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Quarterly Bulletin of
Malaysian Islamic Capital Market
by the Securities Commission

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Contents

Seizing Global Opportunities

The Malaysian Islamic capital market (ICM) has entered a new phase of development. Policy makers, regulators and intermediaries have shifted their focus, beyond meeting domestic demand, to leveraging on strengths developed over time and seizing the opportunities presented in the global market place. Simply put, the new phase we are embarking on is about going global.

Policies, strategies and business models which have worked well in the initial phase of meeting domestic demand must now be assayed and refined, reconfigured or replaced accordingly. First, it is important for initiatives to move from being policy-driven to market-driven, by articulating the vision of taking ICM global, establishing the necessary building blocks, removing impediments, and providing incentives.

Second, market participants intending to go global must abide by the norms and rules of the global market place which require products, services and practices to be benchmarked internationally. They must have the ability to not only respond swiftly to changing market demands, but also anticipate and lead in making changes. These efforts, if pursued more aggressively, will put Malaysia in the driving seat of global Islamic finance and broaden the opportunities for both intermediaries and investors.

Suruhanjaya Sekuriti
Securities Commission

Sources and Research Methodologies (Manhaj)

ICM products have become one of the vital components in the overall financial landscape locally and internationally. Before being introduced into the market, ICM products undergo thorough research studies to ensure their permissibility from the Shariah perspective. For this purpose, the SC Shariah Advisory Council (SAC) has adopted two significant approaches:

- Study the validity of conventional instruments from the Shariah point of view, focusing on the structure, mechanism and use of the instruments to ensure their compliance with Shariah principles.
- Formulate and develop new financial instruments based on Shariah principles.

Research plays an important role in ensuring the continuous development of the ICM. When conducting research, the SAC uses both primary and secondary sources. The primary sources are the Quran and the Sunnah. This is based on the fact that Islam urges its followers to refer to these sources in solving problems in their daily lives, as commanded by Allah s.w.t.

In Surah al Nisa verse 59, Allah s.w.t. said:

> Meaning: "O you who believe! Obey Allah and obey the Messenger, and those charged with authority among you. If you differ in anything among yourselves, refer it to Allah (Quran) and His Messenger (Sunnah)".

Also in Surah al-Hasyr verse 7, Allah s.w.t. said:

> Meaning: "So take what the Rasulullah s.a.w. (the Messenger) assigns to you, and deny yourselves that which he withholds from you".

Apart from the two primary sources, the SAC also uses secondary and other sources which have already been applied in Islamic jurisprudence, including:

- *Ijmak* – consensus of Islamic scholars and jurists.
- *Qiyas* – analogical reasoning from a known injunction (*nas*) to a new injunction. According to this method, the ruling of the Quran and Sunnah may be extended to a new problem provided that the precedent (*asl*) and the new problem (*far*) share the same operative or effective cause (*`illah*).
- *Maslahah* – making a judgement based on the principle of general benefits on matters that have no clear *nas* from the Quran or the Sunnah.
- *Istihsan* – disregarding a *hukm* (law) that is backed by *dalil* (evidence) and applying another *hukm* that is more convincing and stronger than the former, based on *Syara` dalil* permitting the act in question.
- *Istishab* – maintenance of the previous *hukm*, as long as there is no other *dalil* that can change that particular *hukm*.
- *Sadd zari`ah* – approach used to curtail anything causing a Muslim to do the forbidden. It is considered an early preventive measure to prevent a Muslim from doing what is forbidden by Allah s.w.t.
- *`Urf* – norms of the majority of a society whether applied in speech or deed.
- *Maqasid shari`ah* – desired objectives of the Shariah when determining a *hukm* aimed at protecting human *maslahah*.
- *Siyasah Syar`iyyah* – area in Islamic jurisprudence

which explains rulings related to policies and approaches taken in organising the national administrative structure (and its people) in accordance with the spirit of the Shariah.

- *Ta'wil* – an effort to explain or interpret *Syara`* principles through a *dalil* without being restricted by its literal meaning.

- *Istiqra'* – a thorough scrutiny of a matter before a conclusive *hukm* is made on the matter.

- *Talfiq* – introducing an approach which has never been used or discussed by past *mujtahid*.

This is based on a *hadith* (prophetic tradition) when the Prophet s.a.w. appointed Muaz as *qadhi* (judge) in Yaman. He asked Muaz about certain important principles. He asked: "Muaz, what references do you use when you make a decision?" Muaz replied that he would refer to the Quran. The Prophet s.a.w. then asked: "What if the matter in question is not found in the Quran?" To which Muaz replied that he would refer to any decision that had been made by the Prophet s.a.w. The Prophet s.a.w. asked again: "What if the matter had never been decided by me?" Muaz then replied that he would apply *ijtihad* (reasoning of qualified scholars) using his own thinking and wisdom to come to a decision. The way Muaz handled the questions on making judgment received the blessings of the Prophet s.a.w. He then said: "Praise be to Allah s.w.t. for giving guidance to the Prophet s.a.w. and his representative (Muaz)."

Thus, all matters relating to secondary sources are included in *ijtihad*, as stated in the *hadith*.

Based on the above research methodologies, the SAC has determined important resolutions to facilitate the development of Malaysian ICM, both in the equity and *sukuk* market. Among others, the utilisation of proceeds raised from the issuance of *sukuk* can be used for various purposes, including financing, provided the instruments used and financing objectives are Shariah compliant. The proceeds can also be used for the general business operations of conventional financial institutions, as long as the proceeds are not directly used for any activities and instruments which are prohibited by the Shariah.

Another resolution concerns compensation and rebate. Investors in *sukuk* are allowed to impose compensation (*ta`widh*) on late and default payment by issuers. *Ta`widh* can be imposed after it is found that *mumathil* (deliberate delay in payment) is present on the part of the issuer to settle payment of the principal or profit.

