



ISLAMIC FINANCIAL SERVICES BOARD

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**EXPOSURE DRAFT - 19**

**GUIDING PRINCIPLES ON DISCLOSURE REQUIREMENTS  
FOR ISLAMIC CAPITAL MARKET PRODUCTS  
(ŞUKŪK AND ISLAMIC COLLECTIVE INVESTMENT  
SCHEMES)**

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*Comments on this Exposure Draft should be sent  
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**31 October 2016**

## **ABOUT THE ISLAMIC FINANCIAL SERVICES BOARD (IFSB)**

The IFSB is an international standard-setting organisation which was officially inaugurated on 3 November 2002 and started operations on 10 March 2003. The organisation promotes and enhances the soundness and stability of the Islamic financial services industry by issuing global prudential standards and guiding principles for the industry, broadly defined to include the 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.

For more information about the IFSB, please visit [www.ifsb.org](http://www.ifsb.org).

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## ABBREVIATIONS

CIS	Collective investment scheme
ETF	Exchange traded fund
EU	European Union
ICIS	Islamic collective investment scheme
ICM	Islamic capital market
IDBG	Islamic Development Bank Group
IFSB	Islamic Financial Services Board
IFSB-15	Revised Capital Adequacy Standard for Institutions offering Islamic Financial Services [Excluding Islamic Insurance ( <i>Takāful</i> ) Institutions and Islamic Collective Investment Schemes]
IIFS	Institutions offering Islamic financial services
IOSCO	International Organization of Securities Commissions
KID	Key information document
MMF	Money market fund
OEIC	Open-ended investment company
OTC	Over the counter
RSAs	Regulatory and supervisory authorities
SICAV	Société d'Investissement à Capital Variable
SPV	Special purpose vehicle
UCITS	Undertakings for collective investments in transferable securities

***Bismillahirrahmānirrahīm.***

*Allahumma ṣalli wasallim ‘alā Sayyidinā Muḥammad wa ‘alā ālihī waṣaḥbiḥī*

## **SECTION 1: INTRODUCTION**

### **1.1 Background**

1. The Technical Committee of the Islamic Financial Service Board (IFSB), in its 27th meeting held in Kuala Lumpur, Malaysia, on 11 June 2012, observed that there is a need to ensure that investors are provided adequate information about the products offered in the Islamic Capital Market (ICM). In September 2012, the IFSB, with the International Organization of Securities Commissions (IOSCO) and Securities Commission Malaysia, held a Roundtable on Disclosure Requirements for Islamic Capital Market Products in Kuala Lumpur, the papers and commentaries for which were published jointly in September 2013. The Roundtable identified a number of respects in which ICM products raised disclosure issues different from or additional to those of their conventional counterparts. In its 21st meeting, on 12 December 2012 in Jeddah, Kingdom of Saudi Arabia, the Council of the IFSB agreed to start preparing a standard focusing on disclosure requirements for ICM products.

### **1.2 Objectives**

2. The Guiding Principles on Disclosure Requirements for Islamic Capital Market Products (*Ṣukūk* and Islamic Collective Investment Schemes) (“the standard”) are intended to meet the following objectives:

- (i) to provide a basis for regulatory and supervisory authorities (RSAs) to set rules and guidelines on disclosure requirements for ICM products, specifically for *ṣukūk* and Islamic collective investment schemes (ICIS);
- (ii) to outline a basis for RSAs to assess the adequacy of the disclosure frameworks specified by others;<sup>1</sup>
- (iii) to provide a comprehensive disclosure framework for participants in the ICM; and
- (iv) to create greater harmonisation of regulation and practice in the ICM, and thus to facilitate cross-border offerings.

### **1.3 Scope and Coverage**

3. This standard is applicable only to *ṣukūk* and ICIS. However, as the ICM continues to develop, it may become appropriate for standards for other ICM products to be set in the future. Some elements of this standard may also be applied by analogy to any such products for which RSAs are responsible.

4. Reflecting current practice in the ICM, the standard has been aimed primarily at those *ṣukūk* that are economically analogous to conventional bonds,<sup>2</sup> and at ICIS that invest in transferable securities. It does, however, also discuss other types of *ṣukūk* and ICIS in particular places, and covers the specific disclosure issues relating to some special types of ICIS.

5. This standard covers the main stages of disclosure – that is, initial, ongoing (periodic and immediate) and point-of-sale disclosure, in so far as they are applicable to *ṣukūk* and ICIS. “Initial disclosure” refers to the disclosures made, typically in a prospectus or other offering document, when a security is first offered. “Periodic disclosure” refers to the disclosures that are required at specified intervals thereafter – for example, in some instances, annual or quarterly financial statements. “Immediate disclosure” refers to disclosures that may be required, usually within a short period, when a price-sensitive development or other specified event occurs – for example, the resignation of a director. In the case of some collective investment schemes (CIS), because investors may often acquire the issued securities long after the original prospectus was published, it is common both for the

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<sup>1</sup> For example, by an exchange that is also a listing authority.

<sup>2</sup> It should be noted, though, that *ṣukūk* are in essence entirely different from conventional bonds in terms of their Sharī‘ah basis and rulings.

prospectus to be updated regularly and for there to be a document that summarises the relevant information and provides additional information on, for example, performance and major holdings. This may be referred to as a “key information document” (KID) or “fact sheet”, or some similar term. This type of point-of-sale disclosure is covered by the present standard, but it does not address wider aspects of financial intermediation, such as suitability of securities offered to customers or the disclosures made by financial intermediaries – for example, about their own remuneration.

#### **1.4 Other Relevant Standards**

6. The IFSB has developed several standards that have some relevance to disclosure in ICM, as follows:

*IFSB–6: Guiding Principles on Governance for Islamic Collective Investment Schemes*

*IFSB–9: Guiding Principles on Conduct of Business for Institutions offering Islamic Financial Services*

*IFSB–10: Guiding Principles on Sharī'ah Governance for Institutions offering Islamic Financial Services*

7. These aforementioned standards are addressed primarily at institutions providing financial services, while capital markets regulation addresses market intermediaries as well as issuers of securities, many of which will not be financial institutions. In addition, the above standards are largely concerned with setting substantive requirements in matters other than disclosure, although they do specify some associated disclosures. Where the present standard specifies disclosures in the same areas, and by the same parties (e.g. about the Sharī'ah governance of an ICIS), it should be regarded as superseding those standards, to that extent only.

8. As regards Sharī'ah governance, IFSB-10 covers the relationship between Sharī'ah governance in individual institutions and whatever Sharī'ah governance arrangements may exist for a jurisdiction as a whole. It recognises that Sharī'ah governance may take several forms, and that jurisdictions have adopted diverse approaches to it. The present standard has been prepared within that context and accommodates whatever Sharī'ah governance arrangements consistent with IFSB-10 may apply in an institution or jurisdiction.

9. The primary international standard setter for conventional securities markets is IOSCO. It has published a number of standards relevant to the matters covered by this standard. They include:

*Objectives and Principles of Securities Regulation (2010) and the associated assessment methodology*

*Principles for the Supervision of Operators of Collective Investment Schemes (1997)*

*Principles for Ongoing Disclosure and Material Development Reporting by Listed Entities (2002)*

*Performance Presentation Standards for Collective Investment Schemes: Best Practices Standard (2004)*

*International Disclosure Principles for Cross-Border Offerings and Listings of Debt Securities by Foreign Issuers (2007)*

*Principles for Periodic Disclosure by Listed Entities (2010)*

*Disclosure Principles for Public Offerings and Listings of Asset-backed Securities (2010)*

*Principles on Point of Sale Disclosure (2011)*

*Principles on Suspensions of Redemptions in Collective Investment Schemes (2012)*

This standard is not intended to supersede any of the IOSCO standards mentioned above. Instead, it aims to complement those standards by dealing with issues specific to Islamic capital market products, and by setting out principles and practices pertaining specifically to disclosure requirements for *ṣukūk* and ICIS. However, if on any point this standard is in conflict with one of these IOSCO standards, then, for ICM products only, this standard should prevail.

10. In addition to the IOSCO standards mentioned above, the regulatory requirements of the European Union (EU) have influenced capital markets regulation well beyond its borders. In preparing the present standard, the IFSB has taken cognisance of the EU regime as an example of accepted good practice in conventional capital markets. In particular, it has reviewed aspects of practice represented by the Prospectus Directive (2003/71/EC), the Transparency Directive (2004/109/EC) and the UCITS Directive (2009/65/EC), in each case as amended to the date of this standard.

## **1.5 General Approach**

11. The IOSCO standards mentioned above establish a very substantial disclosure framework for conventional capital markets, including the conventional analogues of *ṣukūk* and ICIS. A large majority of this framework is also applicable to ICM. In addition, most RSAs who regulate Islamic capital markets also regulate conventional ones and have already adopted regulatory provisions based on these standards. The present standard therefore deals only with those areas in which ICM products require disclosures additional to, or different from, their conventional counterparts. It does not attempt to duplicate the conventional standards by specifying all relevant disclosures, including those that are common to conventional and Islamic products. This standard thus assumes that RSAs will implement it in the context of a regulatory regime based on the IOSCO standards.

12. In preparing this standard, the IFSB has recognised that ICM products are to some extent in competition with conventional ones, both in terms of where investors choose to deploy their funds and what issuers decide to offer. This standard seeks to strike a balance between the need to provide adequate information to enable investors to make informed decisions, especially in Sharī'ah-related areas, and the need to ensure that issuers are not unnecessarily burdened in meeting the requirements. It also seeks to provide a sound basis of regulation to allow what have been nascent Islamic capital markets to develop to maturity with greater levels of integrity and transparency.

13. Although practice varies from jurisdiction to jurisdiction, it is common for there to be some capital market offerings that are exempt from detailed regulation in respect of disclosure, due to the nature of the offering or of the offeror. These may, for example, include securities offered to small numbers of sophisticated investors, or issued by governments or multilateral financial institutions such as the Islamic Development Bank Group (IDBG) or the World Bank Group, among others. The applicability of this standard in such areas is discussed more fully later, but the IFSB notes that, even where disclosures are not required by regulation, they are often made as a matter of good market practice. It hopes, therefore, that this standard will be taken into account by those responsible for making disclosures in respect of such offerings.

## **1.6 Implementation Date**

14. RSAs are expected to start implementation of this standard in their jurisdictions by 1 July 2018. Such implementation should be undertaken within the applicable Sharī'ah governance, legal and regulatory framework applicable in the jurisdiction.

