels of disclosure and scrutiny.
38. Wherever possible, it is important to ensure that information is readily available in a comparable, understandable, readable and reliable form, so that it is easily accessible not only by ICIS investors, but by information intermediaries for consumers such as the media, financial analysts and personal finance advisers. Besides these information intermediaries, SROs as well as consumer associations are also likely to use the information to draw attention to good and bad features of an ICIS more effectively than

ordinary consumers would typically be able to do for themselves. This process would be helped by:

- (i) standardisation of terms and language;
- (ii) comparable measures of, or ways of explaining, charges, risks, profit calculation, asset allocation and movement, investment strategies, as well as mechanics of smoothing the returns (if any); and
- (iii) easy access to such information.²⁴

Supervisory authorities may wish to establish rules or guidance in these areas.

39. ICIS Insiders should ensure that their information and data facility is well monitored and updated to facilitate more efficient dissemination of information to the relevant stakeholders, including the ICIS investors. Providing real-time access to portfolios, as well as to a host of third-party information, would assist ICIS investors to be better informed about the performance of their investments, as well as about any changes in the types of risks to which their investments are exposed from time to time.²⁵ This would not only enhance awareness and transparency, but also, more importantly, market efficiency.
40. In most jurisdictions, even without specific financial laws, there would be liability for misleading and/or fraudulent statements, thus attracting potential legal actions by users of the information and, possibly, criminal and regulatory action by the public authorities. Therefore, ICIS Insiders should carefully consider the management of such potential risks whenever they are making any disclosure or are responsible for others who make such disclosures. The general rule should be full and frank disclosure of material information to those who have a proper and legitimate interest in receiving it.

²⁴ For example, in addition to monthly and quarterly investment statements sent to the investors, ICIS can facilitate dissemination of timely information by enabling the investors to check the performance of their investment in the ICIS by accessing the appropriate websites, covering useful information for investors and researchers, including updates on any changes to the fund based on the terms and conditions of the ICIS, as well as the unit price of the fund on the day of valuation, whether on a daily, weekly, bi-weekly or monthly basis. Similar information should be made widely available in the daily newspapers.

²⁵ See, for example, IOSCOPD no. 59: *Disclosure of Risk – A Discussion Paper*, IOSCO Technical Committee, September 1996; IOSCOPD no. 114: *Performance Presentation Standards for CIS*, IOSCO Emerging Markets Committee, December 2000; and IOSCOPD no. 169: *Performance Presentation Standards for Collective Investment Schemes: Best Practice Standards*, Report of the Technical Committee of IOSCO, May 2004.

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

Principle 3: The GB of an ICIS shall ensure that appropriate systems and mechanisms for monitoring *ex-ante* and *ex-post Sharī'ah* compliance are in place and are effective.

Structure and Process

41. Considering that the offering of any ICIS is fundamentally conditioned on its promise to be in strict compliance with *Sharī'ah* rules and principles, one could not envisage any ICIS operating without *Sharī'ah* supervision of any sort. Therefore, the GB of an ICIS should use its best efforts to ensure that appropriate systems and mechanisms for monitoring *ex-ante* and *ex-post Sharī'ah* compliance are in place and are effective. In order to strengthen its *Sharī'ah* governance structure, an ICIS shall adopt and implement an appropriate *Sharī'ah* governance system that caters for the following processes:

- (i) monitoring consistent compliance with the *Sharī'ah* rules and principles in its daily operations;
- (ii) portfolio screening to ensure its investment portfolios remain within *Sharī'ah*-permissible assets/projects; and
- (iii) purification (*tazkiyyah*) of tainted income, whereby income that is contaminated by prohibited (*haram*) elements is removed from the ICIS.

These mechanisms through which the ICIS ensures its compliance with *Sharī'ah* rules and principles shall be the subject of public disclosure accessible through appropriate publication and communication channels. For example, ICIS can provide a brief summary in the offering documents, as well as in the annual report, as to how the *Sharī'ah* governance system works.

42. In establishing a comprehensive and effective *Sharī'ah* governance system, an ICIS should particularly ensure that the following processes are observed:

- (i) *Ex-ante*:
 - (a) There should be an independent organ providing the *fatāwa* that govern the general operation and product structure of the ICIS. Usually, this may take the form of an SSB or a *Sharī'ah* advisory firm.
 - (b) There should be a compliance function that disseminates information on such *fatāwa* to the operative personnel of the ICIS and monitors the day-to-day compliance with the *fatāwa* vis-à-vis every level of operation and each transaction. A designated compliance officer or a *Sharī'ah* compliance department would normally undertake such a task.
- (ii) *Ex-post*:
 - (a) There should be an internal *Sharī'ah* audit function (either as part of, or separate from, the internal audit function) that would, on a periodic basis (whether quarterly, semi-annually or annually), verify that the required *Sharī'ah* compliance level has been met. During this internal *Sharī'ah* compliance review, any incident of non-compliance should be recorded and reported. Thus, this process should appropriately be assigned to someone adequately trained in *Sharī'ah* compliance review. While it may not be objectionable for the same person to handle both the compliance check and internal audit functions, on the condition that he or she is qualified for both tasks, nevertheless the two processes should still be carried out separately.
 - (b) There should be an external audit function that can independently verify that the internal *Sharī'ah* compliance review has been appropriately carried out and has met the required standards. The SSB or *Sharī'ah* advisory firm that issued the *fatāwa* (as the case may be) could in some cases take charge of this process. Alternatively, the ICIS sponsor may check whether its external auditor is able and willing to accommodate *ex-post Sharī'ah* compliance reviews (relying, where appropriate, on work

carried out by internal auditors/*Sharī'ah reviewers*) within their terms of reference. Hence, this process can be covered by the external auditor of the ICIS sponsor by expanding the terms of reference of its audit scope. This may require the GB and the internal auditor/*Sharī'ah reviewer* to work closely with the external auditor to enhance the external auditor's effectiveness in conducting such *Sharī'ah* compliance reviews.

43. There is a need to ensure that these reviews are conducted by competent and adequately trained internal auditors/*Sharī'ah reviewers*. The lack of scrutiny and monitoring of the actual *Sharī'ah* compliance status of an ICIS raises genuine concerns about the legal, economic and reputational risks to which the ICIS is exposed. Therefore, supervisory authorities should take appropriate action in order to ensure that all forms of ICIS adhere to a satisfactory level of disclosure and scrutiny.