In addition, upon request by the issuers of *sukuk* for an early settlement, a rebate (*ibra'*) is allowed to be given to investors. The *ibra'* clause for an early settlement can be inserted in the primary legal document of a *sukuk* transaction. The resolution is provided on the basis of *`urf* (custom), *maslahah* (public interest) principles and avoidance of *gharar* (uncertainty). The *ibra'* clause in the primary legal document is considered as a *syart* (condition) that complies with *muqtadha `aqd* (purpose of contract). However, the SAC has advised that the *ibra'* clause be separated from the pricing section in the primary document. The *ibra'* clause can be inserted in the payment and settlement section.

In summary, every SAC resolution is subjected to comprehensive analysis using all of the mentioned sources – the holy Quran, Sunnah, *ijma`*, *ijtihad*, etc. This method of analysis provides a high level of confidence to the industry and stakeholders, on the Shariah status of the ICM products being introduced in the market.

Issuance of Foreign Currency-denominated Sukuk in Malaysia

On 27 March 2007, the SC and Bank Negara Malaysia (BNM) released a Joint Information Note on the facilitative regulatory framework for the issuance of foreign currency-denominated *sukuk* and bonds in Malaysia.

The Joint Information Note outlines the procedures for the issuance of foreign currency-denominated *sukuk* and bonds by qualified issuers. Qualified issuers include the Malaysian government, foreign governments, multilateral development banks (MDBs), multilateral financial institutions (MFIs), agencies or national corporations of the Malaysian government or foreign governments, foreign multinational corporations (MNCs) and resident corporations.

Specific flexibilities are accorded under the SC's Practice Note 1A to expedite the issuance of foreign currency-denominated *sukuk* (*Practice Note 1A on Issuance of Foreign Currency-denominated Islamic Securities or Sukuk in Malaysia*) and bonds (*Practice Note 1A on Issuance of Foreign Currency-denominated Bonds Malaysia*).

Under this facilitative approval process, a submission to the SC by an issuer with a credit rating of at least single 'A-' is deemed approved upon filing of the prescribed documents with the SC, at least two working days prior to the issuance of the *sukuk* or bonds. In addition, international credit ratings are acceptable. International legal documentation governed by the laws of England or the US is also allowed. Under the facilitative regulatory framework, both resident and non-resident issuers are free to use the proceeds from the issuance onshore and offshore. The issuers are also free to hedge to the full amount of the underlying commitment.

Non-resident investors are free to invest in foreign currency-denominated *sukuk* and bonds onshore and there are no restrictions on the repatriation of capital, profits and income earned from Malaysia, including any coupon or profit earned from their investments. Investments by resident investors will be in accordance to the prevailing foreign exchange administration policy on investment in foreign currency assets. Resident investors are exempted from payment of income tax on the profits received from foreign currency-denominated *sukuk* issued in Malaysia. Similarly, profits or income on non-residents' investments in foreign currency-denominated *sukuk* issued in Malaysia are also fully exempted from withholding tax.

The foreign currency-denominated *sukuk* and bonds shall be issued on a scripless basis through the Fully Automated System for Issuing/Tendering (FAST) and deposited with the Real Time Electronic Transfer of Funds and Securities (RENTAS) System with BNM as the central depository agency and authorised depository institutions as the sub-depositories.

Further information on the Joint Information Note can be obtained from www.sc.com.my.

Shariah Tradeable Index for Global Investors

Following the successful launch of the FTSE-Bursa Malaysia (FBM) EMAS Shariah Index in January 2007, Bursa Malaysia has further expanded its index series with a new Shariah tradeable index – the FBM Hijrah Shariah Index. The launch of the country's first Shariah tradeable index marked another significant milestone in the development of key initiatives to enhance the attractiveness of the Malaysian ICM to domestic and global investors. Designed using FTSE's global indexing standards, the FBM Hijrah Shariah Index is an internationally accepted benchmark which will increase the Malaysian ICM's competitiveness.

Similar to the previous Shariah index, the FBM Hijrah Shariah Index (Figure 1) was subjected to the same international indexing features, such as free float and liquidity, and ultimately the rigorous Shariah screening process performed by the SC Shariah Advisory Council (SAC) and Yasaar Research Ltd – a global leading Shariah consultancy that offers Shariah-compliance services to institutional clients. Constituents in the FBM Hijrah Shariah Index must comply with stringent financial criteria and with principles set out by the SAC and Yasaar Research Ltd to ensure they are not involved in non-*halal* core activities, such as alcohol, tobacco and gaming.

This collaborative screening process and a fixed number of 30 constituents makes the FBM Hijrah Shariah Index a highly investable, liquid and transparent index for international investors (Table 1 on page 6). The new index will create further opportunities for investors seeking Shariah-compliant investments to

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Figure 1
FBM Hijrah Shariah Index design

Investable universe	Filter	Filter	Investable index
FBM EMAS Index →	Yasaar Research Ltd →	SAC list of Shariah-compliant securities →	FBM Hijrah Shariah Index

Note:
- FBM Hijrah Shariah Index is a tradeable index with a total number of constituents fixed at 30
- All stocks are free float weighted to accurately represent the stocks available for investment
- All stocks are liquidity screened to ensure stock availability and ease of trading
- Constituents must pass Yasaar Research Ltd and SAC screening for Shariah compliance.

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benchmark their investments, and for asset managers to create new products serving the investment community. It will create opportunities for capital market intermediaries to work with Bursa Malaysia to package a broad range of attractive products to enhance the choice of investments in the Malaysian capital market, such as Islamic exchange-traded funds (ETFs) and structured products.

