

# **IFSB WORKING PAPER SERIES**

**WP-13/12/2019**

## **INTERMEDIARIES IN THE ISLAMIC CAPITAL MARKETS**

**December 2019**



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### **Technical and Research Department**

**WP-13/12/2019**

## **INTERMEDIARIES IN THE ISLAMIC CAPITAL MARKETS**

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**December 2019**

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## 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 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 includes holding several Working Group meetings, issuing exposure drafts, and organising public hearings/webinars and reviews by the IFBS's Sharī'ah Board and Technical Committee. The IFSB also conducts research and coordinates initiatives on industry-related issues, and 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)**.

## ABBREVIATIONS

APERD	Agen Penjual Reksa Dana (Mutual Fund Selling Agent)
BRSA	Banking Regulation and Supervision Agency of Turkey
CMSL	Capital Market Services Licence
CPICM	Core Principles for Islamic Capital Market
DFSA	Dubai Financial Services Authority
ICM	Islamic capital market
IFSB	IFSB Islamic Financial Services Board
IFSI	IFSI Islamic financial services industry
OJK	Otoritas Jasa Keuangan
RSAs	Regulatory and supervisory authorities

## GLOSSARY

<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.
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.
Sharī'ah board	An independent body set up or engaged by the institution offering Islamic financial services to supervise its Sharī'ah compliance and governance system.
Sharī'ah non-compliance risk	An operational risk resulting from non-compliance of the institution with the rules and principles of Sharī'ah in its products and services.
<i>Ṣukūk</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

## Abstract

This exploratory working paper derives from the pertinent role played by intermediaries in the Islamic capital market (ICM). While intermediaries are expected to provide unbiased investment guidance to their clients in a manner that prioritises the interests of their clients in their contractual dealings, the changing market landscape where ICM intermediaries operate today makes managing their fiduciary responsibility towards their clients very complicated. From a regulatory standpoint, the paper considers four key core principles in IFSB-21: *Core Principles for Islamic Finance Regulation (Islamic Capital Market Segment)* relating to ICM intermediaries' assessment of issues affecting their intermediation activities. Data elicited via a survey questionnaire distributed to ICM intermediaries in the IFSB's member jurisdictions forms the basis for the analysis used in the paper. There are commendable licensing and entry requirements in place in various jurisdictions, as well as ongoing assessments of due compliance by ICM intermediaries with those requirements. While the ICM intermediaries are susceptible to conflict-of-interest risk, they nonetheless generally have internal mechanisms catering for the consequences arising therefrom. Finally, there seem to be procedures in place that provide early warning of potential failure of the ICM intermediaries prior to their infringing on the soundness and safety of the Islamic capital market.

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## SECTION 1: INTRODUCTION

### 1.1 Background

Over the past three years, the Islamic capital market (ICM) has recorded consistent and significant growth, which further entrenches it as a key and viable segment of the global Islamic financial services industry (IFSI).<sup>1</sup> The ICM sector offers financial inclusion benefits, as well as mobilisation and optimal allocation of Sharī'ah-compliant funds through efficient financial intermediation for economic development purposes in various jurisdictions where the sector has attained a significant presence.<sup>2</sup>

The basic function of the ICM is to ensure that capital is transferred from those who have it to those who need it in a manner that is Sharī'ah-compliant considering that both parties are capable and willing to share the risk involved. Intermediaries in the ICM play an important role in effectively performing this basic function. Intermediaries trade and manage capital on behalf of their clients. They also help to address issues relating to high transaction costs by searching for Sharī'ah-compliant, yet profitable investments, and reduce susceptibility to moral hazards and adverse selection in investment decisions, especially for retail investors.<sup>3</sup>

Due to the relative advantage of their access to and understanding of the workings of the financial markets, intermediaries in the capital market and elsewhere in the financial ecosystem are in a position of trust.<sup>4</sup> They are expected to provide unbiased investment guidance<sup>5</sup> to their clients in a manner that, together with their agents, prioritises the interests of clients in their contractual dealings. However, the changing market landscape in which ICM intermediaries operate today makes managing their fiduciary responsibility towards their clients very complicated.