Recommended Best Practices

44. At present, different jurisdictions have adopted different sets of requirements for ICIS in order to ensure adequate monitoring of compliance with the *Sharī'ah*. While some supervisory authorities dictate specific requirements on the formation of a SSB, most jurisdictions leave this to the ICIS themselves and to market forces. The presence of an appropriate *Sharī'ah* governance system lends credibility to an ICIS, and it would be difficult for the ICIS to promote itself if it could not show to potential investors how it would deal with *Sharī'ah* issues that arise from time to time.
45. Nevertheless, the emphasis here should be on the availability of some form of *Sharī'ah* governance system, whereby ICIS would have direct access to *Sharī'ah* scholars with appropriate competence in the discipline of Islamic jurisprudence and, in particular, on how *Sharī'ah* rules and principles can be applied to modern financial transactions, from whom it can seek advice and expertise in regard to *Sharī'ah* compliance. Ideally, the number of *Sharī'ah* scholars should increase in line with the size and volume of activities in the ICIS. Where the ICIS sponsor or manager is itself an Islamic institution, that institution may appoint its existing internal SSB to review the transactions, or alternatively it may appoint a group of scholars recommended by one of its advisers, or even a *Sharī'ah* advisory firm. However, regardless of which *Sharī'ah* governance system is adopted, it is important for it to be totally independent of the ICIS sponsor or manager and to act in the interest of the ICIS investors.
46. Prior to issuance of the ICIS share/unit certificates, there should be a portfolio screening process whereby the ICIS sponsor and/or investment manager consults *Sharī'ah* scholars on its SSB or an external *Sharī'ah* advisory firm to ensure that the investment portfolio is *Sharī'ah* compliant. This should be followed by reasonable periodic reviews, especially when there is any change in the profile of the investment portfolio. The actual role of the *Sharī'ah* scholars may vary from one ICIS to another, depending on the terms of reference of their appointment. In addition to the critical portfolio selection approvals, as noted above, other roles may include:
- (i) the study of the offering memorandum, constitutional documents, and any major agreements controlling the relationship between the functionaries of the structure;
 - (ii) giving general advice to the ICIS sponsor/manager regarding compliance with *Sharī'ah*; and
 - (iii) advising on the use of instruments and techniques for efficient cash management and their compliance with the principles of *Sharī'ah*.
47. The ethical standards that ICIS Insiders should comply with may, in certain contexts, be unclear and uncertain. In considering issues of this nature, it is important that the *Sharī'ah* scholars work closely with the GB and the ICIS senior management on policies

and guidelines that will adequately cover these issues. Islamic investing is governed by ethical considerations in a way that has much in common with the modern form of ethically based investment. This includes making investment-related decisions on the basis of social, religious or environmental considerations. Each of these investment sectors, or sub-sectors, has much of value to contribute; and each has something in common with the teachings of Islam. Furthermore, *Sharī'ah* scholars should be in the position to provide a *Sharī'ah* perspective in the monitoring of ethics, including that of practices that involve moral hazard – that is, which are suspicious or redolent of conflicts of interest, such as insider dealing, “rat trading”, “dustbin”, etc. as mentioned in footnote 16. It is therefore important for *Sharī'ah* scholars to keep abreast of what is happening in these areas.

48. The fact remains that the industry still suffers from a shortage of well-qualified *Sharī'ah* scholars to sit in SSBs. This has forced some ICIS to find other ways to see to the *Sharī'ah* supervision of their businesses. For example, some funds have retained the services of a single *Sharī'ah* supervisor, who is assigned to track an Islamic index. Obviously, such an index fund will require less *Sharī'ah* supervision for its portfolio than an actively managed portfolio, because its range of investments will already have been screened by the SSB of the index provider. Another way that an Islamic fund may ensure *Sharī'ah* supervision without retaining the services of a SSB is for it to appoint a *Sharī'ah* scholar to sit on its GB. There the scholar may either chair a sub-committee or work alone to supervise the ICIS for *Sharī'ah* compliance and oversee other *Sharī'ah*-related matters. However, most likely the presence of a full panel of SSB or a credible *Sharī'ah* advisory firm would be more assuring to investors, and possibly more effective.
49. Notwithstanding this, an ICIS shall have in place an appropriate mechanism for consistent screening of its investment portfolios to ensure they conform to *Sharī'ah* rules and principles. While Islamic indices can be used to facilitate the portfolio selection by fund managers and as benchmarks to monitor the performance of *Sharī'ah*-compliant securities across the stock exchanges, similar services are hardly available for non-securitised portfolios such as commodities and projects. The same could be said about private equity, such as investments in start-up companies that have often been evaluated by venture capital funds. Hence, it is pertinent for each ICIS to have its own internal screening process as well as appropriate benchmarking mechanisms, especially when it holds portfolios other than securities approved by Islamic indices. The mechanisms should be made transparent to the potential investors in order to help them make an informed decision before participating in the ICIS, and the *Sharī'ah* scholars shall be vigilant in alerting the ICIS about any part of the portfolios that has become non-compliant with the *Sharī'ah*.
50. Realising the volatility of the stock market and the domination of the *riba*-based conventional financial system in the market, sometimes ICIS cannot avoid receiving income that is tainted with non-*halāl* (impermissible) activities or is from *shub'hah* (ambiguous) sources. This is exemplified by investments in the equity of certain corporations that have earlier been considered *halāl*, but which, over time, became non-*halāl* as the corporation crossed certain boundaries of the *Sharī'ah*. Sometimes such cases happen following the merger and acquisition of corporate entities. Therefore, ICIS shall put in place appropriate mechanisms for removal of income and profit derived from such non-*halāl* or *shub'hah* sources before distributing the purified profit to the investors.
51. In this regard, the ICIS's internal and external auditors need to have full awareness of and adequate access to information relating to the purification process, in order to ensure that appropriate checks are made on any liquidation of the ICIS's assets, and on the justification for separating its earnings. Among other matters, there is a need to ensure that the charity organisations benefiting from the ICIS's purification process are not related or connected to any ICIS Insider in a manner that may raise suspicions of conflict

of interest. Hence, there should be established a close and reliable relationship between the GB, the *Shari`ah* scholars and the auditor/*Shari`ah* reviewers in order to be able to prepare such reports for ICIS investors.

Part IV – Additional Protection for ICIS Investors

Principle 4.1: The GB of an ICIS shall ensure that any movement of the ICIS's funds or assets, to the extent that such movement is lawful, will be carried out in conformity with the ICIS's investors' objectives and their best interests and always supported by appropriate and objective valuations.