## **1.7 Structure of the Standard**

15. The principles set out in Section 2 of this standard are arranged into three sections. Section 2.1 sets out general principles that are applicable to disclosure requirements for *ṣukūk* and ICIS. Section 2.2 deals with principles specific to *ṣukūk* disclosures, and section 2.3 states the principles for ICIS disclosures. Both sections 2.2 and 2.3 provide explanations on how the principles under each section should be applied in certain areas. Each principle is supported by a description of the underlying

rationale, and by recommended disclosures. While the principles are intended to be capable of regulatory implementation at a high level, the recommended disclosures provide an outline of a more detailed regulatory framework for RSAs to consider in the light of the needs and characteristics of their own jurisdictions. They may also be applied on a voluntary basis where local regulatory provisions do not cover the issues in question.

## SECTION 2: THE GUIDING PRINCIPLES

### 2.1 General Principles

16. The three principles that follow (Principles G.1–G.3) are common to both *ṣukūk* and ICIS. These principles speak to good practice for both conventional and Islamic capital market products. However, the specific characteristics of ICM products, and the particular concerns of investors in such products, mean that the detailed application of these three principles will raise the specific issues discussed below.

#### 2.1.1 Principle G.1: Clear and Accurate Information

**Information provided in offering documents or other documents prepared for investors and prospective investors should be clear, accurate and not misleading.<sup>3</sup>**

##### Rationale

17. Investors rely on information to make investment decisions, whether to invest in a new product, or to continue or discontinue their investment in an existing product. In order to protect investors' interests and the integrity of their decision making, disclosures related to the product (initial, ongoing and point of sale) must be clear, accurate and not misleading.

18. It is a fundamental requirement, therefore, that an issuer,<sup>4</sup> or others acting on its behalf,<sup>5</sup> should not mislead investors by disclosing untrue information or failing to disclose material information. In particular, such parties should not issue information that is misleading to investors or the market regarding the Sharī'ah aspects of an issuance.

19. Disclosure must be in a clear and understandable language and presentation. How this requirement is implemented will depend on the sophistication of the investors at whom the offering is targeted. An offering targeted at retail investors should, for example, not assume familiarity with challenging areas of law and/or Islamic jurisprudence. It should not present key concepts in small print or at the back of a long document. On the other hand, an issuance aimed at large institutional investors might reasonably assume a greater level of sophistication and expertise.

20. The requirement to be clear, accurate and not misleading applies not only in initial disclosures, but also in both ongoing and point-of-sale disclosures.

21. RSAs should ensure that this principle is applied to all those who bear regulatory responsibility for the disclosures in question, subject to whatever legal defences may be available.

22. Some jurisdictions require specific disclosures for retail investors. Where such disclosures are required, RSAs should ensure that the requirements of this principle are applied to such documents, and should give particular attention to ensuring that they are clear and jargon-free.

##### Recommended Disclosures

23. No specific disclosures are recommended under this principle, beyond those that would be required as part of a regime designed to meet IOSCO standards. However, it is recommended that as part of such a regime, there should be a general requirement along the lines of the principle, and that its terms should be broad enough to cover whatever disclosures are made about the Sharī'ah aspects of the issuance.

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<sup>3</sup> In order to avoid repeating the phrase "investors and prospective investors" throughout the document, later references to "investors" should be taken to include prospective investors, where appropriate.

<sup>4</sup> In the case of *ṣukūk*, where the issuer is likely to be a special purpose vehicle (SPV), the term should be taken to include the originator of the *ṣukūk*, which will use the proceeds and may be responsible for payments under the agreement.

<sup>5</sup> For example, the manager of an ICIS, or the advisor to a *ṣukūk* issuer.

24. Where RSAs have responsibility to scrutinise prospectuses or other disclosure documents, and have a general provision of this kind within their regime, their application of it should cover the disclosures made about Sharī'ah matters, even where these Sharī'ah matters are not specified in more detailed terms by the RSAs.

### 2.1.2 Principle G.2: Sufficient Information

**There should be full disclosure of information which a reasonable investor would view as material to their decision whether to invest, or to remain invested.**

#### Rationale

25. The regulatory framework should ensure that, for securities whose disclosure is regulated, relevant disclosures are made initially, on an ongoing basis, and in point-of-sale material where this forms part of the regulatory framework.

26. In some circumstances the consistency and comparability of the information may be important. Examples are the annual financial statements of an issuer, where any change in the basis of accounting needs to be clearly stated, or the regular performance figures for a CIS.

27. What is considered as material will depend on both the instrument itself and the type of investor at whom it is targeted, or who may hold it. If an instrument is held out to be Sharī'ah-compliant, whether expressly or by implication,<sup>6</sup> disclosure on Sharī'ah matters is necessary because at least some of the potential investors in such an instrument can be assumed to be Sharī'ah-sensitive investors.

28. Disclosed material needs to be reasonably accessible to investors. The regulatory regimes of many jurisdictions require issuers of securities to file or make available documents beyond those normally distributed directly to investors or the general public. (Examples might be past financial statements or copies of transaction documents). Where this is done, those documents should be readily accessible to investors, normally online, and investors should be made clearly aware of how they may be accessed.

#### Recommended Disclosures

29. The regulatory framework should impose a standard format for disclosure under prospectuses. A typical standard format would require the disclosure of information under specific headings. The conventional standards already cited, and examples of good practice such as the EU regime, provide a good basis for specifying such a standard format.

30. In addition, the offering documents should provide information on the basis on which Sharī'ah compliance is claimed. Specific issues in this respect for *ṣukūk* and ICIS, including special types of ICIS, are discussed later in this standard.

31. Since the requirement of Sharī'ah compliance necessitates concern with relevant matters on a continuing basis, ongoing disclosures should include any facts that materially affect the judgement that the investment is, and will remain, compliant.

32. Risk disclosures should include any risks arising from Sharī'ah non-compliance, and also any other risks – for example, legal risks – arising from the structure of the instrument. Some specific aspects of this are discussed later in this standard.

33. Conventional disclosure frameworks commonly include a general requirement that, in addition to specific disclosures required by that framework, disclosures should include any other matters of which

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<sup>6</sup> In some jurisdictions, terms other than "Islamic" may be used. For example, in Turkey the word "participation" is often a signal that an investment claims Sharī'ah compliance. The use of some Arabic terms, particularly where the language otherwise used is not Arabic, may also signal at least an implicit claim to Sharī'ah compliance.

an investor should be aware. The use of such a “catch-all” provision is particularly helpful in an area that is developing as rapidly as ICM, and is recommended.<sup>7</sup>

### 2.1.3 Principle G.3: Timely Information

**There should be timely disclosure of information which is reasonably material to an investment decision.**

#### Rationale

34. Information that is material to investors’ decisions to invest, or to continue or discontinue an investment, should normally be disclosed as soon as reasonably possible. However, what constitutes timely disclosure will vary depending on the nature of the information and the circumstances. Regulatory regimes will normally recognise this by making different provisions for different cases.

35. During an offer period, immediate disclosures need to be made if required to ensure that the information in an offering document is accurate, complete and not misleading. This will normally be done through a supplementary or amended offer document.

36. Subsequently, there are likely to be periodic disclosures mandated by regulation, and these should be made within a reasonable time after the period to which they relate. Examples would be the publication of annual accounts, or a periodic update to ICIS investors on the performance of their investments. The relevant period will normally be specified by regulation.

37. Certain developments will require to be disclosed as soon as practicable after they occur due to their likely impact on investors’ willingness to buy or hold a security. In particular, where the instrument is one that is already traded, failure to make such disclosure risks creating a false market, and may offer opportunities for market abuse. The circumstances under which derogation from full and timely disclosure is permitted should therefore be limited and the safeguards that apply in such circumstances should be clearly defined.

38. The conventional standards and regulatory regimes already cited provide a sound basis for specifying required disclosures, and appropriate timescales, for all the broad types of case mentioned above.

39. In the case of *ṣukūk* and ICIS, it should be assumed in addition that investors are sensitive to *Sharī’ah* issues, and that material developments in such issues will affect their willingness to buy or hold the instrument. Thus, timely disclosures should be made about any matter that is reasonably likely to affect the ongoing *Sharī’ah* compliance of the instrument. The type of event that may occur is likely to differ between ICIS and *ṣukūk*, and will therefore be discussed separately later in this standard.

40. Where disclosures are regulated, RSAs should monitor to ensure that disclosures are made as required. If the instrument is listed, some jurisdictions may delegate this monitoring function to an exchange, but should nevertheless ensure that the exchange is discharging its responsibilities properly. This applies even if the instrument is not traded on-exchange, because the information can be assumed to be relevant to prices and investor decision making even in over-the-counter (OTC) markets.

#### Recommended Disclosures

41. Specific disclosures are recommended under subsequent principles.

## 2.2 *Ṣukūk* Disclosure

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<sup>7</sup> One example of such a provision would be a requirement that an offering document “shall contain all the information which an investor would reasonably require and expect to find in such a document for the purpose of making an informed assessment of: (a) the assets and liabilities, financial position, profits and losses, and prospects of the issuer and any guarantor; and (b) the nature of the securities and the rights and liabilities attaching to those securities”.

## 2.2.1 Application

### *Offerings Covered by this Standard*

42. Most jurisdictions have the concept of private and public offerings of securities. The definitions vary among jurisdictions, and this standard is not intended to affect those definitions or how RSAs would classify a particular offering. However, where an offering is classified as private, the effect is generally that this offering is substantially exempt from the registration and disclosure requirements normally applicable to securities offerings in that jurisdiction. Public offerings may or may not be listed, as is also the case with private offerings. As already noted, RSAs vary in what they classify as private offerings, but typically offerings by certain types of offerors (e.g. governments, multilateral financial institutions, etc.) and offerings with certain types of limitations (e.g. to sophisticated investors, to a limited number of offerees, below a prescribed size or with a prescribed minimum denomination) are classified as private offerings. In some jurisdictions, any security that is to be listed is regarded as being publicly offered, unless it comes from exempt offerors such as governments. Based on its balancing of the burdens involved and investor access, an issuer may choose to structure an offering to be a private one.

43. In addition, while private offerings may be exempt from detailed disclosure requirements, they may well be regulated by an RSA as to other aspects of the offering – for example, as to liability for defective offering material or by requiring filings. This standard addresses only disclosure requirements and is not intended to affect the regulation or treatment of other aspects of offerings by RSAs.

44. The disclosure requirements in this standard should be applied by RSAs to public offerings (however these may be defined in the relevant jurisdiction), but RSAs may choose to apply some or all of these disclosure requirements to some or all private offerings (as defined in the relevant jurisdiction). Such a decision will require weighing the issuer burdens and investor interests involved.

45. Similarly, issuers of privately offered securities and their advisors may consider applying the disclosure requirements in this standard. This will entail balancing international good practice and investor preferences on one hand with the burdens involved and investor sophistication on the other hand.

