

**MFSA**

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MALTA FINANCIAL SERVICES AUTHORITY

**MFSA Guidance Note for Shariah Compliant Funds**

### **1. Purpose of Guidance Note:**

- To provide guidance to fund promoters considering setting up a Shariah fund under the Investment Services Act.
- To set out the issues which the MFSA expects Shariah funds established in Malta to address as part of their licence conditions. The Shariah fund's licence will include a reference to the fact that apart from the Standard Licence Conditions set out in the MFSA's Investment Services Rules for Retail Collective Investment Schemes or for Professional Investor Funds – as applicable – the fund is expected to comply with this Guidance Note and will need to seek MFSA's prior approval for any deviations therefrom.

### **2. General Introduction**

Collective investment schemes are regulated by the Malta Financial Services Authority (MFSA) under a framework regime incorporated in the Investment Services Act ("the Act"). Within the parameters set by the Act and subsidiary legislation, Rules published by the MFSA provide for the specific regulation of collective investment schemes based on the level of sophistication (and therefore the level of protection required by) the target investor.

The principal categories of collective investment schemes that can be set up under this common framework are the following:

- **Retail Investment Schemes** - which are in turn divided into:
  - UCITS
  - Non-UCITS
- **Professional Investor Funds** – which are in turn divided into:
  - Experienced Investor Funds
  - Qualifying Investor Funds
  - Extraordinary Investor Funds

The regulatory standards that underpin the regime as applied to the different types of funds relies mainly on the principles of disclosure and transparency as means of protecting investors' interests as well as on the investor's understanding of risk as a key motive for applying regulation in a proportionate manner.

The regime is applied to a large variety of conventional and alternative investment funds. This Guidance note is meant to illustrate how the current funds regime applies to funds established under Shariah rules and clarifies a number of related issues for the benefit of fund promoters.

### **3. Licensing Framework**

As a general rule Shariah compliant funds may be set up as Retail Investment Schemes and Professional Investor Funds, although the nature of the investment and the methods used may have a determining effect on the fund category under which the fund may be licensed:

1. Shariah compliant equity funds can be set up as Maltese UCITS Schemes, Maltese non-UCITS Schemes or Professional Investor Funds;
2. Ijarah Funds, which generally invest in non-conventional asset classes, may only be licensed in Malta under the Professional Investor Funds regime;
3. Commodity Funds, which generally invest in non-conventional asset classes similar to Ijarah Funds, can only be licensed in Malta under the Professional Investor Funds regime;
4. Murabaha Funds can only be licensed in Malta under the Professional Investor Funds regime.

Shariah compliant funds shall abide by the Standard Licence Conditions that are applicable to funds established under the Act. Due to the particular nature of Shariah funds, or certain types of Shariah funds, note should be taken of the following principles:

- Shariah compliant funds will be expected to follow the risk-spreading principle except when this can be waived in terms of the proviso to the definition of 'collective investment scheme' in the Act.
- The managing body of a Shariah fund (Board of Directors in the case of a corporate fund), will be responsible for ensuring that the fund satisfies the relevant Shariah principles and requirements as disclosed in the fund's prospectus and other investor information documentation.
- Except for the applicability of this Guidance Note, Shariah funds set up as retail funds (UCITS or non-UCITS), or Professional Investor Funds, will be regulated in the same manner as non-Shariah compliant funds falling under the same category.
- The selected extra-financial criteria (Shariah Guidelines which the fund will adopt) must comply with all prevailing regulatory and statutory requirements. No specific

difficulties arise provided that the extra-financial criteria do not infringe regulatory principles.

#### **4. Application of Rules in particular situations**

Shariah compliant funds established in Malta are expected to adhere to the following:

##### **[A] Appointment of Shariah Advisory Board**

###### ***Appointments***

The Manager of the fund shall appoint a Shariah Advisory Board composed of at least two internationally recognised Islamic Shariah Scholars to ensure that the fund meets Shariah compliance standards in the management of its assets. Members of the Shariah Advisory Board are to be independent from the Manager.

The fund may opt to appoint a legal entity as a Shariah Advisor, which would in turn appoint a Shariah Advisory Board to carry out the above functions, and which may replace, at its absolute discretion, the members by others of equal standing and reputation.

###### ***Role of Shariah Advisory Board***

The Role of the Shariah Advisory Board shall be :

- a) to provide guidance to the fund on the steps to be followed to meet Shariah compliance standards in the management of its assets, rather than being an investment advisor which issues specific investment recommendations to the fund or its Manager;
- b) at the outset, prior launch of the fund, to approve the fund structure and the investment methodology of the Investment Manager, including the Shariah Guidelines which it will be following to manage the fund in order to be Shariah compliant. These Guidelines may change from time to time subject to the Board's prior approval and any such changes will be notified to investors before they come into effect;
- c) review the fund's contractual relationships with relevant parties;
- d) generally to approve all matters pertaining to Shariah compliance in an autonomous manner from the Manager who remains responsible for the investment management of the fund's assets;

- e) to provide ongoing services to the Company and the fund, including supervising and monitoring the operations of the Company and the fund to aid in its ongoing adherence to the Shariah Guidelines;
- f) to report to unit holders annually in the fund's audited financial statements expressing its opinion regarding the extent of Shariah compliance by the fund.