Table 1
FBM Hijrah Shariah Index information

Index universe	FBM EMAS Index
Investability screens	Size, free float, liquidity, Yasaar Research Ltd and SAC
Index calculation	Calculated in real time every 15 seconds and end of day
Calculation states	Firm, closed, held, indicative
End of day distribution	19:01 local time, 11:01 GMT & 12:01 BST
Currency	Ringgit Malaysia, euro, US dollar, yen, sterling
Base value / base date	6,000 / 31 March 2006
Index constituent review	End of June and December
Launch date	21 May 2007

Updated List of Shariah-compliant Securities by the SAC

The SC released an updated list of Shariah-compliant securities approved by its SAC. The updated list of Shariah-compliant securities listed on Bursa Malaysia took effect from 25 May 2007. The full list is available at www.sc.com.my.

Seventeen newly classified Shariah-compliant securities by the SAC have been added to the list, which currently totals 875 securities. Eleven securities, which were in the October 2006 list, have been excluded. Based on the current list, 86% of the listed securities on Bursa Malaysia are classified as Shariah compliant.

In classifying the listed securities, the SAC has received input and support from the SC and has applied standard criteria in focusing on the activities of the companies listed on Bursa Malaysia. The approach and criteria in classifying the securities as well as the SAC's advice and guidance on the disposal of Shariah non-compliant securities are stated in the list.

A booklet on the list is issued free of charge by the SC. The next updated list will be available in November 2007.

SUKUK

Biggest sukuk funding programme

The SC has approved a RM60 billion funding programme issued by Cagamas Bhd, Malaysia's national mortgage firm, which will be the biggest issue. Cagamas, which uses funds raised from the debt market to buy housing loans from banks, has the highest credit rating from the country's two rating agencies and the issue will cover Cagamas' funding needs for four decades. The programme consists of commercial papers and medium-term notes, and has maturities between three and five years. However, the programme will also be a mixed issuance of both *sukuk* and conventional tranches.

The *sukuk* will use multiple Shariah principles, such as *murabahah*, *ijarah*, *mudharabah*, *musyarakah* and *istisna`*. CIMB Islamic Shariah Committee, HSBC Bank Malaysia Bhd Shariah Committee and Maybank Shariah Committee will be joint Shariah advisers for the *sukuk* issuance.

Sukuk istisna` for toll highway project

In the first quarter of 2007, the SC approved a RM1.4 billion junior and senior *sukuk istisna`* issuance by Lebuhraya Kajang-Seremban Sdn Bhd (Lekas), an associate company of IJM Corporation Bhd, to fund the construction of a 44.3km toll highway which will connect Kajang, Semenyih and Seremban.

In the *sukuk istisna`* structure, Lekas is the special purpose vehicle set up to undertake concession of the Kajang-Seremban Highway which comes with the right to collect toll for 32.5 years. The construction cost is estimated at RM900 million, to be part-financed by the RM785 million proceeds from the senior *sukuk istisna`* sale. The other portion of RM633 million, arising from the junior *sukuk istisna`* issue, will be used to repay older debts incurred by the highway project.

The *sukuk istisna`* have maturities ranging from seven to 15 years and were accorded AA3 and A1 ratings respectively by Rating Agency Malaysia Bhd. AmInvestment Bank Bhd is the lead arranger for the financing facilities while Bank Muamalat Malaysia Bhd is the co-arranger of the programme.

Sukuk ijarah for plantation company

In May 2007, Kuala Lumpur Kepong Bhd (KL Kepong) issued a five-year *sukuk ijarah* Islamic commercial papers (ICP)/Islamic medium-term notes (IMTN) to raise RM500 million. The *sukuk ijarah* programme allows KL Kepong to issue ICP and/or IMTN of different tenors to meet its short- to medium-term funding requirements, with the flexibility to issue ICPs in tenors of below 12 months and IMTNs in tenors of one year to five years. Of this total amount, RM210 million from the proceeds will be used to refinance its existing bank borrowings while the rest to finance future Shariah-compliant investments and working capital requirements, such as buying more plantation land and expanding its oleochemicals business.

Aseambankers Malaysia Bhd and CIMB Investment Bank Bhd are joint lead arrangers, lead managers and book runners for the *sukuk ijarah* programme.

SHARIAH-BASED UNIT TRUST FUNDS

New capital protected Shariah-compliant fund

A new capital protected fund known as ING Baraka Capital Protected Fund was launched on 9 May 2007 by ING Funds Bhd. With an approved fund size of 200 million units, it offers investors capital protection and access to global Shariah-compliant equities, and an expected average annualised return of between 10% and 12% over its three-year life.

The fund is targeted at investors with a low to moderate risk appetite who want to diversify investments locally and offshore. Like other capital protected funds, at the end of the fund's maturity period of three years, the ING Baraka Capital Protected Fund will return unit holders' initial capital plus returns from the offshore investments, if applicable.

The fund's investment portfolio will be selected from the Dow Jones Islamic Market World Index. The allocation of the portfolio will be as follows: at least 85% in ringgit-denominated Islamic negotiable instruments (INIs), 10% in the Societe Generale Asset Management's (SGAM) Alternative Investments Baraka Options with the remaining 5% in Islamic fixed-income instruments.

The fund will be managed in-house by ING Funds Malaysia and SGAM in France. To ensure compliance with the Shariah, Yasaar Research Ltd will act as the global Shariah consultant, while the Islamic Banking and Finance Institute of Malaysia (IBFIM) will be the local Shariah adviser for the INIs.