### *Application to Governments, Governmental Entities and Multilateral Financial Institutions*

46. As mentioned above, offerings by some or all governments, governmental entities and multilateral financial institutions are typically exempted from disclosure requirements (though they often choose to observe them as a matter of good practice). To the extent an RSA already exempts offerings by such offerors from disclosure requirements generally, it could similarly choose to exempt their offerings from the disclosure requirements in this standard. To the extent an RSA applies more limited disclosure requirements to offerings by such offerors, it could choose to apply a subset of the disclosure requirements in this standard to such offerings. However, an RSA may wish to note that as a Sharī'ah matter (rather than a regulatory matter), the relevant Sharī'ah board may require disclosures as to certain Sharī'ah points. (Examples might include those appearing in paragraphs 88 and 103 below.) It should be noted that, as a matter of practice, such Sharī'ah-related information is almost always disclosed.

### *Application to Cross-border Offerings*

47. A cross-border offering is typically one where the issuer and offerees are in different jurisdictions, and denominated in either an international reserve currency or the currency of the target market. Cross-border issuances are often marketed to institutional, rather than retail, investors through private offerings. Most RSAs do not apply different disclosure requirements to an offering, solely due to the offering being a cross-border one. But the disclosure requirements applicable to a particular cross-border offering may be different for other reasons – for example, where the cross-border offering is a private offering (as is often the case).

48. IOSCO's disclosure standards for debt securities were expressed as being for cross-border offerings but were subsequently used as the basis for domestic disclosure regimes as well. This contributes to harmonisation of capital market standards across jurisdictions. Similarly, IFSB standards

aim to bring some harmonisation to the Islamic Capital Market. It follows that domestic offerings as well as cross-border offerings should, where possible, follow the same disclosure standards. This is particularly important where offerings are made into multiple jurisdictions simultaneously, which is the case with some larger international issuances. This standard therefore does not differentiate disclosure requirements solely based on whether a *ṣukūk* is a domestic or cross-border offering.

49. In applying this standard, RSAs should take care not to introduce undue burdens on cross-border private offerings – for example, through a requirement to rely on only Sharī'ah boards or scholars in their jurisdiction or to use a local securities information dissemination platform.

### *Terminology*

50. As already noted, the entity that formally issues a *ṣukūk* is often a special purpose vehicle.<sup>8</sup> In such cases, the proceeds of the *ṣukūk* will typically be received and deployed outside the *ṣukūk* structure by a commercial party. In line with past IFSB practice, this party is referred to in this standard as the “originator”.<sup>9</sup> In addition, while the issuer SPV has payment obligations under a *ṣukūk* structure, typically there is a commercial party that is the actual source of the periodic and final amounts expected to be paid to *ṣukūk* holders.<sup>10</sup> This entity is referred to in this standard as the “obligor”. The originator and the obligor are often, but not necessarily, the same.

## **2.2.2 Principle S.1: General Disclosure Principles Applicable to *Ṣukūk***

**The disclosure framework for any *ṣukūk* should reflect the particular characteristics of the securities.**

### *Rationale*

51. Some *ṣukūk* have certain characteristics that are broadly similar to types of existing conventional securities, whether simple (such as a debenture or a bond) or complex (such as a convertible bond or conventional asset-backed security), with which RSAs are already familiar. Many of the basic disclosures – for example, about the business and management of the originator – should therefore be similar. However, new *ṣukūk* structures may be introduced with basic financial, credit, risk or other characteristics that differ significantly from existing conventional instruments. Any such *ṣukūk* would additionally require disclosure which reflects those characteristics, as well as reflecting any special Sharī'ah considerations relating to those characteristics that a reasonable Sharī'ah-sensitive investor would find material.

52. *Ṣukūk* are sometimes offered without any mention of the term “*ṣukūk*” in the offering material, and investors infer from other indications that what is being offered is *ṣukūk*. In addition, it is conceivable that a security could be marketed with indications that would suggest it is a *ṣukūk*, when in reality it is not. In order to protect the integrity of the *ṣukūk* market, it is important that this standard applies to all *ṣukūk* irrespective of their name, and also that any security that appears to be a *ṣukūk* is held to the disclosure requirements for *ṣukūk*. This standard is designed to apply to any instrument that is a *ṣukūk* or would appear to be a *ṣukūk*, irrespective of the terminology used.

53. Some RSAs have regulatory provisions that allow them some discretion in the way they classify *ṣukūk* for regulatory purposes, depending on their economic characteristics. Such provisions are helpful in the light of the discussion above, but the IFSB recognises that not all legal systems would accommodate such discretionary provisions.

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<sup>8</sup> This term is used broadly in this standard to cover any structure established for the sole purpose of issuing securities, and with no other commercial function. While an SPV may take the form of a company, other structures are in use, particularly in civil law jurisdictions.

<sup>9</sup> This use of the term “originator” in the context of *ṣukūk* should not be confused with other uses of “originator” in finance – for example, in the context of conventional asset-backed securities – to refer to the entity creating a financial asset by, for instance, extending a loan or lease.

<sup>10</sup> For example, in an *ijārah ṣukūk*, this would be the party making periodic lease payments and then purchasing the leased asset through a purchase undertaking mechanism.

### Recommended Disclosures

54. Where a *ṣukūk* is similar in certain of its financial and risk characteristics to a conventional debenture or bond, for such a *ṣukūk* RSAs should base the disclosure requirements on the disclosure principles applicable to those securities.

55. *Ṣukūk* may have various features that vary the basic financial, credit and risk characteristics. These include security, any *kafālah* or guarantee, any redemption option, convertibility, exchangeability and subordination. For *ṣukūk* with one of these features, RSAs should base the additional or varied disclosure requirements relating to that feature on those that apply when a similar feature is included in a conventional debt security.<sup>11</sup>

56. In the case of *ṣukūk* that are convertible or exchangeable into equity of a listed company or include warrants giving *ṣukūk* holders the right to purchase equity of a listed company, additional disclosures relating to that equity or its issuer may also be appropriate, and should again parallel those for a conventional bond with corresponding features, subject to any special characteristics (e.g. as to the structure used to achieve convertibility, which may be different from that in the conventional case).

57. Some *ṣukūk* are issued by institutions offering Islamic financial services (IIFS) with the aim that they should be admissible as regulatory capital within either the Basel III regime or that set out in IFSB-15. Such *ṣukūk* must have specified loss-absorbency or convertibility characteristics, depending on whether they are to rank as Additional Tier 1 or as Tier 2 capital.<sup>12</sup> Their eligibility as regulatory capital will be a matter for the relevant banking supervisor to consider, which can be expected to mandate detailed disclosure of the loss absorbency or convertibility characteristics as a condition of its approval and to ensure that they are legally effective.

58. Some *ṣukūk* are designed to present the characteristics of conventional asset-backed securities (as described, for example, in IOSCO's *Principles for Public Offerings and Listings of Asset-Backed Securities* (2010)). There is no uniform definition for conventional asset-backed securities, though they tend to have certain characteristics<sup>13</sup> that differentiate them from conventional bonds. For *ṣukūk* presenting such characteristics, RSAs should base disclosure on the 2010 IOSCO principles (or on any existing regime in their jurisdiction for such securities).

59. Offering material for securities should not be misleading as to whether the securities offered are in fact *ṣukūk*. If the offering material taken as a whole would suggest to a reasonable Sharī'ah-sensitive investor that the securities offered are *ṣukūk*, the disclosure requirements in this standard should apply. Examples include the use of Arabic terms (in a non-Arabic text) for contracts (*aqd*), references to Sharī'ah, or references to Sharī'ah scholars or boards.

### **2.2.3 Principle S.2: Sharī'ah-related Disclosures for *Ṣukūk***

**Sufficient disclosures should be made about Sharī'ah aspects of the *ṣukūk* to allow an informed judgment as to initial and ongoing Sharī'ah compliance of the *ṣukūk* to be made.**

#### Rationale

60. Compliance with Sharī'ah is a key part of what *ṣukūk* offer. The sensitivity of investors to Sharī'ah issues varies, as does the extent to which they will be willing and able to form a view on such issues themselves. (Many retail investors, for example, would be content to rely on the existence of a *fatwā*

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<sup>11</sup> It should be noted that the starting point chosen by an RSA for developing disclosure requirements for a feature in *ṣukūk* does not imply anything about the debt basis of a *ṣukūk*.

<sup>12</sup> See paragraphs 27 and 29 of IFSB-15 for a more detailed discussion.

<sup>13</sup> These securities generally involve: (a) underlying financial assets that generate the cash flow supporting the securities; (b) absolute transfer of the financial assets such that the securities can withstand insolvency of the originator; (c) recourse only to the underlying financial assets (rather than the originator); and (d) a credit analysis focused on the financial assets (rather than the originator).

from any group of reputable scholars, while on the other hand a substantial IIFS might well submit the relevant documentation to detailed review by its own Sharī'ah advisors.)

61. Even where investors do not themselves wish to go deeply into Sharī'ah issues, disclosures made in publicly available, or otherwise accessible, documents allow commentators and others to discuss the issues raised by a particular issuance. This may also help in the longer term to promote convergence of Sharī'ah interpretation in this market.

62. Although this does not happen frequently, the need for Sharī'ah input may arise in a *ṣukūk* after issuance – for example, where the underlying asset or activity changes, or if there is to be enforcement or restructuring. It is important for investors to know what, if any, arrangements have been made for this.

63. Disclosures for a security would normally include the choice of governing law and jurisdiction of dispute resolution for each of the agreements involved. However, in the case of *ṣukūk*, it may be important for investors to have some indication of how Sharī'ah requirements may be taken into account within the relevant legal system.<sup>14</sup> This may be significant even if the investor is not himself Sharī'ah-sensitive, because of the possibility that challenges on such grounds might be brought by others.

### Recommended Disclosures

#### *Sharī'ah Scholars and the Review Process*

64. Disclosure should identify which Sharī'ah board or advisory firm has opined on the Sharī'ah compliance of a *ṣukūk*, name the Sharī'ah scholars involved, and describe the nature of their relationship<sup>15</sup> to the originator, obligor or arranger. Sufficient information about the scholars (including their credentials and experience) should be disclosed to allow an investor to decide the reliance it is prepared to place on them.

65. If the relevant jurisdiction regulates Sharī'ah governance or interpretation on a nationwide or market-wide level (e.g. by having a national Sharī'ah board or capital markets Sharī'ah council), this should be described.

66. Disclosure should describe the Sharī'ah review process followed and what documents (e.g. term sheets, summary papers, drafts contracts and/or final contracts) were reviewed by the scholars. It should also indicate whether there were related external arrangements that were not considered (e.g. external hedging arrangements).

67. If the originator, the arrangers or any other party to the *ṣukūk* arrangements is making a representation as to the Sharī'ah compliance of the *ṣukūk*, this should be clearly disclosed. Where none of these parties is making any representation as to the Sharī'ah compliance of the *ṣukūk*, this should be disclosed in a clear disclaimer.