**[B] Disclosures in Prospectus or Offering Memorandum**

The Prospectus or Offering Memorandum shall include the following disclosures:

- a) Details regarding the Members of Shariah Advisory Board (and the Shariah Advisor, if any);
- b) Reference that the fund (or the Shariah Advisor, as the case may be) may replace any members of the Shariah Advisory Board with individuals whom it considers, in its absolute discretion, to be of equal standing and reputation;
- c) Terms of appointment of the Shariah Advisory Board;
- d) Reference to the Shariah compliance review carried out by the Shariah Advisory Board prior to the launch of the fund and to the opinion given by the Board in this respect;
- e) Reference to the main features of the Shariah Guidelines to be followed by the fund setting out:
  - i) the nature of assets which the fund will not be permitted to invest in;
  - ii) the investment strategy/ stock selection technique to be adopted;
  - iii) permitted asset classes and screens to be adopted;
  - iv) any leverage restrictions;
  - v) where applicable, the possible distribution of income to third parties who are not fund investors, such as charities, and the nature of such income and the criteria for determining when this can be done, to whom and a maximum permitted limit on such distributions together with disclosure of any tax implications for investors/ full disclosure of all Shariah related processes and potential outcomes (eg purification or cleansing of dividends received);
  - vi) the requirements related to Shariah compliance vetting and certification by the Shariah Advisory Board both following the launch of the fund;
- f) Disclaimer that the fund Directors and Manager are responsible for ensuring the fund satisfies the relevant Shariah principles and requirements as disclosed in the Prospectus or Offering

Memorandum and that the MFSA has not assessed the competence or otherwise of the members of the Shariah Advisory Board; has made no assessment or value judgement on the accuracy or completeness of statements made or opinions expressed with regard to the compliance of the fund with Shariah principles, and will not be monitoring the extent of compliance of the fund with such principles on an on-going basis;

g) Risks associated with Shariah compliance with reference to the following:

i) Risks related to limitation of investment universe: -

reference to the fact that the fund will operate within the requirements of Shariah as interpreted by the Shariah Advisory Board. The interpretation of Shariah by the Shariah Advisory Board may limit certain investment opportunities and may impose structural requirements that could increase costs and taxes, and that, due to the restricted nature of the permitted investment of Shariah compliant investments universe, a risk warning that returns of the fund may be lower and with higher volatility than a non-restricted fund.

ii) warning that prospective investors should not rely solely on the pronouncement of the Shariah Advisory Board on the compliance of the fund with Shariah principles, and that the investments comply with Shariah, in deciding whether to invest, and that they should consult their own Shariah advisor as necessary;

iii) disclosure of increased susceptibility of the fund to fluctuations in value resulting from adverse economic or business conditions affecting the particular issuer, security or market to the extent that the Manager concentrates the fund's investments in particular industries or market sectors in view of the limitations imposed by Shariah;

iv) risks related to changes in Shariah compliant rules - changes to the Shariah compliant investment rules may result in a reduced opportunity to sell in certain cases and higher costs of trading;

v) increased counterparty risk due to the possible use of limited prime brokers and administrators in the market place offering the required level of Shariah compliance as well as risk of increased cost from lack of a competitive marketplace;

- vi) risk warning on possible increased costs to be incurred by a Shariah-compliant fund compared to a non compliant one.
  - vii) risks associated with limited Shariah compliant cash management tools and techniques – risk of lower returns to those generated by conventional cash management methods;
  - viii) risks associated with possible decreased opportunities for financing and increased costs of financing given that the fund would need to utilise financing in a Shariah-compliant manner/ increased liquidity risk due to borrowing restrictions and illiquid investments) and potential foreign exchange risk in view of hedging restrictions;
  - ix) liquidation risk associated with any investment that may not be Shariah compliant.
- h) Disclosure regarding treatment of the fund’s investments which in the opinion of the Shariah Advisory Board are no longer Shariah compliant and the time within which the fund is permitted to liquidate such positions.

**[C] Disclosure in Audited Financial Statements of Shariah Fund**

In addition to the disclosure requirements ordinarily applicable to non-Shariah funds in terms of their licence conditions, the audited financial statements of Shariah funds shall also include:

- a) A report by the Shariah Advisory Board expressing its opinion on whether the fund has been able to comply with Shariah principles and its Shariah Guidelines during the period under review;
- b) Disclosure (where applicable) of the actual distribution of income to entities other than investors in the fund, the circumstances which led to such distributions and the recipients of such funds.