Structure and Process

52. Economies of scale have a profound influence on the ICIS business. They give ICIS sponsors and managers strong incentives to expand funds under management, since costs should rise by a relatively much lower amount; therefore, a very high proportion of the extra revenues represents profit. Various tactics can be employed by ICIS sponsors and managers in pursuit of economies of scale, some of which definitely raise concerns over conflicts of interest. Depending on the jurisdiction, ICIS sponsors and managers may, among others, dictate or influence the shuffling or movement of ICIS funds and assets under their control through the following practices:
- (i) *Commingling*: This practice refers to the act where the ICIS sponsor or manager mixes funds or assets that it holds on behalf of ICIS investors with its own funds/assets, making it difficult or impossible to determine which assets belong to the sponsor/manager and which belong to the investor. Conflicts of interest could easily arise where the ICIS funds are so invested – for example, as to how gains or losses from the investments should be allocated.
 - (ii) *Switching*: This refers to the movement of assets of an ICIS from one specific pool to another pool under the management of the same ICIS sponsor/manager, resulting in a change to the risk profile of the investment regardless of the investor's original risk preference.
 - (iii) *Redeeming and reinvesting*: This involves the redemption of the ICIS units by the ICIS investors at a certain price, and reinvestment of the eligible funds into a different ICIS managed by the same ICIS sponsor/manager.
 - (iv) *Divestment*: This is the disposal of the ICIS assets either to earn a profit, to reduce a loss or to rationalise the portfolios, normally based on economic considerations. Conflicts of interest may particularly be triggered by biased or unfair valuations of the ICIS assets prior to the divestment, especially if the divestment is made to the ICIS sponsor/manager itself or to parties related to it,, whereby there could be an incentive to seek a price unfairly favourable to the recipient.
53. In general, through fluid movements of funds and assets under their control, ICIS sponsors/managers are able not only to optimise the scale of their resources and so achieve better portfolio diversification, but also, in particular, to create an image of strong performance for all the funds they sponsor/manage. Although it is recognised that this practice is not peculiar to ICIS, considering the nascent stage of development of this industry, it is important for the GB of an ICIS and the supervisory authorities to take appropriate precautions in order to ensure that any such practices are not carried out with misleading, manipulative or fraudulent motives. In particular, the main concern with regard to commingling is the possibility of a conflict of interest between the ICIS sponsors/managers and the investors. A major problem with regard to switching is that it is done to the detriment of the investors, particularly where funds or assets of an ICIS are parked somewhere to favour the ICIS sponsor/manager, its shareholders, family members or affiliates, or other related parties. While redeeming and reinvesting, as well as divestment, more often than not require an ICIS sponsor/manager to seek express permissions from ICIS investors, the question is whether all the material information has been appropriately made available to the investors before these activities are carried out.

54. Bearing in mind that, particularly under the principle of *Mudārabah* and *Wakālah*, the ICIS sponsor/manager could be bound by specific mandates and instructions, adequate oversight, control and review should be exercised by other ICIS Insiders such as the SSB, custodian/trustee and external auditor in order to protect ICIS investors from any malfeasance or gross negligence. It is also important to note that the legal requirements of jurisdictions do vary in the extent to which such practices may be undertaken; the GB of an ICIS should be particularly aware that, especially in more advanced jurisdictions, any breach of fiduciary laws could trigger personal liability and even criminal prosecution. Furthermore, the ability to undertake such transactions, and upon what terms they may be undertaken, will often be established in the relevant trust and contractual documents. These provisions must be strictly complied with. Inevitably, absolute transparency with regard to asset allocation, investment strategy and fund/asset movements is crucial for adequate protection of the investors' interest.

Recommended Best Practices

55. Hence, the GB of an ICIS must ensure that any transaction in respect of the ICIS's funds and assets, especially those undertaken with the ICIS sponsor/manager itself or its related party (including another ICIS under the same sponsor or manager), is conducted on terms at least as favourable to the ICIS as any comparable arrangement on normal commercial terms negotiated at arm's length with an independent third party. Ideally, any such transactions shall be carried out upon explicit request or consent from the ICIS investors themselves. However, if it has been disclosed in the offering documents that any particular act of shuffling or moving the ICIS funds or assets will be a feature of the fund, such transactions shall at least be:
- (i) carried out on an arm's-length basis;
 - (ii) reported to the GB and the SSB, and shall proceed only upon their approvals;
and
 - (iii) disclosed periodically, at least in the annual report.
56. The GB shall, at all times, satisfy itself that a competent valuer is assigned to evaluate and appraise the ICIS's assets, as well as to calculate the net asset value (NAV) of the ICIS. Reasonable care shall be exercised to ensure that the valuer has carried out his or her duties in an objective manner. Where possible, the valuer shall have the highest expertise in the relevant market of assets being assessed. Although the valuer may not necessarily be legally independent from the ICIS sponsor/manager, there shall be adequate independence in terms of functions and reporting structure between the valuer and the GB of the ICIS.
57. It is not uncommon for an ICIS sponsor also to become a market-maker for the sale and purchase of share-units in an ICIS, as sometimes the ICIS's assets (such as real-estate projects or private equities) are illiquid and do not have a ready market. Where the ICIS plays a match-maker role between willing buyer and willing purchaser of existing ICIS share-units, the GB should safeguard the integrity of asset valuations and calculation of NAV that may be factored into the pricing of those share-units by at least ensuring that the staff/department carrying out the valuation is separate from, and cannot be influenced by, the staff/department who actually manages the fund. In the event of a divestment of the ICIS's assets to the ICIS sponsor/manager itself, it is not acceptable for the ICIS sponsor/manager to use an internal valuer. The valuation must be carried out by an independent party such as the trustee/custodian or a professional valuer; and, where possible, the valuation report should be verified by a public accountant.
58. The GB of the ICIS should seek assurance that the valuation system is robust and will produce accurate results. For this purpose, periodic review of the outputs from the

system shall be carried out at least annually (depending on the type of assets), and on any significant system change.²⁶