#### *Fatwā and Reasoning*

68. Any *fatwā* relating to the *ṣukūk* (and its issue and trading) should be disclosed in the offering document, or otherwise by making it available to prospective investors – for example, by posting it on a website accessible to them.

69. Disclosure should include: (a) the rationale for the conclusion of Sharī'ah compliance; and (b) the *applicable Sharī'ah principles* and rulings. Disclosure of these items may be through disclosure of the *fatwā* itself, to the extent it includes the items mentioned.

#### *Underlying Assets and Activities*

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<sup>14</sup> If the rules of a legal system would be fundamentally irreconcilable with Sharī'ah requirements, then that legal system would not be an appropriate choice of governing law for a *ṣukūk*.

<sup>15</sup> This might include, for instance, the party who appointed the Sharī'ah board or advisory firm, and whether the Sharī'ah advisors are internal employees or external advisors.

70. Any particular Sharī'ah deficiency or limitation in relation to the asset(s) or activities underlying the *ṣukūk*, as well as the risks of these arising in the future, should be disclosed. For example, where a pool of underlying assets includes cash and receivable-type assets, any ratios that must be observed for the asset pool should be disclosed. In addition, any underlying assets or activities that include an impermissible component that requires purification should be disclosed.

#### *Tradeability*

71. If, in the view of the Sharī'ah board or advisory firm opining on the *ṣukūk*, there are limitations to be observed on the tradeability of the *ṣukūk* in the secondary market (e.g. trading only at par or on a spot basis), these limitations should be disclosed and the reasoning should be explained. If the limitation is such that the *ṣukūk* may not be traded or transferred in a Sharī'ah-compliant manner at negotiated prices, then the offering document for the *ṣukūk* should bear a prominent legend stating that the *ṣukūk* may not be traded or transferred in a Sharī'ah-compliant manner.

#### *Purification and Compensation Payments*

72. Disclosure should state whether or not there are arrangements made in the *ṣukūk* contracts for purification payments to be made in respect of non-Sharī'ah-compliant income arising within the *ṣukūk* arrangements. If such arrangements are made, the basis on which purification payments are made should be described, as should the bodies to which they will be made in so far as these are known at the time.

73. Disclosure should state whether or not there are arrangements made in the *ṣukūk* contracts for *ta'widh* or other compensation payments to be made on overdue amounts under the *ṣukūk*, and if so under what circumstances such a payment is imposed, on which party it is imposed, and the rate and manner of payment and how it will be utilised (to the extent mentioned in the *ṣukūk* documentation).

#### *Other Sharī'ah-related Payments*

74. If there are arrangements within the *ṣukūk* structure for *zakāh* or any other Sharī'ah-related payments to be made in relation to the asset or activity underlying the *ṣukūk*, disclosure should describe these arrangements, including how and to whom payments are to be made.

75. If *ṣukūk* holders are to be responsible for determining and paying their own Sharī'ah-related payment obligations arising from acquiring, holding or disposing of the *ṣukūk*, this should be stated.

#### *Sharī'ah and Interpretation*

76. Disclosure should state what role (if any) Sharī'ah would play in the interpretation of the *ṣukūk* contracts (whether interpretation by the parties performing the contracts, or interpretation in a legal forum applying the selected governing law), and particularly in default, enforcement, amendment or restructuring. In jurisdictions where courts are not bound to apply Sharī'ah in interpreting contracts, disclosure should state that courts would be expected to apply the relevant national law rather than Sharī'ah principles in interpreting the *ṣukūk* contracts, and, if it is the case, describe the possibility that the resulting interpretation may not be consistent with Sharī'ah principles.

#### *Sharī'ah Guidance in Matters Arising Post-Issuance*

77. Disclosure should describe any arrangements in place to provide Sharī'ah assessments or ad hoc Sharī'ah determinations in extraordinary matters that may arise following issuance of the *ṣukūk*, such as default, enforcement, amendment or restructuring. If there are no such arrangements, any potential consequences for Sharī'ah-compliant investors should be disclosed.

#### *Ongoing Disclosure*

78. Periodic Sharī'ah-related disclosures for *ṣukūk* should include details of payments made in respect of purification or compensation as described in paragraphs 72 and 73 and Sharī'ah-related

payments made as described in paragraphs 74 and 75. Any conflicts of interest relating to such payments should be disclosed.

79. Immediate Sharī'ah-related disclosures for *ṣukūk* should include:

- (i) any new *fatwā* or confirmation relating to the *ṣukūk*;
- (ii) any material changes in the matters disclosed under paragraph 70 (*Underlying Assets and Activities*);
- (iii) any changes in the matters disclosed under paragraph 71 (*Tradeability*); and
- (iv) any changes to the arrangements disclosed under paragraph 77 (*Sharī'ah Guidance in Matters Arising Post-Issuance*).

### 2.2.4 Principle S.3: Structure-related Disclosures for *Ṣukūk*

**The structure of the *ṣukūk* should be described with sufficient clarity to allow an investor to understand it and any risks associated with it, including any legal risks associated with the interactions of multiple parties within the *ṣukūk* structure under various agreements.**

#### Rationale

80. In the disclosure of structure-related aspects of *ṣukūk*, clear and understandable language and presentation format are particularly important because of the complexities involved and the use of terminology that may not be familiar to some investors. In the application of Principle G.1, particular attention should therefore be paid to the issue of clarity of language and presentation, taking into account the type of investor who may invest in the particular *ṣukūk*. The language and format of disclosure may take account of the likelihood that some types of investors may or may not have access to and consult with professional advisors. The standard for clarity for a publicly offered *ṣukūk* is therefore higher than for a privately offered one.

81. One of the most fundamental of the financial and risk aspects of a *ṣukūk* is the ultimate source of payments on the *ṣukūk*. Clear and consistent disclosure on this point is necessary so that individual investors, and the market as a whole, have a clear and common understanding.

82. A particular issue in *ṣukūk* contracts and disclosure concerns the recourse that *ṣukūk* holders, or a trustee or other party acting on their behalf, have to the assets underlying the *ṣukūk* or their proceeds. In some cases, the proceeds of the underlying assets are available for *ṣukūk* payments only with the significant limitation that they may not be freely disposed in enforcement. Therefore, undue emphasis on recourse to the underlying assets can deflect from the fact that the proceeds of the underlying assets depend fundamentally on the creditworthiness and performance of the *ṣukūk* obligor, rather than solely on the performance of the underlying assets. It is important that any asset recourse arrangements, and any related Sharī'ah matters, are clearly explained and their limitations described.<sup>16</sup>

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<sup>16</sup> As mentioned in footnote 115 in IFSB-15, the Sharī'ah board of the IDB is of the following view:

*Ṣukūk* assets must be undividedly owned by the *ṣukūk* holders either directly or through their agent (SPV). This ownership should be valid from both the legal and Sharī'ah perspectives, in the sense that the *ṣukūk* holders (whether as individuals or through their agent – that is, an SPV) have the ownership of the underlying assets. The ownership of the underlying assets should be transferred to the *ṣukūk* holders and registered in their names with legal authorities. (These *ṣukūk* may be known, rather incongruously, in the market as “asset-backed”.) However, in jurisdictions where there is a prohibition on transferring legal titles to such assets, only the beneficial ownership is permitted to be transferred to the *ṣukūk* holders (such *ṣukūk* may be known, rather incongruously, in the market as “asset-based”) based on the following conditions:

- (a) The definition of beneficial ownership must be stated clearly in the *ṣukūk* documentation. The beneficial ownership of *ṣukūk* assets refers to valid ownership with all the rights and obligations, but excluding the right of registration with the legal authorities.
- (b) There must be a statement by the SPV (included in the trust certificate) confirming that valid ownership has been transferred to the *ṣukūk* holders along with associated rights and obligations. The SPV may only utilise the assets in accordance with terms permitted by the *ṣukūk* holders, as the assets have been registered under the SPV's name as a fiduciary only.
- (c) The trust certificate can be enforced through legal mechanisms in legal systems which prohibit the legal transfer of the underlying assets to the *ṣukūk* holders.

83. In the capital market, if an obligor's obligation experiences an "event of default",<sup>17</sup> then that obligor's other obligations typically also experience an event of default via a so-called contractual cross-default provision. These provisions serve important purposes, including ensuring that all holders of obligations are treated in accordance with their contractual and legal expectations in a restructuring or insolvency, and that the obligor treats all its obligations without bias. The absence of such clauses can materially impact the rights of *ṣukūk* holders.

84. Finally, when a *ṣukūk* obligor encounters difficulties in meeting its obligations in relation to its *ṣukūk*, three possible outcomes are: (i) a restructuring of the *ṣukūk* (either before or after an actual default), (ii) enforcement (following default and acceleration), and (iii) insolvency. All of these options may be constrained by two factors, however – namely, Sharī'ah considerations and limitations on ownership rights of *ṣukūk* holders in the asset underlying the *ṣukūk* structure. The effect of these two factors on restructuring of the *ṣukūk*, enforcement of the *ṣukūk* and participation in insolvency proceedings requires disclosure.

#### *Structure and Contracts*

85. In order to present an overall view of the interaction of parties to the *ṣukūk* structure and the contracts creating the *ṣukūk* structure, both the structure and the flows of funds should be summarised by way of diagrams. In particular, the disclosure should include a structural diagram identifying the parties to the *ṣukūk* structure, their capacities and the principal contractual relationships among them. The disclosure should also include a diagram showing the parties to the *ṣukūk* structure and the movements of funds and assets among them, both initially at issuance and periodically during the life of the *ṣukūk* through repayment.

86. If the sequence in which the entry into contracts, making of payments, transfer of assets and issuance of the *ṣukūk* is significant to the determination of Sharī'ah compliance, the sequence should be disclosed.

87. If a particular nominate contract (*aqd*) is used in the structure, the name should be disclosed, along with its translation into the language of the disclosure document.

88. A summary of the principal contracts that comprise the *ṣukūk* structure should be disclosed. In particular, terms with legal significance and allocations or transfers of risks (e.g. any *kafālah* or guarantee or *takāful* or insurance arrangements) should be described.

#### *Some Specific Contracts and Arrangements*

89. The paragraphs that follow set out items of disclosure for some specific contracts or arrangements used in *ṣukūk* but are not intended to be exhaustive.

90. In the case of a *ṣukūk* based on or including an *Ijarah* arrangement, the following specific matters relating to the *ijārah* should be disclosed:

- (a) the asset(s) being leased and the usage of the asset;
- (b) the lease period and the rental rate (if the rental rate is variable, with a detailed explanation of the manner of calculating the rate);
- (c) whether a sublease of the asset is permitted;
- (d) the circumstances in which the lease may be terminated early, and the consequences of early termination for *ṣukūk* holders;
- (e) the arrangements for maintenance of the leased asset;
- (f) the arrangements, if any, for *takāful* or insurance of the leased asset; and
- (g) the mechanism, if any, for re-transfer of the asset from the lessor at the end of the lease period.