Islamic cash management fund

Public Bank Bhd, through its subsidiary Public Mutual Bhd, launched its new Shariah-based unit trust fund known as PB Islamic Cash Management Fund (PBICMF). PBICMF is an Islamic money market fund which provides liquidity and current income while maintaining capital stability by investing in instruments that comply with Shariah requirements. The fund has IBFIM as the Shariah adviser.

The fund, with an approved fund size of 1 billion, offers an option to investors with low tolerance to risk to invest on a short-term basis before investing in or switching back to equity, balanced or bond funds. It is suitable for those interested in short-term investments with conservative risk-reward temperament.

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Another prerequisite for going global is the ability of intermediaries and institutions to, not only swiftly respond to changing market demands, but also to anticipate and lead changes. By way of example, the origination and distribution of Islamic financial products is a key focus area of the MIFC. Products and services under the MIFC can be in any currency and offered to both residents and non-residents. These flexibilities, coupled with Malaysia's acknowledged leadership in the global *sukuk* market, must be swiftly capitalised by industry to extend its reach to foreign issuers and investors.

These efforts, if pursued more aggressively, will no doubt put Malaysia in the driving seat of global Islamic finance and broaden the opportunities for both intermediaries and investors. It is important for the Malaysian ICM to capitalise on its strengths, experiences and track record to propel itself into the next phase of development. The opportunities are tremendous and there is potential reward for all.

Strategies Going Forward[1]

No single sector within the Malaysian capital market has, within a short span of time, received as much attention, commitment, resources and facilitation from the government and the regulators, as the ICM. And these have been received with unanimous and resounding reciprocity from the market.

It is therefore not surprising that the Malaysian ICM has emerged as a significant area of growth. Today, it has a full complement of products, infrastructure, institutions, intermediaries and investors, contributing to the development and deepening of the entire capital market. ICM products and services are now an integral component of the Malaysian capital market, offering viable and competitive forms of financing and investment alternatives to their conventional counterparts.

The growth of the *sukuk* market, for instance, has been particularly impressive. Last year, over 55% of all bonds approved by the SC were *sukuk* – with a total value of RM42 billion. In fact, it has been independently recognised that Malaysia originates over 60% of the world's *sukuk* issues. Increasingly, these involve innovative structures using internationally accepted principles, such as *musyarakah*, *mudharabah* and *ijarah*.

In the equity market, 86% of all securities listed on Bursa Malaysia are classified as Shariah compliant. This amounts to about RM684.3 billion or 64.8% of the total market capitalisation of Bursa Malaysia. Last year also saw the listing of an Islamic real estate investment trust (REIT) on Bursa Malaysia – a world's first. On the demand side, growth in the Shariah-based unit trust industry has been remarkable over the last few years. There are now more than 102 Shariah-based unit trust funds with a total net asset value (NAV) amounting to RM9.5 billion, representing 7.1% of the total NAV of the unit trust industry.

In terms of developmental efforts, the products and services offered cater to the needs and risk-reward profiles of all investors and issuers. The strategy of mainstreaming the ICM has worked very well because it thrives best within an overall strong, deep and efficient capital market.

Indeed, the Malaysian capital market has experienced considerable growth. The capital market is now 2.4 times nominal GDP. Adding the equity and bond markets together, the size of the Malaysian capital market as at end-2006 was RM1.3 trillion, expanding by 17% or by RM190.1 billion, year-on-year.

The Malaysian ICM has entered into its next phase of development. The strategy of taking ICM global is not something thought of just yesterday. In fact, the *Capital Market Masterplan* (CMP), which was launched in 2001, provides a strategic blueprint for developing an internationally competitive ICM for Malaysia that is well positioned to meet the increasing challenges of international competition and financial globalisation. The CMP identified the establishment of Malaysia as an international ICM as one of its six strategic objectives. In the third and final phase of implementing the CMP, a significant number of recommendations on the ICM were completed.

The introduction of Islamic securities guidelines, which effectively addressed legal and regulatory impediments to the development of the *sukuk* market, and the guidelines on Islamic real estate investment trusts (REITs), as well as the promotion of the use of *musyarakah*, *mudharabah* and *ijarah* structures are efforts consistent with the recommendations of the CMP. The fact that the market has responded positively to these efforts by quickly introducing new products, whether in the form of global *sukuk* or other innovative *sukuk*

[1] This article is based on the SC Chairman's keynote address delivered at Invest Malaysia 2007 on 21 March 2007.

structures and Islamic REITs, is testimony to the fact that the recommendations of the CMP, though ambitious, are achievable.

Going forward, it is the intention of the final phase of the CMP to remove remaining inefficiencies and rigidities to enhance the efficiency of the capital market intermediation process. The vision of taking the ICM global is reaffirmed by the government in the Ninth Malaysia Plan (9MP) which has extended the ICM agenda beyond the CMP. Of course, the Malaysia International Islamic Financial Centre (MIFC) agenda, launched last year, signifies the confluence of the vision and strategies, and all policy and regulatory initiatives with respect to taking the entire Islamic financial services forward.

There is vast potential in the global ICM, with deposits in Islamic banks estimated to be in excess of US$560 billion, and growing at between 10% and 20% annually. There are presently more than 350 Islamic equity funds with assets exceeding US$300 billion operating in major financial centres around the world. The availability of such a large amount of Islamic funds internationally is a clear indication of the potential of the ICM.

But going global is not just about setting sights on the tremendous opportunities that are available in the market place. To effectively tap the global market, the government, regulators and most critically, the intermediaries must be ready, able and willing, to do things differently. Policies, strategies and business models which have worked well in the initial phase of meeting domestic demand need to be assayed, refined, reconfigured or replaced accordingly.