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

Structure and Process

59. One of the most common abuses by CIS Insiders is the imposition of hidden fees that might be excessive or even totally unjustified. It is therefore of utmost importance for ICIS Insiders to ensure that the determination and charging of fees, and their recording and reporting, be undertaken with integrity.
60. Meanwhile, some ICIS sponsors/managers adopt the practice of smoothing/stabilising returns from the funds, such that the returns for periods of weak performance are enhanced by drawing on returns for periods of good performance. This is often done through the creation of profit equalisation reserves (PER). Alternatively, the ICIS sponsor/manager may resort to creating an investment risk reserve (IRR) in order to cushion any capital loss of the ICIS. Even without the creation of such reserves, ICIS sponsor/managers may find other ways of smoothing or enhancing the returns of the ICIS, especially as a means of competing against the returns offered by their conventional counterparts. For example, an ICIS may simply decide to reduce the *Muḍārib* or *Wakeel* fees chargeable to the ICIS investors. The sponsor/manager may also defer the collection or retention of its fees until a higher or sufficient level of profits is made. In addition, particularly in ICIS based on the principle of *Muḍārabah*, the ICIS sponsor/manager may voluntarily decide to waive its portion of profits in order to meet the level of returns expected by the ICIS investors.
61. Arguably, such a practice might be seen as a benefit for the ICIS investors, as it buffers them from a weak market. On the other hand, a closer look reveals complicated governance issues. For example, in the absence of adequate disclosure, such practices may create a false and misleading impression to investors and the market that an ICIS has been performing better than it has been. This might well result in some investors being misled, leading to allegations of market abuse and manipulation. There are also issues of providing a true and fair view in accounting and financial reporting. The fact that there is no process regulating how an independent organ of governance – such as the Governance Committee as recommended in IFSB-3 – scrutinises and oversees the smoothing of returns, makes it an area for potential abuse, misrepresentation and misappropriation.²⁷
62. As the building up of PER in the first instance involves the commingling of profit-portions shared between the ICIS investors and the ICIS sponsor/manager's own funds, the GB of the ICIS should have careful regard to the general fiduciary law and, in particular, the specific terms and authority in the relevant trust and contractual documents.

Recommended Best Practices

63. Full, accurate and timely information on fees and expenses should be disclosed in a way that allows ICIS investors to make informed decisions about whether they wish to invest in a fund and thereby accept a particular level of costs. This includes disclosure in the offering documents as well as periodic reports. The disclosure should enable investors to understand what fees and expenses are charged to them and the cost structure of the

²⁶ See also IOSCO PD no. 91, *Regulatory Approaches to the Valuation and Pricing of CIS*, IOSCO Technical Committee, May 1999.

²⁷ In addition, PER and IRR raise issues of weakness in asset allocation and investment strategy as well as "inter-generational" conflicts. Please refer to IFSB-3 for further guidance on how these issues can be addressed.

ICIS (for example, the management fee, operational costs such as custody fees, and any performance fee). It should describe the fees and expenses actually paid on a historical basis, and may likewise describe those likely to be paid on an anticipated basis. Information on fees and expenses should enable investors to compare costs between ICIS.²⁸

64. A performance fee, if imposed, should not create an incentive for the ICIS sponsor/manager to take excessive risks in the hope of increasing its performance fee. For example, there is a greater likelihood that the performance fee will create an incentive to take excessive risks if the management fee is set at a very low level, below the actual management costs, and the ICIS sponsor/manager relies on a high performance fee to recover its management costs. If such an incentive cannot be avoided, it should be identified and minimised. Furthermore, it should not deny investors a return from the risks taken on their behalf that is adequate and in accordance with what was pre-agreed when they initially participated in the ICIS. The following items should be unambiguously determined and disclosed to the ICIS investors:
- (i) how the performance of the fund will be assessed (over what time frame, including or excluding subscription/redemption fees, etc.);
 - (ii) what benchmark reference the performance will be compared to. This reference must be verifiable and provided by an independent party; and
 - (iii) what the calculation formula will be (including the description of the methods used to offset gains with past losses, if applicable).
- A performance fee should not result in a breach of the principle of equality between ICIS investors.
65. Wherever possible, ICIS Insiders, especially the fund manager, are encouraged to put a cap on all types of fees so that ICIS investors are well informed of the maximum charges that will be deducted from their investment. Alternatively, the ICIS sponsor/manager may consider adding a clause to the fees section of the offer documents which states that "all other fees not related or not included in the published management fees will not exceed [a specified percentage] of the NAV".
66. GBs of ICIS shall further lay down practices, procedures and entitlements that adequately address any undesirable ambiguity in the smoothing of any dividend payment. This calls for appropriate transparency in the method and manner of smoothing – for example, where PER and IRR are created, an independent organ of governance should scrutinise and oversee their utilisations.²⁹ Adequate disclosure shall be produced in the offering documents and periodic reports.
67. The attempt by some ICIS sponsors to smooth dividend payments to ICIS investors further requires them to develop and maintain an informed judgment about the appropriate level of balance in the reserves created (if any), bearing in mind that their essential function is to mitigate displaced commercial risk. Therefore, where applicable, the GB of ICIS shall ensure that they have in place appropriate policy and framework for managing such risk.³⁰

²⁸ Note that IOSCO PD no. 178, *Final Report on Elements of International Regulatory Standards on Fees and Expenses of Investment Funds*, Report of the Technical Committee of IOSCO, November 2004 also contains extensive recommendations of best practices on this subject, including appropriate definitions for various types of fees and expenses.

²⁹ In the absence of a proper Governance Committee, this role can be mandated to the custodian/trustee or depository/administrator.

³⁰ In addition to the recommended minimum best practices under IFSB-3 in respect of the smoothing of dividend payments, the IFSB Guiding Principles on Risk Management for IIFS and the IFSB Capital Adequacy Standard, both issued by the IFSB in December 2005, set out some requirements for an adequate framework in managing displaced commercial risk.

DEFINITIONS

The following definitions provide a general understanding of the terms used in this document. The glossary is by no means an exhaustive one.