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In the view of the Sharī'ah board of the IDB, "asset-based" *ṣukūk* may only be issued in a Sharī'ah-compliant manner by the observance of the above conditions.

<sup>17</sup> "Event of default" refers to an event the occurrence of which permits the holders of an instrument to effectively terminate the funding created by that instrument. The terminology for such events can vary from instrument to instrument. Events of default are negotiated among transaction participants and defined in the relevant contracts. They can be as narrow as a failure of holders to receive a payment when scheduled, or may be broader and include breach of representation or covenant, insolvency-type events, invalidity or ineffectiveness of contracts or security, illegality, repudiation, or material adverse change.

91. In the case of a *ṣukūk* based on or including an *istisnā`* (or parallel *istisnā`*) arrangement, the following specific matters relating to the *istisnā`* must be disclosed:

- (a) the asset(s) being manufactured or built and the usage of the asset;
- (b) the delivery date of the asset(s);
- (c) the form, amount(s) and timing for payment(s) of the *istisnā`* consideration, including any down payment;
- (d) any additional manufacturers, builders or subcontractors of the asset(s);
- (e) any security given for the obligations under the *istisnā`*;
- (f) any warranties and any arrangements for maintenance of the asset(s) after delivery; and
- (g) the circumstances in which the asset(s) may be rejected, and the consequences of any failure to deliver or accept delivery for *ṣukūk* holders.

92. In the case of a *ṣukūk* based on or including a *mushārah* arrangement, the following specific matters relating to the *mushārah* should be disclosed:

- (a) the identities of the partners, the capital contributed by each, and the form of that capital (whether cash, in kind or both);
- (b) the identity of the manager of the *mushārah*;
- (c) the subject of the *mushārah* venture;
- (d) if a *kafālah* or guarantee of the capital is provided, the identity of the guarantor, the principal terms of the guarantee and what amounts are guaranteed, any fee payable and whether the guarantee is Sharī'ah-compliant;
- (e) the manner of allocation of profits and losses of the *mushārah* among the partners; and
- (f) waiver (*tanāzul*) of a partner's rights to profit payments (if any).

93. In the case of a *ṣukūk* based on or including a *muḍārah* arrangement, the following specific matters relating to the *muḍārah* should be disclosed:

- (a) the identities of the *rabb al-māl* and the *muḍārib*;
- (b) the capital contributed by the *rabb al-māl* and the form of that capital (whether cash, in kind or both);
- (c) the subject of the *muḍārah* venture;
- (d) if a *kafālah* or guarantee of the capital is provided by a third party, the identity of the guarantor, any relationship to the *ṣukūk* obligor or issuer, the principal terms of the guarantee and what amounts are guaranteed, any expenses payable, and whether the guarantee and the related expenses paid are Sharī'ah-compliant;
- (e) if any *rahn* (collateral) is given by the *muḍārib*, to secure against losses resulting from its negligence, misconduct or failure to satisfy conditions, the principal terms of the *rahn* and under what circumstances it may be applied against losses resulting from its negligence, misconduct or failure to satisfy conditions;
- (f) the manner of allocation of profits of the *muḍārah* between the *rabb al-māl* and the *muḍārib*, and under what circumstances the *muḍārib* may be liable for losses; and
- (g) waiver (*tanāzul*) of the *rabb al-māl*'s or *muḍārib*'s rights to profit payments (if any).

94. In the case of a *ṣukūk* based on or including a *wakālah bil istithmār* arrangement, the following specific matters relating to the *wakālah* should be disclosed:

- (a) the identity of the *wakīl*;
- (b) the subject of the *wakālah* investments;
- (c) if a *kafālah* or guarantee of the capital is provided by a third party, the identity of the guarantor, any relationship to the *ṣukūk* obligor or issuer, the principal terms of the guarantee and what amounts are guaranteed, any expenses payable and whether the guarantee and the related expenses paid are Sharī'ah-compliant;
- (d) any investment policy or parameters to be observed by the *wakīl*; and
- (e) the fee of the *wakīl* (including any performance incentive fee).

95. In the case of a *ṣukūk* based on or including a *salam* arrangement (or parallel *salam*), the following specific matters relating to the *salam* should be disclosed:

- (a) the parties;
- (b) the commodity that is the subject of the *salam*;
- (c) the capital of *salam*;
- (d) the delivery date of the *salam* commodity; and
- (e) any security given for the obligations under the *salam*.

96. In the case of a *ṣukūk* with an exchangeability or convertibility into shares arrangement, the following matters should be disclosed:

- (a) on what basis and by whom the relevant shares have been determined to be Sharī'ah-compliant;
- (b) any risk that the relevant shares might become non-compliant in the future; and
- (c) any accommodation for *ṣukūk* holders should the relevant shares become non-compliant.

#### *Underlying Assets and Ownership Rights*

97. The assets, investments and/or activities underlying the *ṣukūk* structure should be disclosed, together with the intended use of the assets within the *ṣukūk* arrangements. Any partial or incidental use, investment or activity that does not comply with Sharī'ah should be described (see paragraph 70 above).

98. Where valuation of the asset is relevant to the Sharī'ah analysis, disclosure should state who has performed or will perform the valuation, the basis for the valuation (e.g. based on market value, on fair value, or on another basis), when the valuation was performed and whether a valuation report has been prepared).

99. If there are arrangements for assets underlying the *ṣukūk* structure to be varied or substituted during the lifetime of the *ṣukūk*, these arrangements and the substitution parameters should be disclosed, including how substituted assets will be valued.

100. Any arrangement that transfers or mitigates the ownership risks or price risks relating to assets underlying the *ṣukūk* structure, such as *takāful* or insurance or a repurchase undertaking, should be disclosed.

101. Any encumbrance on the assets underlying the *ṣukūk* should be disclosed, together with the consequences of enforcement or other action by the party for whose benefit the asset is encumbered.

102. The mechanisms for the transfer of the asset into the *ṣukūk* structure at the time of issuance and the transfer of the asset out of the *ṣukūk* structure at redemption (e.g. via purchase undertaking) should be disclosed.<sup>18</sup>

103. The precise legal interests of the issuer and *ṣukūk* holders in the asset should be disclosed, without solely relying on terms such as "legal ownership", "beneficial ownership"<sup>19</sup> or "usufruct right", whose meanings may vary across jurisdictions. In addition, any particular rationale for choosing a more limited legal interest where a more extensive one exists should be explained.

104. If the rights that the issuer and *ṣukūk* holders have in the asset underlying the *ṣukūk* structure (directly or via an agent or trustee or otherwise) are limited under the *ṣukūk* contracts to something less than the full rights of an owner holding that type of asset free of any encumbrances, the limitations should be disclosed (e.g. if *ṣukūk* holders are legally constrained in the right to take control of the asset, use it or dispose of it).

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<sup>18</sup> Refer to footnote 16.

<sup>19</sup> Refer to footnote 16.

### *Trustee, Delegate Trustee or Agent*

105. Where a trustee or delegate trustee or agent is appointed to act for *ṣukūk* holders, disclosure should describe:

- (a) the rights, obligations and powers of the trustee, delegate trustee or agent;
- (b) the circumstances and prerequisites for the trustee, delegate trustee or agent acting on behalf of *ṣukūk* holders (e.g. requirements for valid instructions and indemnity requirements);
- (c) the role of the trustee, delegate trustee or agent in default, acceleration, enforcement or restructuring of the *ṣukūk*;
- (d) provisions for termination of the trustee, delegate trustee or agent; and
- (e) which party will be responsible for the fees and expenses of the trustee, delegate trustee or agent.

### *Use of Proceeds*

106. The use of proceeds of the *ṣukūk* issuance by the entity or entities that ultimately deploy the proceeds, in whole or in part, for some use outside the *ṣukūk* structure should be disclosed. This means disclosure should describe the use of proceeds beyond the initial application by any SPV used in the *ṣukūk* structure.

### *Source of Payments and Recourse*

107. The ultimate source(s) of funds used to make distributions on a *ṣukūk*, both on an ongoing basis and in enforcement, should be disclosed clearly and prominently. For example, if investors must ultimately look to the creditworthiness and performance of the *ṣukūk* obligor for payment, or to the performance and credit quality and disposal value of the underlying assets, this should be disclosed. Where the structure of the *ṣukūk* is such that the ultimate source of payments, whether on an ongoing basis or in enforcement, is the *ṣukūk* obligor, disclosure of the recourse aspects should focus on the *ṣukūk* obligor and not unduly on the underlying assets. References to the underlying assets as a source of payments on the *ṣukūk* should be accompanied by clear statements explaining any contractual limitations in disposing of or enforcing against those assets and explaining that the performance of the underlying assets depends entirely on the performance of the *ṣukūk* obligor under its contractual obligations. If the *ṣukūk* structure includes forms of Sharī'ah-compliant credit enhancement that elevate its effective credit quality above the creditworthiness of the *ṣukūk* obligor (such as security or *kafālah* or guarantees), these should be disclosed, based on disclosure requirements relating to conventional credit enhancement.

### *Default, Acceleration, Enforcement, Restructuring and Insolvency*

108. Disclosure should state whether or not the *ṣukūk* obligor has conventional debt (bonds or bank loans), and if so whether or not (a) its *ṣukūk* contains a cross-default provision that is triggered by default of its conventional debt, and (b) its conventional debt contains a cross-default provision that is triggered by default of its *ṣukūk*.<sup>20</sup> If either of these linkages does not exist, this must be disclosed and the risks to *ṣukūk* holders must be described.<sup>21</sup>

109. Disclosure should state whether the *ṣukūk* contracts limit a restructuring of the *ṣukūk* (assuming that necessary *ṣukūk* holder consents are obtained) to one that is Sharī'ah-compliant, or whether the *ṣukūk* contracts would also permit a non-compliant restructuring to take place. Any arrangements set out in the *ṣukūk* contracts to facilitate a Sharī'ah-compliant restructuring (such as for obtaining Sharī'ah guidance) should be disclosed. If a non-compliant restructuring is not contractually excluded, any provisions or accommodations for the treatment of *ṣukūk* holders who may not want to participate in a non-compliant restructuring should be disclosed.

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<sup>20</sup> See footnote 17.

<sup>21</sup> While appropriate *ṣukūk* cross-default provisions do not appear to be systemically lacking in practice, under basic disclosure principles the risks associated with such an absence, if it were the case, should be disclosed.