There is therefore a lot that needs to be done differently. First, it is important to move from policy-driven to market-driven initiatives. Up till now, the government and the regulators have been at the forefront of efforts to develop the ICM – articulating the vision, establishing the necessary building blocks, removing the impediments and providing the

"...in taking the ICM to its next phase, the role of the private sector becomes more critical."

incentives. In fact, the government and government-linked companies (GLCs) have, as issuers, also been pushing the frontiers of innovation in the *sukuk* market. These efforts were critical to the success of Malaysian ICM and undoubtedly will continue to be pursued.

However in taking the ICM to its next phase, the role of the private sector becomes more critical. There is expectation for higher levels of investment into product origination and distribution capabilities, and into building intellectual capacity to accelerate growth momentum and to maximise the capture of opportunities. Indeed, the widespread availability of high-quality intermediation services is critical to the next phase of growth. The government and regulator will continue to play their roles as catalyst and facilitator. Product innovation, ensuring global compatibility and acceptance, branding and promotion must, however, be pursued by the private sector.

Second, going global means abiding by the norms and rules of the global market place. It is recognised that while the global market offers infinite opportunities, it also demands that products, services and practices be benchmarked internationally. The presence of foreign intermediaries in Malaysia, the pursuit of international alliances, the opening of offices abroad and the structuring and offering of products for the international market by local intermediaries will ensure that Malaysian intermediaries can extend their reach and influence to regional and international markets. Strategic alliances with leading global players and direct participation in key foreign markets must be pursued.

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CROSS-SECTORAL REGULATORY APPROACH TO SUPERVISING[2]

Today, more than ever before, regulators are faced with the challenge of having to understand and respond to complexities brought about by rapid changes in global financial markets. The increasing integration of various segments of the market, the trend towards "commoditisation" of transactions and the blurring of boundaries between once-separate institutions, products and market sectors are challenging the traditional parameters of regulatory and supervisory roles and functions.

The activities of banks, insurance companies and mutual funds have traditionally been considered as distinct from each other. To protect the soundness of each sector and its role in enhancing the soundness of the financial system, inter-sector activities were prohibited. Hence, each service is also traditionally regulated and supervised by a distinct and specialised authority. However, the regulators' ability to ensure seamless regulation is increasingly being challenged by the growing functional integration of financial intermediaries.

This trend has been the result of a number of factors:

- Cross-sectoral mergers and acquisitions between banks and securities firms, and between banks and insurance companies.
- Market participants are increasingly branching out and diversifying to offer a broader range of products and services, in order to compete and grow.
- New products with hybrid characteristics are entering the market place; mostly banking products which have investment-like profile, e.g *mudharabah* deposits offered by Islamic banks, capital protected structured products, investment-linked insurance products (ILIPs), etc.

"...the scope and nature of financial activities are increasingly developing well beyond those of traditional regulatory structures and jurisdictions..."

As a result, the scope and nature of financial activities are increasingly developing well beyond those of traditional regulatory structures and jurisdictions. These developments have resulted in the blurring of historical distinctions between institutional arrangements and financial activities.

Hence, as investors are responsible for their own investment choices, there is a need for them to understand and fully appreciate the nature and risk profiles of investment-type products. Likewise, the financial institutions also need to acknowledge the unique risks emanating from the products they offer. Islamic banks, for example, must recognise their fiduciary duty towards their investment account holders, and put in place quality risk management systems.

Regulators must react and respond swiftly to changes. Additionally, the increasing internationalisation of financial operations has also accentuated the international dimension to regulation. Regulators at the national level, no longer concern themselves only with issues within national boundaries, but are forced to deal with international issues affecting their constituents. As a result, regulators are increasingly moving away from prescriptive rules to a market-based approach, in order to react swiftly and respond adequately to changes in the market place. A market-

[2] This article is extracted from the SC Chairman's keynote presentation at the IFSB Summit in Dubai, UAE on 15 May 2007.

based approach allows greater flexibility but it assumes a level of sophistication among investors and strong governance and compliance culture among market players.

Shift in regulatory perspectives

Regulators in a number of markets have attempted to effect changes to better address these challenges. But first, they need to be aware that functional regulation[3] of financial institutions is crucial for optimising and streamlining existing regulatory resources to ensure seamless regulation. This is particularly so in a dual or multiple regulator environment where increasingly, a cross-sectoral approach to regulation and supervision needs to be pursued.

The idea of functional regulation emphasises the principle of regulatory parity. The need for a functional perspective is reinforced by the increasing scope for hybrid and complex transactions; the trend for the unbundling of financial products and services into their constituent economic, risk and value components; and the blurring of boundaries between once-separate institutions, products and market sectors. The notion is that if a market participant is engaged in a particular activity, the participant should be regulated in the same manner as other market participants who engage in substantially equivalent activities. This level playing field promotes confidence and consistency in the overall regulation of the market place.

From the capital market perspective, it is absolutely vital that cross-sectoral regulatory approaches comply with universally accepted principles of securities regulation, i.e. they must provide the same level of protection for investors, be adopted within markets that are fair, efficient and transparent, and must not be susceptible to systemic risks. The success of regulators in this case is seen in terms of the extent to which they can build investor confidence in the integrity and fairness of capital market transactions, and the extent to which they are able to develop the markets in the direction of better transparency, greater competition and hence greater efficiency. Further, for Islamic products, the market must inspire investor confidence in the Shariah-compliant process, and that the Islamic products are true to label and perceived to be fair.

"From the capital market perspective, it is absolutely vital that cross-sectoral regulatory approaches comply with universally accepted principles of securities regulation..."

The role of the regulator is not restricted just to regulatory oversight but also includes initiating developmental activities, especially in the area of Islamic finance. They include facilitating the development and introduction of new products through new regulatory framework and guidelines, and investor education.