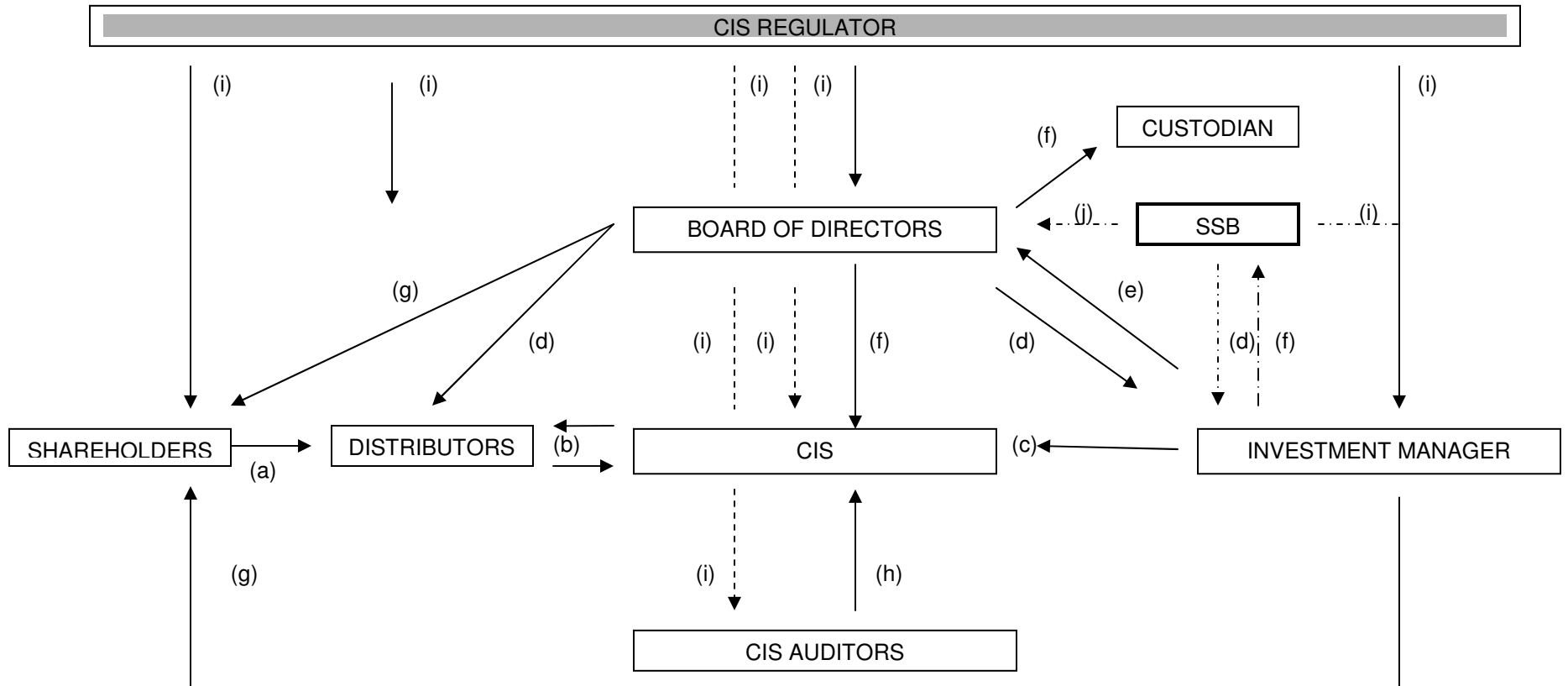
Investment risk reserve (IRR)	The amount appropriated by the ICIS out of the income of ICIS investors, after allocating the ICIS Insiders' fees, in order to cushion against future investment losses for ICIS investors.
Investment <i>Wakālah</i>	An agency contract where the ICIS investor (as principal) appoints the ICIS sponsor/manager (as agent) to carry out on their behalf the investment for a fee or for no fee, as the case may be.
Islamic collective investment scheme (ICIS)	Please refer to page 2.
<i>Muḍārabah</i>	A <i>Muḍārabah</i> is a contract between the capital provider and a skilled entrepreneur whereby the capital provider would contribute capital to an enterprise or activity, which is to be managed by the entrepreneur as the <i>Muḍārib</i> (or labour provider). Profits generated by that enterprise or activity are shared in accordance with the terms of the <i>Muḍārabah</i> agreement, whilst losses are to be borne solely by the capital provider unless they are due to the <i>Muḍārib</i> 's misconduct, negligence or breach of contracted terms.
Profit equalisation reserve (PER)	The amount appropriated by the ICIS out of the <i>Muḍārabah</i> income, before allocating the ICIS Insiders' fees, in order to maintain a certain level of return on investment for ICIS investors and to increase owners' equity.
Restricted investment account	The account holders authorise the IIFS to invest their funds based on <i>Muḍārabah</i> (profit sharing) or <i>Wakālah</i> (agency) contracts with certain restrictions as to where, how and for what purpose these funds are to be invested.
Stakeholders	Those with a vested interest in the well-being of ICIS, including: (i) employees; (ii) customers (ICIS investors, including IAH, if any); (iii) suppliers; (iv) the community; and (v) supervisors and governments based on the unique role of ICIS Insiders in national and local economies and financial systems.
Unrestricted investment accounts	The account holders authorise the IIFS to invest their funds based on <i>Muḍārabah</i> (profit sharing) or <i>Wakālah</i> (agency) contracts without laying any restriction. The IIFS sometimes commingle these funds with their own funds and invest them in a pooled portfolio.

APPENDIX: ICIS Models

<i>Models</i>	Corporate Model 1 – Board of Directors	Corporate Model 2 – Depository	Contractual Model 1 – Depository	Contractual Model 2 – Trustee	Hybrid of Corporate and Contractual Model
<i>Key feature</i>	In ICIS organised under the corporate form, investors become shareholders by acquiring shares of a company whose principal objective is to invest in a portfolio of securities.		Contrary to ICIS under the corporate form, in the contractual type investors buy unit shares that provide them with interest in a portfolio of diversified securities that does not have legal existence for itself. It follows that the ICIS does not have the legal capacity to contract on its own, and therefore the management of its portfolio has to be entrusted to a management company (investment manager).	ICIS under this type of contractual form are denominated unit trusts (UT) and are established and governed by a trust deed. A UT is an ICIS under which the property is held in trust for the beneficiaries of that trust.	In this model, it is the ICIS Operator who is responsible for the day-to-day oversight and operations of the scheme, and who stands in a fiduciary relationship with ICIS investors. Although BOD, depositories, auditors or trustees can play a role in the protection of the fiduciary duty of the CIS Operator, in this model it is a separate independent entity – that is, a Supervisory Board/Review or Compliance Committee – that has the explicit task of overseeing certain functions of the CIS Operator and the various CIS it operates – in particular, in the area of conflicts of interest.
<i>Main organs of governance</i>	The BOD is responsible for overseeing at a first level the operations of the ICIS and the ICIS Operator and other service providers, such as ICIS distributors, as well as for monitoring conflicts of interest. The action of the BOD is therefore decisive to ensure the protection of the interests of ICIS shareholders.	The depository is responsible for the oversight of the activities of the ICIS and ICIS Operator, as well as for the custody of the ICIS assets. For the purpose of this mandate and in so far as the "overview activity" is concerned, the functions of the depository can be comparable, though not necessarily equivalent, to the activities exercised by the BOD in the previous model.	Similar to the corporate model cases, where the functions of the ICIS Operator are assumed by an investment adviser, the management company becomes committed to the fiduciary duty of acting exclusively on behalf of CIS Unitholders' best interests. For the purpose of this mandate, the depository can nonetheless be compared with those described in the previous model.	This model is comparable to the earlier models, as the functions performed by the depository are exercised by an entity designated as the trustee, which is responsible for both the oversight of the ICIS Operator and the safekeeping of the ICIS assets.	In this model, a Supervisory Board/Review or Compliance Committee plays a central role in the governance structure, monitoring the ICIS Operator's compliance with its fiduciary and regulatory obligations, although it may be complemented by additional entities, including the BOD, the auditor and the ICIS regulator.