110. Disclosure should state whether there is a risk that, in an insolvency proceeding of the *ṣukūk* obligor, its payment obligations under the *ṣukūk* contracts<sup>22</sup> may be treated differently than its (other) unsecured obligations.

111. If the *ṣukūk*-issuing SPV, as a Sharī'ah-compliant entity, faces Sharī'ah constraints in participating in an insolvency proceeding of the *ṣukūk* obligor or accepting distributions from the insolvency estate, this should be disclosed and the constraints described.

112. Disclosure should describe the effect that limitations in ownership rights in the asset underlying the *ṣukūk* structure would have on enforcement. For example, if underlying assets in which *ṣukūk* holders have an ownership interest may not be seized and freely sold in an enforcement (subject to the usual legal processes in the relevant jurisdiction), this should be disclosed.

113. The precise mechanisms for pursuing recourse to the *ṣukūk* obligor or asset in enforcement should be disclosed. In addition, the disposition of the underlying asset following default should be disclosed (including who may or will be enjoying its use, and to whom it may or is required to be transferred and under what conditions).

114. If there is uncertainty as to how courts in the relevant jurisdiction might interpret or enforce key provisions in *ṣukūk* contracts that are legally untested (e.g. relating to insolvency or post-default asset transfers), this risk must be disclosed.

#### *Ongoing Disclosure*

115. Immediate structure-related disclosures for *ṣukūk* should include any amendments or modifications to the contracts disclosed under this principle that would affect the Sharī'ah aspects of the *ṣukūk*, any changes in the matters disclosed under paragraph 96 in relation to convertible or exchangeable *ṣukūk*, any material changes in the assets, investments and/or activities underlying the *ṣukūk* structure (together with the related information to be disclosed under paragraph 97), any appointment or replacement of a trustee, delegate trustee or agent (together with the related information to be disclosed under paragraph 105), and any changes in the matters disclosed under paragraphs 106 (*Use of Proceeds*) or 107 (*Source of Payments and Recourse*).

116. In addition, if a *ṣukūk* becomes subject to a restructuring or an insolvency proceeding, all matters that a reasonable Sharī'ah-sensitive investor would consider material to a decision to hold or dispose of its *ṣukūk*, or would require in order to make an informed decision in any vote of *ṣukūk* holders, should be disclosed.

#### *Other Material Information*

117. In addition to the specific disclosure items described above, initial and ongoing disclosure should include any other matters that a reasonable Sharī'ah-sensitive investor would consider material to an investment decision as to the *ṣukūk*.

### **2.2.5 Principle S.4: Entities about which Disclosures Should be Made**

**Appropriate disclosures should be made about all entities material to an investment decision in the *ṣukūk*.**

#### *Rationale*

118. Conventional debt disclosure principles are based on a structure in which the issuer of the securities receives the proceeds and is the obligor responsible for repayment. However, a *ṣukūk* issuer is typically an SPV and different from the *ṣukūk* obligor. Therefore, RSAs should be careful to require

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<sup>22</sup> This payment obligation may, for example, consist of an obligation to pay the purchase price for an asset under a purchase undertaking in the case of a lessor transferring ownership of leased assets to the lessee on termination of the lease.

relevant disclosures in *şukūk* to be made not only about the *şukūk* issuer but also about the *şukūk* obligor (and *şukūk* originator, where this is different from the obligor).

119. Similarly, in some jurisdictions, liability for defective disclosure may fall on a *şukūk* issuer, without contemplating the possibility of an obligor or originator that is different from the issuer. RSAs should be careful that liability for defective disclosure in *şukūk* falls not only on the *şukūk* issuer but also on the obligor and originator of the *şukūk*.

120. Typically, an offering document that refers to experts and includes their reports is required to disclose that the expert has consented to the inclusion of its name (and, where applicable, report) in the offering document and has not subsequently withdrawn its consent. Sharī'ah advisors should be regarded as experts within such a regime.

121. This standard addresses only disclosure requirements and is not intended to modify existing arrangements within a jurisdiction as to the parties required to prepare, or participate in preparing, disclosure or related filings and reports, nor the duties or standards of care that apply to them (e.g. the responsibilities of directors or auditors).

#### Recommended Disclosures

122. Where the *şukūk* obligor(s) differ from the *şukūk* issuer, the information normally required to be disclosed in relation to an issuer (such as the issuer's business description or its financial statements), whether initial or ongoing, should also be disclosed in relation to the *şukūk* obligor(s). Other than the foregoing requirement, this standard is not intended to modify existing requirements as to parties about which information must be disclosed (such as Sharī'ah-compliant guarantors).

123. Where the *şukūk* obligor(s) or originator(s) differ from the *şukūk* issuer, the liability for defective disclosure normally applying to an issuer should also apply to the *şukūk* obligor(s) and originator(s).<sup>23</sup>

124. A *şukūk* disclosure document that refers to Sharī'ah advisors or includes their *fatwā* should include a statement of consent from the Sharī'ah advisors as to inclusion of their names and *fatwā*.

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<sup>23</sup> This paragraph is not strictly a disclosure requirement, but describes a principle that RSAs should bear in mind in determining which parties must bear liability for defects in disclosure.

## 2.3 ICIS Disclosure

### 2.3.1 Application

#### *Application to Different Legal Structures*

125. ICIS can play an important role, channelling resources to the securities markets and offering *Sharī'ah*-sensitive investors a means to achieve diversified exposure to *Sharī'ah*-compliant investment opportunities. The terms “CIS” and “ICIS” include open-ended funds that will redeem their units or shares (whether on a continuous or periodic basis). They also include closed-ended funds whose shares or units are traded on regulated or organised markets. The rules governing the legal form and structure of CIS vary across jurisdictions. Common forms include open-ended investment company (OEIC, SICAV or similar), closed-ended investment company, unit trust and limited partnership, but this list is not exhaustive.

126. Some jurisdictions allow umbrella funds, in which a single overall governance structure operates a number of subfunds with different investment strategies. Umbrella funds pose certain governance issues,<sup>24</sup> with associated disclosure requirements. However, the special issues and disclosure requirements are similar as between conventional and Islamic variants.

127. The provisions set out in this section are intended to apply across all ICIS structures. Where some distinctions are drawn, most commonly between open-ended and closed-ended structures, they are drawn explicitly. They do, however, assume the kind of separate regulation and legal and structural requirements expected by the relevant IOSCO standards, notably Core Principles 24–27.<sup>25</sup> Some other structures used in Islamic finance – for example, profit-sharing investment accounts and, in particular, restricted profit-sharing investment accounts – have some features in common with ICIS. It is for RSAs to decide to what extent it is appropriate to apply the requirements of this standard to such structures.

#### *Application to Different Types of Investment*

128. This standard, like the main conventional standards,<sup>26</sup> is principally aimed at ICIS that invest in tradeable securities, and specifically securities listed on an exchange. Such securities have the advantages of transparent pricing and a degree of liquidity. These advantages are shared by some other asset types – for example, cash or gold bullion. ICIS that deal in other types of asset, such as unlisted securities or real estate, may raise additional issues. Disclosure provisions for some specific specialist types of ICIS are specified under Principle C.3.

129. Some types of *Sharī'ah*-compliant assets may pose risks that their conventional counterparts do not (e.g. liquidity or valuation risks, for assets that are infrequently traded). Disclosures in respect of such risks would be required by conventional frameworks, but in their supervisory practice RSAs should be alert to ensure that such disclosures are in fact made.

130. Conventional hedge funds typically invest in a wider range of instruments, including derivatives, and also have the ability to sell short. They typically have separate, lighter, regulatory requirements and are not allowed to be sold to retail investors. Because of *Sharī'ah* requirements, it is very difficult to constitute a *Sharī'ah*-compliant hedge fund. This standard is therefore not intended to apply to hedge funds.

#### *Application to Non-retail Funds*

131. CIS normally target retail investors, and the disclosure requirements, both in IOSCO standards and in this standard, are written around the needs of retail investors. However, in practice, most jurisdictions tend to reduce regulatory oversight in relation to private placements or funds available only to a restricted class of investors. The definition of what amounts to an offer to the public, and what funds may be offered to retail investors, varies. Factors commonly taken into account include the number of

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<sup>24</sup> For example, concerned with transactions between subfunds.

<sup>25</sup> In the numbering of the 2011 Principles.

<sup>26</sup> For example, the IOSCO Core Principles.

investors, their net worth or investable assets, and their experience or sophistication. However, this standard does not attempt to set out in what circumstances or in what ways regulatory requirements should be reduced.

132. There are exceptions to this approach for certain specialist types of ICIS – for example, Islamic private equity funds – which in many jurisdictions could not be offered to retail investors. Where a comment to this effect appears in the text, the disclosure requirements are specified for the types of investor who would normally be allowed to invest in such a fund.

#### *Application to Cross-border Sales*

133. Jurisdictions vary in the extent to which they permit CIS from other jurisdictions to be offered to their investors. Where such offers are permitted, the CIS in question normally have to comply with domestic disclosure requirements (subject to any appropriate exemptions – e.g. for private offers). They thus raise no special issues of disclosure. However, in some cases,<sup>27</sup> passporting or mutual recognition arrangements exist that will normally be based either on an assessment that the other jurisdiction's regulation is satisfactory, or on adoption by a group of nations of common regulatory provisions. Where such approaches are adopted for ICIS, the assessment or the common regulatory provisions should cover regulation of ICIS specifically.

#### *Disclosure Documents*

134. Within a normal disclosure framework, an ICIS will need to produce a prospectus that is regularly updated. In some jurisdictions, it may also have to produce a shorter document, a key information document, typically of a few pages at most and often aimed at retail investors.<sup>28</sup> Where a KID is required, the full prospectus should also be available to investors – for example, through a hyperlink. As regards continuing disclosure, an ICIS is likely to have to produce an annual report, and possibly an interim report. There will also be types of change to the ICIS of which investors must be notified, and which in some cases they may have to approve. Because of the expense of notifying a large number of investors, these changes will typically be confined to fundamental ones.

#### *Note on Sharī'ah Compliance Disclosures*

135. This section sets out a number of disclosures that should be made concerning the Sharī'ah compliance of various activities.<sup>29</sup> There are broadly two approaches to such matters. One is to make direct disclosures about what will be done; the other is to describe the process by which compliance will be secured, normally involving the appointment of Sharī'ah advisors. The former will normally be more comprehensible to retail investors (to whom most ICIS are aimed), but some legal environments might leave the ICIS operator open to legal action founded solely on differing interpretations of Sharī'ah. The extent of this risk can be reduced in various ways, including by providing a “reasonable enquiry and reasonable belief” defence against liability, or by submitting all issues of Sharī'ah interpretation to a relevant national-level Sharī'ah authority, where one exists. RSAs implementing this standard should consider the terms in which Sharī'ah-related disclosures should be made in the light of their own legal and Sharī'ah governance environments.