Likewise, regulation should not be so rigid and comprehensive that it raises compliance costs unbearably and stifles innovation and creativity. Regulators should not lose sight of the trade-off between stability and efficiency. The idea is not to add unduly to the regulatory burden while maintaining high standards of investor protection and market integrity.

[3] Functional regulation is the regulatory approach based on the specific purview of the regulatory agency, such as Bank Negara Malaysia (BNM) over the banking system and its intermediaries and insurance industry, and the SC over the regulation of the securities and futures markets and non-bank intermediaries in the capital market.

The Malaysian experience

The regulatory approach in Malaysia is predominantly institutional-based with Bank Negara Malaysia (BNM) regulating the banking system and insurance sector, and the SC presiding over the regulation of the securities and futures markets and non-bank capital market intermediaries. Further, the Islamic banks were accorded exempt dealer status to undertake capital market activities. As a consequence, there were regulatory gaps in the provision of investor protection for products issued by Islamic banks. While they take on investment characteristics, the structure of the product and disclosure requirements differ.

Under securities laws, disclosure is governed by section 32 of the *Securities Commission Act 1993* where there is statutory obligation for adequate, accurate and timely disclosures. In this case, false and misleading disclosures are subject to criminal sanction.

As financial modernisation increases within the domestic market and a wide variety of institutions engage in substantially similar activities, there is gradual progress towards functional regulation with cross-sectoral offering of investment-linked products by financial conglomerates and Islamic financial institutions.

Regulating Islamic banks

The year 2007 sees the introduction of the Capital Market and Services Act (CMSA) which reflects many of the cross-sectoral regulatory philosophies. Islamic banks no longer need a licence from the SC to undertake capital market activities. They only need to be licensed by BNM and will be accorded "registered person" status under the CMSA.

There are two very significant developments here. First, the CMSA recognises the important role that Islamic banks play in developing the ICM and enables them to broaden the scope of their activities and to carry out additional ICM activities, such as fund management, initial public offering (IPO) submissions and private placements, without further need for licensing by the SC. The elimination of dual licensing will significantly reduce friction costs and promote business flexibility and efficacy.

Secondly, the CMSA enables the achievement of regulatory parity for all participants carrying out capital market activities. This is done by recognising Islamic banks as registered persons which then extends the provisions relating to investor protection under the CMSA to Islamic banks. As mentioned earlier, the structure and disclosure requirements for collective investment scheme (CIS) products under securities laws take on a different dimension from those existing for Islamic banks.

Regulating investment banks

The SC and BNM introduced the framework for the establishment of investment banks (IBs) in 2005. This has led to the rationalisation and integration of businesses of merchant banks, discount houses and stockbroking companies within a single banking group into one entity. This is a relatively new development with IB licences issued late last year. As IBs undertake both capital market and banking activities, they are licensed both by the SC and BNM.

BNM is responsible for the prudential regulation of IBs to preserve their stability and soundness. The

> *"...there needs to be a strong regulatory framework which promotes principles of securities regulation for investment-type products."*

thrust of the SC's regulations is to promote market integrity and investor protection. BNM and the SC are finalising an MoU to facilitate co-ordination and collaboration between the two regulatory agencies. Both agencies have powers to prescribe and enforce regulations, supervise and conduct inspections on IBs to meet their objectives.

Regulating Islamic products with profit-sharing characteristics

As many of the Islamic products are distributed to retail clients, it is pertinent to deal with their regulation. Islamic banks and *Takaful* companies offer a form of *mudharabah* investment based on profit-sharing characteristics. How should such products be regulated? How does the status of such products compare with other capital market products? This is likely to become a major issue confronting regulators in the years ahead, given the rapid growth of these products. At the core of a strong Islamic financial system in any jurisdiction, there needs to be a strong regulatory framework which promotes principles of securities regulation for investment-type products.

In Malaysia, the *mudharabah* deposits and *Takaful* products are regulated by BNM. These investments are eligible to have a share of the profits earned. Given that the returns are not pre-determined, the capital provider may have to bear any loss. This places a higher degree of fiduciary risk on the Islamic financial institutions in ensuring that investment deposits funds are managed in the most effective and efficient manner.

Hence, apart from fiduciary responsibility, investor protection and transparency issues need to be aligned. The crucial challenge is to adapt existing regulations so that clients of Islamic banking and *Takaful* products enjoy similar, although not necessarily the same, protection as clients of capital markets.

Conclusion

Going forward, there is a need for the regulatory framework to be flexible and effective in adapting to the fast-changing market environment. To have the capacity to accommodate change and the evolution of market structures, regulation must not lag behind or act as an impediment to market development and innovation. The challenge ahead lies in the ability of regulators to balance flexible regulatory structures with uncompromisingly robust provisions, with regard to the fundamental principles and objectives on which they are based: the protection of investors; ensuring that markets are fair, efficient and transparent; and reducing systemic risks.

Furthermore, the regulatory framework must also recognise the increasing integration of the various segments of the financial market, resulting in a network of economic, commercial and legal relationships. Proper functional regulation has thus become more important due to the increasing trend towards the "commoditisation" of transactions; unbundling of financial products and services into their constituent economic, risk and value components; and the blurring of boundaries between once-separate institutions, products and market sectors.

NEWS ROUNDUP

Mutual recognition with Dubai Financial Services Authority

On 27 March 2007, a mutual recognition agreement was signed between the SC and the Dubai Financial Services Authority (DFSA). The signing ceremony between the SC Chairman, Dato' Zarinah Anwar and DFSA Chief Executive, David Knott was witnessed by the Second Finance Minister of Malaysia, Tan Sri Nor Mohamed Yakcop. This agreement follows an earlier announcement made on 15 August 2006 on the commencement of a joint initiative on regulatory alignment to facilitate Islamic finance transactions between the Dubai International Financial Centre (DIFC) and Malaysia.