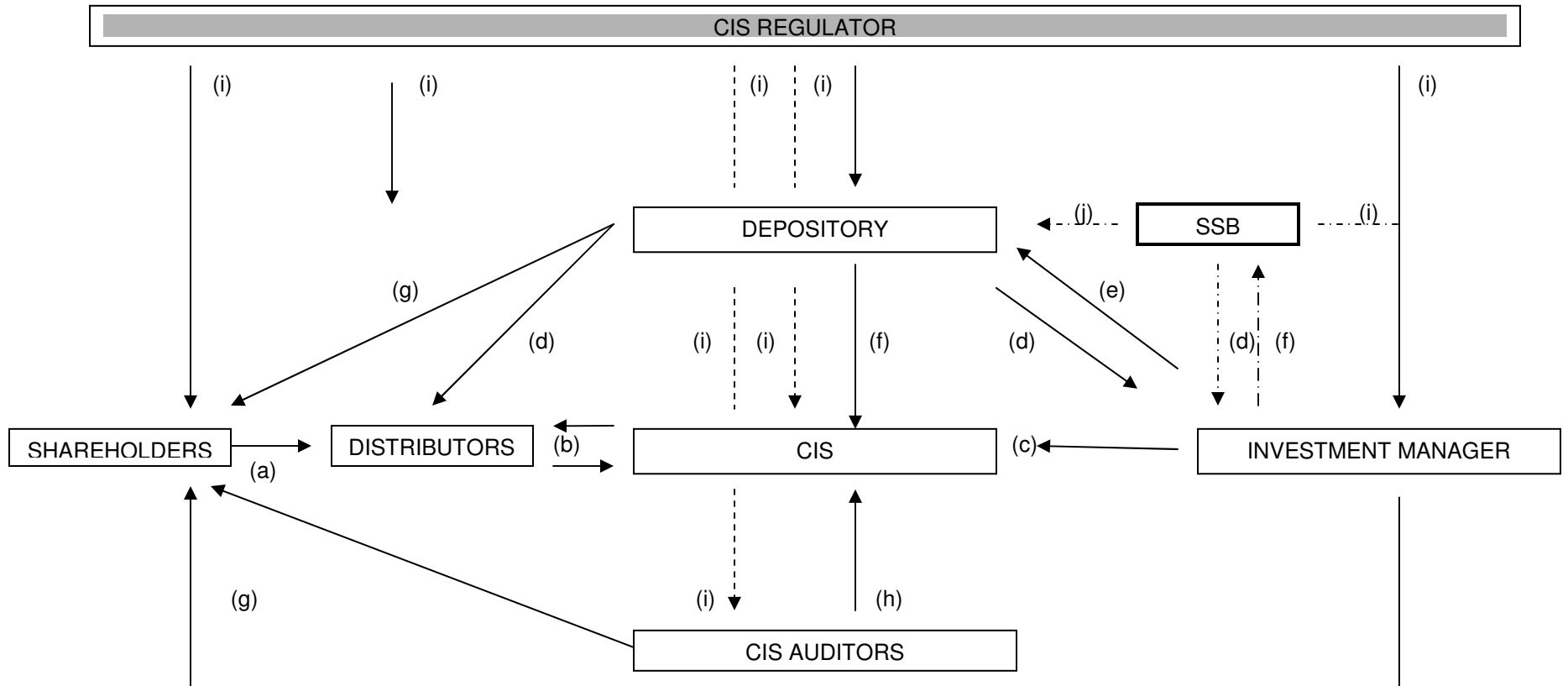
<i>Other features</i>	The acts of purchasing and redeeming CIS shares are generally processed through an authorised distributor on behalf of the CIS. The management of the CIS's securities portfolio is conducted by an investment adviser (CIS Operator) that is appointed through a contract approved by the BOD of the CIS, although sometimes the BOD directly manages the CIS themselves ("self-managed"). The investment adviser has a fiduciary duty to act in the best interests of CIS Shareholders.			Subscriptions from investors are pooled together and then used to purchase a portfolio of assets managed by the manager (CIS Operator). Investors receive units in proportion to the amount of money invested.	
<i>Schematic governance structure</i>	See Diagram 1.	See Diagram 2.	See Diagram 3.	See Diagram 4.	See Diagram 5.