### **2.3.2 Principle C.1: Sharī'ah-related Disclosures for ICIS**

**An ICIS should make sufficient disclosures about its Sharī'ah governance and Sharī'ah compliance to allow an investor sensitive to those issues, and of a type for whom the ICIS is intended, to make an informed decision whether to invest or to remain invested.**

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<sup>27</sup> For example, within ASEAN.

<sup>28</sup> A document of this kind may be called a “key information document (KID)” or a “factsheet”, or some other name. The term “KID” is used here to refer to any such document.

<sup>29</sup> For example, that cash balances will be invested in a Sharī'ah-compliant way.

## Rationale

136. ICIS pose different issues of Sharī'ah governance from *ṣukūk*, because they buy and sell investments during their lifetime, and issues of Sharī'ah compliance therefore arise continuously throughout their lifetime. For most ICIS, Sharī'ah advisors cannot make individual decisions each time a stock is bought or sold, and they therefore approve a set of screening criteria on the basis of which investments can be judged compliant or otherwise. Some ICIS do not have their own Sharī'ah advisors, but rely instead on a list of approved investments, or a screening method, produced by a national body or a commercial one (e.g. an index provider) and approved by its Sharī'ah advisors.

137. Some Sharī'ah-related disclosures particularly relevant to specialist types of fund are discussed under Principle C.3.

## Recommended Disclosures

### **Investments, Sharī'ah Review and Governance**

138. An ICIS should disclose in its prospectus the type or types of Sharī'ah-compliant assets in which the fund will invest, and the process that will be used to ensure that each such asset is Sharī'ah-compliant.

139. Where this depends on an externally produced list of compliant assets or a screening methodology, the ICIS should give details. Where the information is extensive, broad details may be given in the prospectus, together with a reference (e.g. through a URL) to more detailed information. It should give the names and qualifications of the Sharī'ah scholars responsible for approving the methodology and, where available, the relevant *fatwā*.

140. Where the ICIS maintains or employs its own Sharī'ah board or other Sharī'ah advisory body, it should give the names of the Sharī'ah scholars, their qualifications, the roles and responsibilities of the Sharī'ah advisory body and the Sharī'ah review process followed. This should include the frequency of Sharī'ah meetings, the frequency of review of the ICIS's investments or investment methodology, circumstances where Sharī'ah non-conformity of the Sharī'ah principles may occur, and the internal controls and procedures to detect and to minimise the risks of such non-conformity.

141. An ICIS should disclose in its prospectus the processes for internal and/or external Sharī'ah audit.

142. An ICIS should disclose in a KID, where one is required, the type or types of Sharī'ah-compliant assets in which it will invest, the names of its Sharī'ah advisors (if any), and brief details of any externally produced list or screening methodology it will use. It should also disclose any special Sharī'ah-related risks.

143. Material changes to any of the matters set out above should be reported in the annual and/or interim reports. A material change in investment strategy is likely also to be a matter requiring investor approval and, therefore, immediate disclosure.

144. An ICIS should also include in its annual report a report from its Sharī'ah advisors (if any) on the operations of the ICIS during the year, and the report of any external Sharī'ah auditor.

### **Treatment of Tainted Assets or Income**

145. An ICIS should explain in its prospectus its processes for review of the continuing Sharī'ah compliance of its investments, and for divestment from any investment determined to be no longer compliant. It should also state whether or not there are arrangements made for purification payments to be made in respect of non-Sharī'ah-compliant income. If such arrangements are made, the basis on which purification payments are made should be described, as should the bodies to which they will be made in so far as these are known at the time.

146. An ICIS should disclose in its annual report the amount of tainted income received, to what bodies purification payments have been made, and the amounts paid to each.

### ***Zakāh or other Sharī'ah-related Obligatory Payments***

147. An ICIS should disclose in its prospectus whether or not it has arrangements for *zakāh* payments or any other Sharī'ah-related obligatory payments, where applicable, to be made on behalf of the investors, on any assets subject to *zakāh*. If such arrangements exist, how and to what bodies *zakāh* or other Sharī'ah-related obligatory payments are disbursed should be described with enough specificity for prospective investors to understand the ultimate use and types of beneficiary.

148. An ICIS should disclose in its annual report the amount of any *zakāh* or other Sharī'ah-related obligatory payments disbursed, the basis of the calculation, and the recipients, as described in the previous paragraph.

### **2.3.3 Principle C.2: Operations-related Disclosures for ICIS**

**An ICIS should make sufficient disclosures about operational matters and their Sharī'ah compliance to allow an investor sensitive to such issues to make a reasonable judgement whether investment in the ICIS is, or remains, appropriate.**

#### Rationale

149. In addition to their investment activities, ICIS have other transactions whose Sharī'ah compliance may be relevant. They will need to manage cash in the short term before investing it. Depending on the regulatory regime in the jurisdiction, they may be allowed to employ leverage. Some conventional CIS engage in securities borrowing or lending, and some specialist funds may hold physical assets that need to be insured. Sharī'ah compliance is thus an issue not only in investment but in other operational aspects of the fund.

150. Some operations-related disclosures particularly relevant to specialist types of fund are discussed under Principle C.3. These include the use of *takāful* to insure physical assets, and the use and structural implications of Islamic mortgages over real estate.

#### Recommended Disclosures

151. An ICIS should disclose in its prospectus:

- (i) how any cash balances maintained in the fund will be invested;
- (ii) whether it will employ leverage, and if so the forms of leverage it will use as well as an indication of their Sharī'ah compliance;
- (iii) whether it will use Sharī'ah-compliant hedging instruments, and if so, the forms it will use;
- (iv) whether it will engage in any form of securities borrowing or lending;

and, in each case, the reason why these activities are judged to be Sharī'ah-compliant or the process by which their compliance will be assessed at the relevant time.

152. The reports from Sharī'ah advisors and Sharī'ah auditors referred to in paragraph 144 should cover these aspects of the ICIS's operations, so far as they are relevant.

### 2.3.4 Principle C.3: Specialist ICIS Disclosure

**Disclosures for special types of ICIS need to reflect their specific structures, operational considerations and risks.**

153. This section deals with some special types of fund that pose particular disclosure issues. Because these disclosure issues are specific to these types of ICIS, each is dealt with separately. The disclosures specified here are in addition to those specified above, where applicable, and to the disclosures normally required for the funds' conventional counterparts. Other types of specialist ICIS are possible, and the IFSB may issue standards dealing with such funds should disclosure and transparency issues be identified in the future.

#### ***Property Funds***

##### Rationale

154. Property funds invest directly in real estate, or in securities related to real estate. Those that invest directly in real estate may invest either in completed buildings, in the expectation of rental income and/or capital appreciation, or in properties still under development. The latter strategy is generally more risky.

155. Property funds that invest only in tradeable securities pose no particular disclosure issues. However, for those that invest directly in real estate, several issues arise that may affect disclosure:

- (i) Real estate is inherently an illiquid asset. Hence, an open-ended fund faces the possibility of being unable to liquidate assets fast enough to meet requests for redemptions of units. Consequently, many property funds are established as closed-ended funds. Where jurisdictions allow open-ended property funds, they generally permit some special mechanism to cope with the issue of illiquidity. This may involve suspension of redemptions, or a requirement to hold a certain proportion of liquid assets, or some other means to obtain liquidity. For an Islamic property fund, investors will expect any liquid assets or other liquidity mechanism to be Sharī'ah-compliant.
- (ii) To provide commercially attractive returns, property funds normally seek leverage by taking mortgages over the properties in which they invest. For an Islamic property fund, any such mortgage will need to be Sharī'ah-compliant. In addition, the structures used to achieve this may well involve the financier holding title to the asset,<sup>30</sup> contrary to the usual principle that a CIS should hold title to its assets. Where regulation in the jurisdiction permits such an arrangement, disclosure may need to be made.
- (iii) A property fund will need to insure the properties it holds, and for an ICIS the issue will arise whether this is done through Islamic insurance (*takāful*). It is possible that some Islamic property funds may wish to invest in jurisdictions in which *takāful* cover is not available to them.
- (iv) Where Islamic property funds invest in tenanted property, especially commercial property, there is a risk that tenants will be engaged in businesses that are not Sharī'ah-compliant.

##### Recommended Disclosures

156. An Islamic property fund should disclose the following in its prospectus:

- (i) if it is open-ended, what Sharī'ah-compliant mechanism will be employed in the event that requests for redemptions exceed the ability of the fund to meet them within the normal timescale;
- (ii) how properties owned by the fund will be insured and, in particular, whether or not this will be through Sharī'ah-compliant means;

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<sup>30</sup> This would be the case for an *ijārah* structure, for example.

- (iii) what processes will be employed to ensure that any mortgages over properties in which the fund invests are Sharī'ah-compliant;
- (iv) if such mortgages involve title to the assets not being held by the fund (and if this is permitted by the regulator), what alternative mechanisms will be used to ensure that the assets of the fund are held for the benefit of the unitholders; and
- (v) what mechanisms, if any, will be used to limit the risk that rental income will be derived from businesses that are not Sharī'ah-compliant, and any benchmark set in respect of the maximum proportion of such income that the fund will accept (e.g. when investing in a multi-tenanted property). (The disclosures in respect of purification payments have already been discussed in paragraphs 145–146 above.)

## **Islamic REITs**

### Rationale

157. An Islamic REIT is a special type of Islamic property fund. Although there is no standard definition of a REIT, the regulatory provisions for REITs commonly (though not universally) include requirements that they invest only or dominantly in income-producing real estate (as opposed to properties under development) and that they distribute the large majority of their income to unitholders. They will commonly be required to be listed on an exchange, and may receive favourable tax treatment. The disclosures relevant to an Islamic property fund will be relevant to a REIT also. Because a REIT specialises in tenanted property, the disclosures in relation to the activities of tenants and the treatment of tainted income will assume particular importance.

## **Exchange Traded Funds**

### Rationale

158. Exchange traded funds (ETFs) are open-ended CIS that trade throughout the day like a stock on the secondary market (i.e. through an exchange). Generally, ETFs seek to replicate the performance of a target index and are structured and operate in a similar way. Like operating companies, ETFs register offerings and sales of ETF shares and list their shares for trading. As with any listed security (including some closed-ended investment companies), investors may trade ETF shares continuously at market prices, but ETF shares purchased in secondary market transactions usually are not redeemable from the ETF except in large blocks.