The agreement was the first between two Islamic markets, and marks a significant milestone, providing a gateway for Malaysian capital market players to venture into the Middle East market. This reciprocal liberalisation between the two Islamic financial centres will enable cross-border marketing and distribution of Islamic funds with minimal regulatory intervention.

Under the agreement, Islamic funds approved by the SC may be marketed and distributed in the DIFC, to be facilitated by the entry of Malaysia on to the DFSA's Recognised Jurisdiction Notice. At the same time, Islamic funds registered or notified with the DFSA will have access to Malaysian investors. Malaysian capital market intermediaries will benefit from the gateway to distribute their Islamic products to a fast growing market while Malaysian investors will have access to a range of Islamic products from the DIFC. Both regulators will work closely in the areas of supervision and enforcement of securities laws to ensure adequate investor protection.

IFSB/IOSCO seminar on ICM regulatory issues

The SC Chairman delivered a welcome speech at the Seminar on Regulatory Issues in Islamic Capital Market, held at the SC on 19 April 2007. The seminar was jointly organised by the Islamic Financial Services Board (IFSB) and International Organization of Securities Commissions (IOSCO). Its main objective was to discuss several relevant issues in regulating the ICM. The SC Senior Executive Director of Strategic & Development Dr Nik Ramlah also chaired a session, entitled "Country Presentations on Regulation of Islamic Capital Market" which gave an insight on the regulation of the Malaysian ICM.

Global Islamic Financial Forum 2007

The Global Islamic Financial Forum 2007 (GIFF 2007), organised by Bank Negara Malaysia (BNM), was held from 26–29 March 2007 at the Kuala Lumpur Convention Centre. The SC Chairman chaired a panel discussion, entitled "Islamic Capital Market: The Next Phase of Development" at the Financial Regulators Forum in Islamic Finance while the SC General Counsel Wong Sau Ngan presented a paper, entitled "Creating Effective and Efficient Regulatory Framework for Islamic Capital Market."

Under the Malaysia International Islamic Financial Centre (MIFC) banner, the SC, together with BNM, LOFSA and Bursa Malaysia set up an exhibition booth showcasing the availability of Islamic banking, guidance and investment services in Malaysia. The exhibition also provided visitors with a platform for learning, networking and discovering business opportunities.

IFSB summit in Dubai

Hosted by the Central Bank of the United Arab Emirates, the 4th Islamic Financial Services Board (IFSB) Summit was held on 15–16 May 2007 in Dubai. The summit, entitled "The Need for a Cross-sectoral Approach to the Supervision of Islamic Financial Services", discussed challenges and efforts towards the standardisation and convergence of the global Islamic financial services industry.

The SC Chairman delivered a presentation, entitled "The Relevance of a Cross-sectoral Approach to the Supervision of Islamic Financial Services: Recent Experience and Prospects". The summit concluded that adopting a more dynamic and flexible approach to the supervision of Islamic financial institutions is essential in moving the industry forward. A cross-sectoral approach to the supervision of Islamic financial services is seen as an alternative, as the industry moves towards greater convergence. This is also exemplified by the cross-border operations of an increasing number of institutions offering Islamic financial services.

ICM talk on Islamic Stock Exchange

On 20 March 2007, the SC organised an ICM talk – presented by Rushdi Siddiqui, Global Director of Dow Jones Islamic Market – on "Islamic Stock Exchange". Rushdi exposed the audience to various issues pertaining to Islamic indices. More than 100 participants from various agencies, namely regulatory bodies, banks and fund management companies attended the event.

Forum for Shariah advisers in Malaysia

The third forum for Shariah advisers in Malaysia, held on 9–11 May 2007 in Seremban, was organised by the Department of Islamic Development of Malaysia (JAKIM). Shariah scholars deliberated on selected Shariah issues relating to Islamic finance. Two speakers from the SC presented on the subject of evaluating the Shariah status of listed securities.

Invest Malaysia 2007

Invest Malaysia 2007 was organised by Bursa Malaysia from 21–23 March 2007 in Kuala Lumpur. It is an investment conference for institutional investors to highlight the latest capital market developments and key investment prospects. The SC Chairman delivered the keynote speech, entitled "The Malaysian Islamic Capital Market – Roadmap and Strategies Going Forward". In her speech, Dato' Zarinah Anwar highlighted the latest ICM developments in Malaysia and the issues and challenges for the next phase of development.

Malaysia International Halal Showcase 2007

The SC participated in the Malaysia International Halal Showcase (MIHAS) 2007 held from 9–13 May 2007 at the Kuala Lumpur Convention Centre. It was organised by the Malaysia External Trade Development Corporation (MATRADE) and the Islamic Dakwah Foundation Malaysia (YADIM), in association with the Ministry of Entrepreneur and Co-operative Development (MECD).

The ICM was identified by the organisers as one of the key components of the exhibition. The SC booth was set up to showcase ICM development in Malaysia and the milestones achieved. In addition, the SC distributed promotional materials on Malaysian ICM covering market infrastructure, products and services to create a greater awareness of the development and regulation of the ICM.

Islamic Markets Programme: 1–6 July 2007, Securities Commission, Kuala Lumpur

This Islamic Markets Programme (IMP) is designed to cater to a wide audience of both experienced practitioners and newcomers in the world of Islamic finance. It is directed towards individuals involved in any aspect of Islamic finance and will be most useful in preparing professionals dealing with Islamic products and institutions.

It offers a step-by-step progressive learning platform for participants to better understand the principles and practice modes of modern Islamic finance; realise its business potential; and explore its implications for industry growth, capital market attractiveness and its contribution to the overall economy.

Presentations will be reinforced by case studies and experiences from practitioners, subject matter experts and capital market regulators.