Diagram 1: ICIS Governance Structure
Corporate Model 1 – Board of Directors



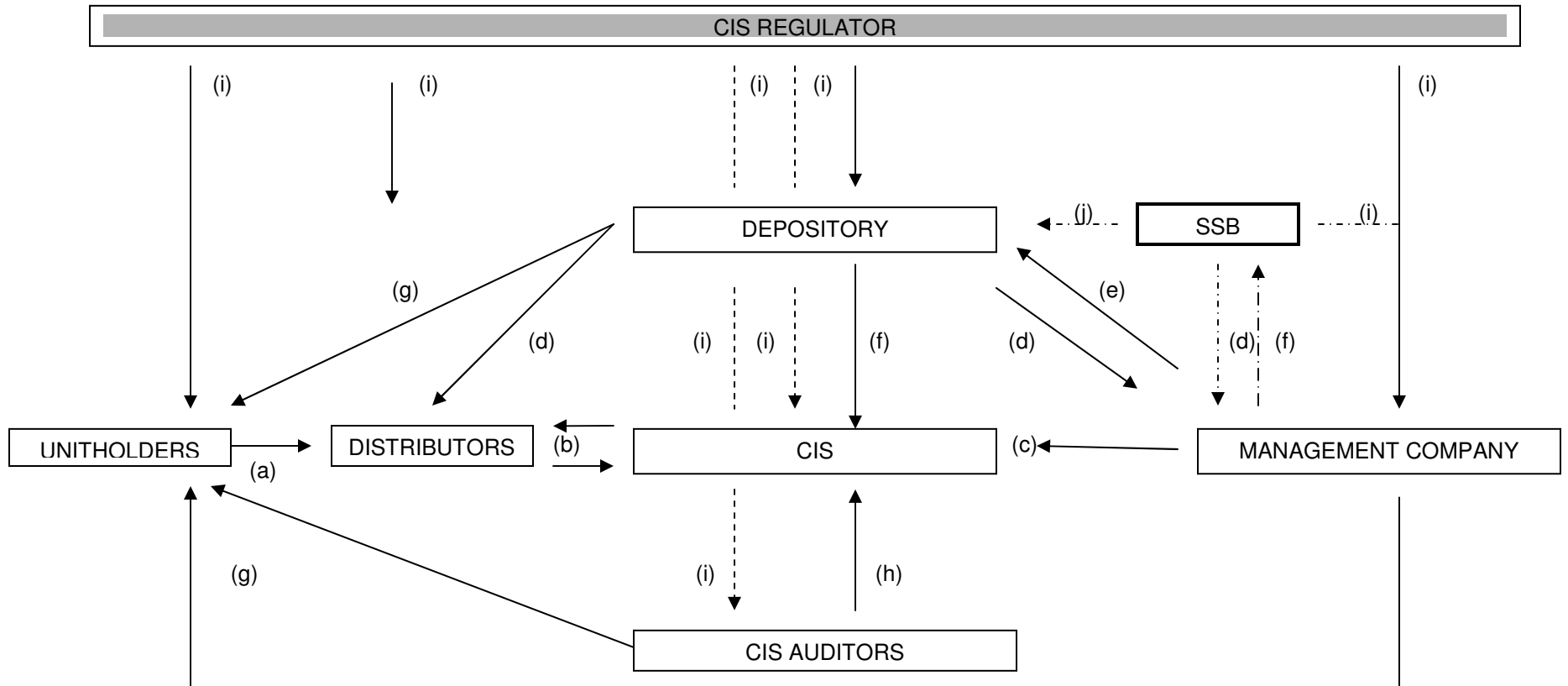
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| <ul style="list-style-type: none"> (a) Placement of orders for purchase/redemption of ICIS shares. (b) Inflow/outflow of money and issue/amortisation of shares. (c) Day-to-day management of the ICIS portfolio. (d) Oversight of ICIS investment manager and distributor activities, including the prevention of conflicts of interest. (e) Duty of reporting and subjection to approval of its contracts. | <ul style="list-style-type: none"> (f) Oversight of ICIS operations and safekeeping of assets (entrusted to a custodian). (g) Protection of ICIS shareholders' best interests. (h) Audit of ICIS financial statements. (i) Global supervision of the ICIS activities and of the respective key players, with the main goal of protecting shareholders' best interests. (j) Duty to advise and supervise ICIS compliance with the <i>Shari'ah</i>. |
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Diagram 2: ICIS Governance Structure
Corporate Model 2 – Depository



- (a) Placement of orders for purchase/redemption of ICIS shares.
- (b) Inflow/outflow of money and issue/amortisation of shares.
- (c) Day-to-day management of the ICIS portfolio.
- (d) Oversight of ICIS investment manager and distributor activities, including the prevention of conflicts of interest.
- (e) Duty of reporting and subjection to approval of its contracts.
- (f) Oversight of ICIS operations and safekeeping of assets.
- (g) Protection of ICIS shareholders' best interests.
- (h) Audit of ICIS financial statements.
- (i) Global supervision of the ICIS activities and of the respective key players, with the main goal of protecting shareholders' best interests.
- (j) Duty to advise and supervise ICIS compliance with the *Shar'ah*.

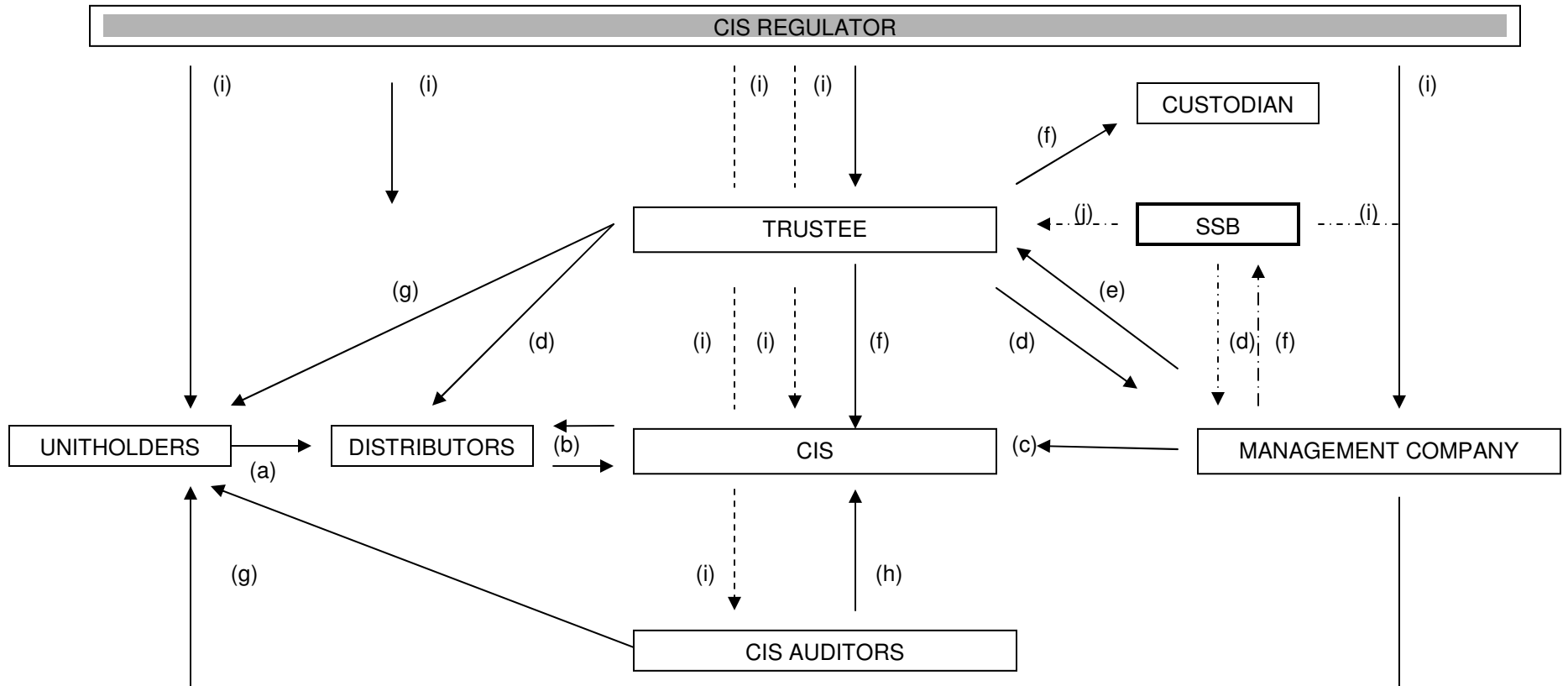
Diagram 3: ICIS Governance Structure
Contractual Model 1 – Depository