159. ETFs may be index-based or actively managed, and may pursue their investment objectives using a physical or synthetic investment strategy. Physical ETFs seek to meet their investment objective by holding physical securities and other assets. Synthetic ETFs seek to meet their investment objective by entering into a derivative contract (typically through a total return swap) with a selected counterparty. Because of the Sharī'ah issues associated with the use of derivatives, Islamic ETFs are likely to be physical. Where an Islamic ETF replicates an index, this is likely to be an Islamic index.<sup>31</sup>

160. In June 2013, IOSCO published "Principles for the Regulation of Exchange Traded Funds".<sup>32</sup> This included recommendations on disclosure that are equally applicable to Islamic ETFs.

### Recommended Disclosures

161. No additional disclosures are recommended for Islamic ETFs beyond those specified above and those recommended by IOSCO. However, regulators of ETFs should pay particular attention to

<sup>31</sup> It is possible for a physical ETF to replicate an index without holding every stock in it – for example, by sampling techniques. However, the differences between Islamic and conventional indices, notably the role that conventional financial services companies play in the latter, would make it difficult for an Islamic ETF to replicate a conventional index while holding only Sharī'ah-compliant assets.

<sup>32</sup> The descriptive material in this section is closely based on that in the IOSCO publication.

disclosures on investment strategy, including, where appropriate, how an index will be tracked, and on the use of any Sharī'ah-compliant hedging instruments.

## **Money Market Funds**

### Rationale

162. Although there is no globally accepted definition, a conventional money market fund (MMF) can be defined as an investment fund that has the objective to provide investors with preservation of capital and daily liquidity, and that seeks to achieve that objective by investing in a diversified portfolio of high-quality, low-duration fixed-income instruments. For an Islamic MMF, these instruments would be likely to be short-term *ṣukūk*, or short-term placements with Islamic banks.

163. MMFs fall into two broad classes. In a variable net asset value (VNAV) MMF, the value of a unit can vary in the same way as for a normal CIS (e.g. if the obligor of a *ṣukūk* is perceived to be at risk of failure). The disclosure issues here are typically around investment strategy, valuation methods, and risk. ("Low risk does not mean no risk.") In a stable net asset value (SNAV) MMF, the value of a unit is held stable, independent of the value of the underlying assets and, if necessary, the operator may have to contribute its own funds to achieve this. Such funds are vulnerable to runs and may have systemic impacts, and not all jurisdictions permit them. For an Islamic SNAV MMF, there might well be Sharī'ah difficulties – in particular, in complying with the prohibition on *ribā*.

164. IOSCO published "Policy Recommendations for Money Market Funds" in October 2012. This included recommendations about disclosure. Recommendations 12 and 13, dealing with disclosure, were that "MMF documentation should include a specific disclosure drawing investors' attention to the absence of a capital guarantee and the possibility of principal loss", and "MMFs' disclosure to investors should include all necessary information regarding the funds' practices in relation to valuation and the applicable procedures in times of stress".

165. These disclosures would be equally relevant for an Islamic MMF. However, such a fund would invest in different instruments from those available to a conventional fund, and the mechanisms, if any, used to stabilise unit value under conditions of stress would require proper Sharī'ah scrutiny.

### Recommended Disclosures

166. In addition to the disclosures for open-ended ICIS generally, and those specified by IOSCO, an Islamic MMF should disclose:

- (i) the types of Sharī'ah-compliant instrument in which it will invest; and
- (ii) the Sharī'ah ruling on any mechanism used to stabilise unit value under conditions of stress.

These disclosures should be made in the prospectus, and the former disclosure should be made also in any KID.

## **Private Equity/Venture Capital Funds**

### Rationale

167. Private equity is equity raised by companies privately rather than through public fundraising. The private equity industry encompasses a wide range of firms that raise capital into funds with a diverse range of potential investment strategies. Equity capital is typically raised in a fund structure from a variety of sources, often restricted to institutional or other sophisticated investors. Private equity funds may use standard fund structures, but the limited partnership structure is a popular one, especially in the US.

168. Private equity funds may specialise in different phases of target firms' development. For example, venture capital firms specialise in early stage and growth targets. Others may buy listed companies and

de-list them while restructuring. They will normally hold a high percentage of a firm's equity, so as to have strong influence or control over its management, and will expect to exit the investment within usually a few years – for example, through a stock market flotation or a trade sale.

169. Private equity investments are inherently risky and also illiquid; hence the fact that they are often not allowed to be marketed to retail investors. Private equity funds also tend to rely heavily on leverage, either at the level of the fund or of the firm, to produce sufficiently attractive returns. On the other hand, they commonly need to invest surplus cash in the time between having raised it and having found an investment target.

170. Many jurisdictions consider that private equity investors are sufficiently sophisticated to negotiate the disclosures they need, and therefore apply minimal disclosure regulation to such funds. As part of the process of establishing a fund, investors do normally negotiate the terms and frequency of continuing disclosure to be made by the operator on behalf of the fund. Investor reporting centres around the production of regular fund valuation reports and transaction reporting, which provide investors, to varying degrees, with details of all new investment/divestment activity, a breakdown of both fund expenses/income and profit/loss, and a detailed review of the performance of individual portfolio assets as well as annual investor meetings. As a practical matter, larger investors often demand and enjoy better access to fund managers than do smaller investors. Some fund managers implement policies to address the potential conflict raised by disclosure disparity.

171. An Islamic private equity fund will need to consider individually the Sharī'ah compliance of the companies in which it invests. It will also need to consider the type of instrument in which it invests any short-term cash, and the routes by which any leverage is achieved. Because private equity deals can be quite complex, each will normally be subject to individual Sharī'ah scrutiny.

#### Recommended Disclosures

172. No additional specific disclosures are proposed for Islamic private equity, beyond those for its conventional counterpart and, to the extent appropriate for the permitted types of investors, those set out above. However, supervisors should pay particular attention to the Sharī'ah governance disclosures, bearing in mind the need for scrutiny of individual transactions and operational arrangements.

### **Commodity Funds**

#### Rationale

173. The term “commodity fund” embraces a range of strategies. Some funds simply hold the securities of firms active in the natural resources industries – for example, shares in oil companies. These raise no disclosure issues beyond those for ICIS generally.

174. Other conventional funds may invest directly in commodities – for example, holding physical gold bullion – or in commodity derivatives (futures and options), or both. These derivatives may raise Sharī'ah compliance issues. Because commodity funds of this type do not invest in tradeable securities, and are generally risky, jurisdictions often do not permit them to be marketed to retail investors.

175. Any ICIS investing in commodities or commodity futures needs to meet the requirements of Sharī'ah. These cover not only the nature of the commodities traded but also the limitations on short selling, or forward selling except in the case of certain specific contracts (*salam*), and the requirement for constructive possession.

#### Recommended Disclosures

176. In addition to the disclosures required for ICIS generally, a fund whose investments include or may include commodity futures (*salam*) should disclose:

- (i) the types of instrument in which it will invest; and

(ii) the Sharī'ah ruling on the permissibility of such instruments on which it relies.

These disclosures should be made in the prospectus, and the former disclosure should be made also in any KID.

## DEFINITIONS

The following definitions explain the terms used in this document. It is not an exhaustive list.

<i>Aqd</i>	Nominate contract.
<i>Fatwā</i> (plural <i>Fatāwā</i> )	A juristic opinion given by the Sharī'ah board on any matter pertinent to Sharī'ah issues, based on the appropriate methodology.
<i>Ijārah</i>	An contract made to lease the usufruct of a specified asset for an agreed period against a specified rental. It could be preceded by a unilateral binding promise from one of the contracting parties. As for the <i>ijārah</i> contract, it is binding on both contracting parties.
<i>Islamic Collective Investment Scheme</i>	Any structured financial scheme that, fundamentally, meets ALL the following criteria: (a) 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. Whether or not the Islamic collective investment scheme is managed by the institutions that established or sponsored it, it is financially accountable separately from those institutions (i.e. it has its own assets and liabilities profile), but excluding <i>shukūk</i> .  (b) The fund is established and managed in accordance with Sharī'ah rules and principles.
<i>Istisnā`</i>	The sale of a specified asset, with an obligation on the part of the seller to manufacture/construct it using his own materials and to deliver it on a specific date in return for a specific price to be paid in one lump sum or instalments.
<i>Kafālah</i>	A guarantee – for example, when a person guarantees a liability or duty (especially debt) of another person.
<i>Muḍārabah</i>	A partnership contract between the capital provider ( <i>rabb al-māl</i> ) and an entrepreneur ( <i>muḍārib</i> ) whereby the capital provider would contribute capital to an enterprise or activity that is to be managed by the entrepreneur. Profits generated by that enterprise or activity are shared in accordance with the percentage specified in the contract, while losses are to be borne solely by the capital provider unless the losses are due to misconduct, negligence or breach of contracted terms.
<i>Murābahah</i>	A sale contract whereby the institution sells to a customer a specified asset, whereby the selling price is the sum of the cost price and an agreed profit margin. The <i>murābahah</i> contract can be preceded by a promise to purchase from the customer.
<i>Mushārahah</i> ( <i>Sharikat Al-Aqd</i> )	A partnership contract in which the partners agree to contribute capital to an enterprise, whether existing or new. Profits generated by that enterprise are shared in accordance with the percentage specified in the <i>mushārahah</i> contract, while losses are shared in proportion to each partner's share of capital.
<i>Rahn</i>	A contract to withhold an asset for the benefit of the creditor as a security against a debt whereby the creditor ( <i>murtahin</i> ) is entitled to hold custody of the asset actually or constructively. In the event of default by the debtor ( <i>rāhin</i> ), the creditor has the right to sell the asset.

<i>Salam</i>	The sale of a specified commodity that is of a known type, quantity and attributes for a known price paid at the time of signing the contract for its delivery in the future in one or several batches.
Sharī'ah	The practical divine law deduced from its legitimate sources: the Qur'ān, Sunnah, Consensus ( <i>ijmā'</i> ), Analogy ( <i>qiyās</i> ) and other approved sources of the Sharī'ah.
<i>Şukūk (sing. Sakk)</i>	Certificates that represent a proportional undivided ownership right in tangible assets, or a pool of tangible assets and other types of assets. These assets could be in a specific project or specific investment activity that is Sharī'ah-compliant.
<i>Takāful</i>	A mutual guarantee in return for the commitment to donate an amount in the form of a specified contribution to the participants' risk fund, whereby a group of participants agree among themselves to support one another jointly for the losses arising from specified risks.
<i>Tanāzul</i>	Waiver of rights.
<i>Wakālah/Wakālah bil istithmār</i>	An agency contract where the customer (principal) appoints an institution as agent ( <i>wakīl</i> ) to carry out the business on his behalf. The contract can be for a fee or without a fee.
<i>Zakāh</i>	An obligatory contribution or tax that is prescribed by Islam on all Muslims having wealth above an exemption limit at a rate fixed by the Sharī'ah. The objective is to make available to the state a proportion of the wealth of the well-to-do for distribution to the poor and needy.