This programme begins on Sunday 1 July 2007 with a full day city tour. Training sessions will start on Monday 2 July 2007. For more details and registration, log on to www.sc.com.my.

Malaysian ICM – Facts and Figures

Table 2
Shariah-compliant securities

Number and percentage	
Number of Shariah-compliant securities – May 2007[1]	875
% of Shariah-compliant securities to total listed securities	86%
Market capitalisation (end-May 2007)	**(RM billion)**
Shariah-compliant securities	685.14
Total market capitalisation	1,060.92
% of Shariah-compliant securities to total market capitalisation	64.58%

Equity market indices	30 April 07	31 May 07	% change
Kuala Lumpur Composite Index	1,322.25	1,346.89	1.9%
Kuala Lumpur Shariah Index	194.99	198.53	1.8%
FBM EMAS Shariah Index	9,102.89	9,317.56	2.4%
FBM Hijrah Shariah Index[2]	9,326.30	9,415.94	1.0%

[1] *The SC SAC releases the updated Shariah-compliant securities list twice a year in May and November.*
[2] *Launched on 21 May 2007.*

Chart 1
Performance of KLCI vs Shariah Indices

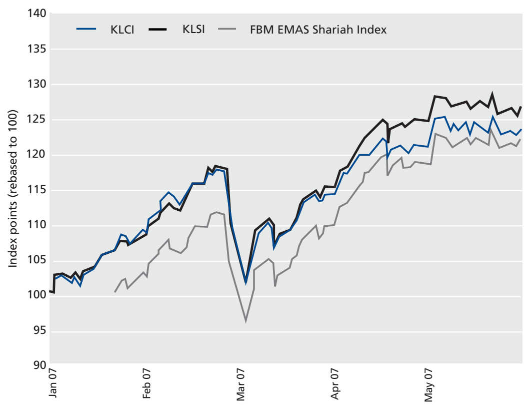
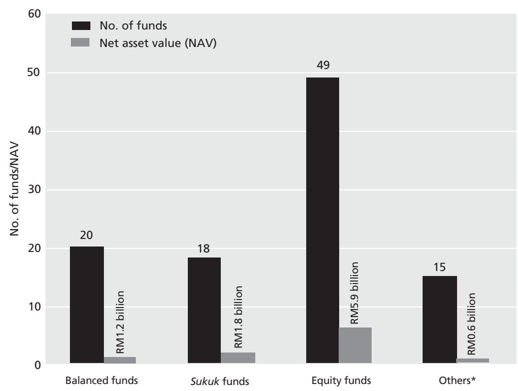


Table 3
Shariah-based unit trust funds[1]

Number of approved funds	
Shariah-based	102
Total industry	429
Net asset value (NAV) of approved funds	**(RM billion)**
Shariah-based	9.6
Total industry	134.2
% of Shariah-based to total industry	7.2%

[1] *As at end-March 2007.*

Chart 2
Shariah-based unit trust funds by category



** Including feeder funds, fixed income funds, money market funds and structured products.*

Table 4
Sukuk

Size of outstanding and percentage	
Size of outstanding *sukuk*[1] (excluding government *sukuk*)	RM112.2 billion
% of outstanding *sukuk* to total outstanding bonds	49.0%
***Sukuk* approved by the SC in Q1 2007**	
Number of *sukuk*	12
Size of *sukuk*	RM3.76 billion
Size of total bonds approved	RM13.22 billion
% of size of *sukuk* to total bonds approved	28.46%

[1] *As at end-April 2007.*

Chart 3
Sukuk approved based on various Shariah principles

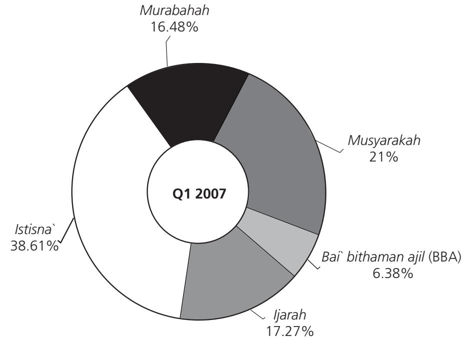


Table 5
Sukuk approved by the SC in Q1 2007

Issuer	Shariah principle	Size of issues (RM million)	Date of approval	Initial rating
1. Malaysian International Tuna Port Sdn Bhd	BBA	240	17 Jan 07	A+
2. Tomei Consolidated Bhd	*Murabahah*	100	19 Jan 07	MARC-1 A
3. Pins Capital Sdn Bhd	*Ijarah*	150	22 Jan 07	P1 AA2
4. Pins Capital Sdn Bhd	*Murabahah*	10	22 Jan 07	Not rated
5. Straight A's Portfolio Sdn Bhd	*Murabahah*	200	15 Feb 07	MARC-1
6. Lebuhraya Kajang-Seremban Sdn Bhd	*Istisna`*	820	15 Feb 07	AA3
7. Lebuhraya Kajang-Seremban Sdn Bhd	*Istisna`*	633	15 Feb 07	A1
8. Arapesona Development Sdn Bhd	*Murabahah*	200	26 Feb 07	AAA
9. Arapesona Development Sdn Bhd	*Murabahah*	70	26 Feb 07	MARC-1
10. United Growth Bhd	*Musyarakah*	800	14 Mar 07	AA2
11. Kuala Lumpur Kepong Bhd	*Ijarah*	500	26 Mar 07	P1 AA2
12. Capable Aspect Sdn Bhd	*Murabahah*	40	26 Mar 07	A+ MARC-2
Total		**RM3,763**		

We appreciate your feedback and comments. If you would like to know more about the Malaysian Islamic capital market or require further information from the Securities Commission, please contact:

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