- (a) Placement of orders for purchase/redemption of ICIS unit-shares.
- (b) Inflow/outflow of money and issue/amortisation of unit-shares.
- (c) Day-to-day management of the ICIS portfolio.
- (d) Oversight of ICIS management company and distributor activities, including the prevention of conflicts of interest.
- (e) Duty of reporting and shared responsibility towards unitholders.

- (f) Oversight of ICIS operations and safekeeping of assets.
- (g) Protection of ICIS unitholders' best interests.
- (h) Independent review of key elements.
- (i) Global supervision of the ICIS activities and of the respective key players, with the main goal of protecting unitholders' best interests.
- (j) Duty to advise and supervise ICIS compliance with the *Shari'ah*.

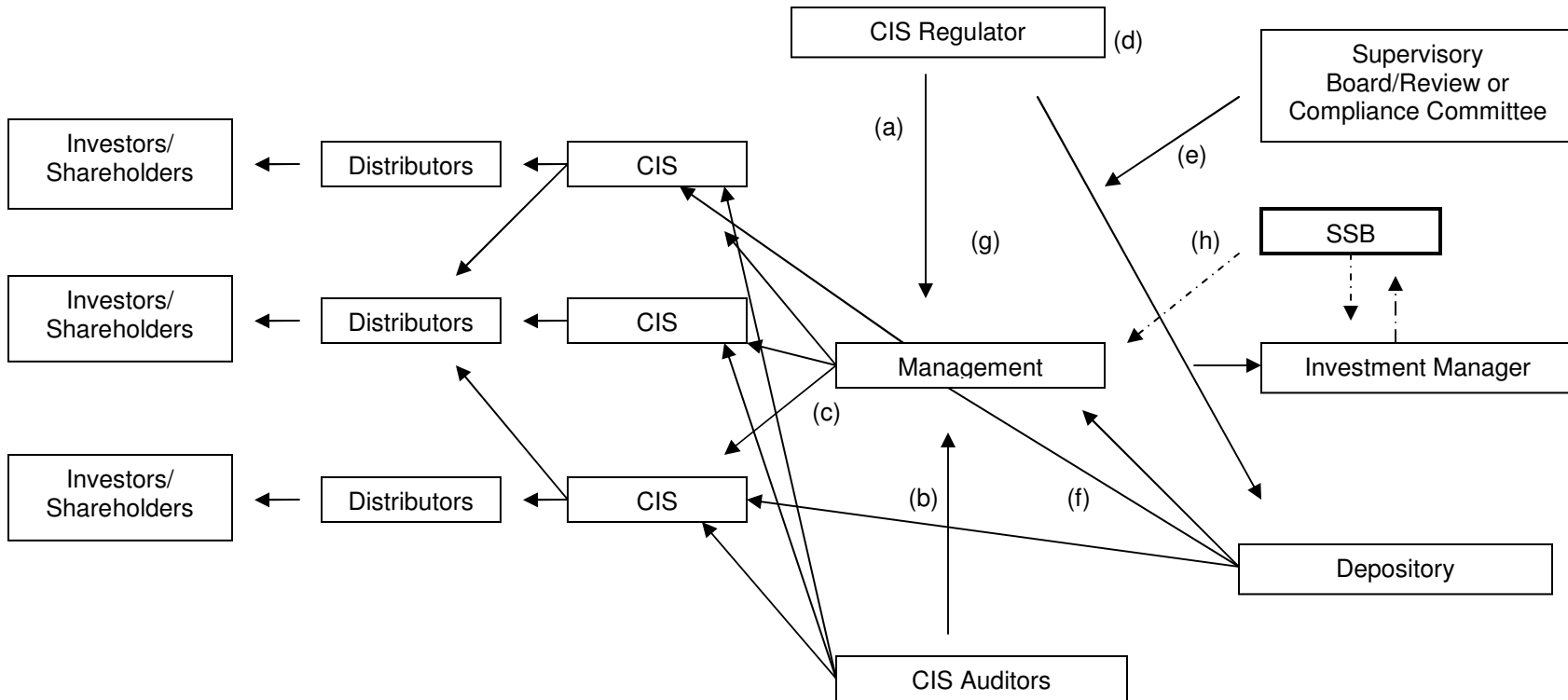
Diagram 4: ICIS Governance Structure
Contractual Model 2 – Trustee



- (a) Placement of orders for purchase/redemption of ICIS unit-shares.
- (b) Inflow/outflow of money and issue/amortisation of unit-shares.
- (c) Day-to-day management of the ICIS portfolio.
- (d) Oversight of ICIS management company and distributor activities, including the prevention of conflicts of interest.
- (e) Duty of reporting and submission to approval/ratifications of contracts and certain restricted transactions.

- (f) Oversight of ICIS operations and fiduciary of ICIS assets, although its safekeeping is entrusted to a custodian.
- (g) Protection of ICIS unitholders' best interests.
- (h) Independent review of key elements.
- (i) Global supervision of the ICIS activities and of the respective key players, with the main goal of protecting unitholders' best interests.
- (j) Duty to advise and supervise ICIS compliance with the *Shari'ah*.

Diagram 5: ICIS Governance Structure
 Hybrid Corporate and Contractual Model – Supervisory Board/Review or Compliance Committee



- (a) License held by management company, offering range of ICIS (UCITS, non-UCITS).
- (b) Auditors review only management company financial reporting, and report irregularities to regulator.
- (c) Auditors review separate financial reporting by ICIS, and report irregularities to regulator.
- (d) Requirement of sufficiently independent Supervisory Board at the CIS or management company level or Independent Review or Compliance Committee.
- (e) Outsourcing and monitoring of investment management.
- (f) Legal ownership of assets separate from ICIS and management company, limited monitoring of asset management.
- (g) Licensed depository, not independent of management company.
- (h) Duty to advise and supervise ICIS compliance with the *Shari'ah*.