As the ICM sector grows, it is expected that issues bordering on conflicts of interest will increase and that its functioning will become more complicated, especially due to (among other reasons) the increasing proprietary dealings<sup>6</sup> and activities of intermediaries<sup>7</sup> and their agents on the one hand, and, on the other hand, technological advancements, which have led to a great deal of de-personalisation of capital market intermediation.<sup>8</sup>

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<sup>1</sup> As per the IFSB's *Islamic Financial Services Industry Stability Report 2019*, the ICM sector is worth about USD 537 billion and accounts for about 27% of global IFSI assets as at end of 2018.

<sup>2</sup> Archer and Karim (2018), p. 287.

<sup>3</sup> Kalač, Bećirović, and Plojović (2013), p. 274.

<sup>4</sup> See Governance Strategies for Investor Protection and Stability, downloaded via: <https://www.sc.com.my/api/documentms/download.ashx?id=3c2ffe3b-1528-4843-b306-47d8a83ae61c>

<sup>5</sup> In the case of Sharia'h-compliant financial intermediation, both the investment product and investment advice offered should be Sharia'h-compliant.

<sup>6</sup> The propensity towards proprietary trading and trade internalisation heightens the ICM intermediaries' susceptibility to conflicts of interest, thus placing their own interests over those of the investors.

<sup>7</sup> While some transactions in the ICM sector require the services of a single intermediary, the increasing complexity of activities may require a network of intermediaries in some situations.

<sup>8</sup> Technology keeps evolving and provides possibilities for transforming the investor–intermediary relationship vis-à-vis routing, executing and booking of underlying trades in such a way that the potential for abuse and attenuation of the traditional fiduciary and self-regulatory duties are amplified.

In addition, to the extent that, for reasons of incentive, ICM intermediaries also retain an equity stake through their private trading and cannot be excluded from doing so,<sup>9</sup> the moral hazard problem may continue to expose them to the issue of conflicts of interest.<sup>10</sup> Numerous incidences of stock price manipulations have been documented in the extant literature. In fact, one particular study found that intermediaries earn anywhere from 50 to 90 percentage points more when they deal on their own accounts compared to when they deal on behalf of their clients.<sup>11</sup>

The ICM intermediaries may also be susceptible to financial innovation and structural changes that have implications for intermediation activities in the sector. Therefore, the diversity of business conducted by ICM intermediaries, and the consequential risks they pose vis-à-vis their relations with and claims made on customers, products offered and disclosure practices, necessitates that regulatory attention<sup>12</sup> is focused more on their business conduct in a manner that does not infringe on their operational efficiency.<sup>13</sup>

Furthermore, such regulatory attention also becomes pertinent in peculiar circumstances where ICM intermediaries, in their bid to avoid Sharī'ah non-compliance costs while advising their clients, would prefer to refer to opinions given by others on the Sharī'ah compliance or otherwise of a fund, rather than to give an opinion of their own. In addition, it needs to be determined how ICM intermediaries handle clients' money between the sale of one investment and the purchase of another, and what Sharī'ah governance is put in place to ensure that Sharī'ah compliance is both clear and well-founded. Therefore, the cost of compliance must not swamp the benefits therefrom if ICM intermediaries are not to be discouraged from offering ICM products.

Furthermore, disclosure alone may not usually be sufficient to address the information asymmetry problem that may exist between buyers and sellers of Sharī'ah-compliant financial products. This is because investors do not enjoy the same level of information availability and awareness. While institutional investors may expend significant resources on information acquisition, individual investors may lack the resources to match such expenditure.<sup>14</sup> Muslim retail investors were found to be risk-averse and bound more by religious permissibility than economic considerations in their investing decisions.<sup>15</sup> As such, compliance with mandatory disclosure requirements may not necessarily address the issue that individual investors are confronted with, especially in terms of interpreting as well as determining the credibility of information disclosed to them. ICM intermediaries in this regard have a comparative advantage if they choose

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<sup>9</sup> Di Tella (2017).

<sup>10</sup> Chotaliya and Trivedi (2014), p. 26.

<sup>11</sup> Khwaja and Mian (2005), cited in Siddiqi (2017), p. 2.

<sup>12</sup> There are arguments, though, that the capital market should not be regulated, especially where existing legal mechanisms are effective. In this case, the potential for political interference through regulation may be avoided. Any misrepresentation or non-disclosure of facts would attract reputational and legal consequences, thus giving the intermediaries the impetus to provide full disclosure (Choi, 2004). This argument is somewhat attenuated by the findings in Siddiqi (2017) that brokers' concern for credibility encourages manipulation, and that even though moderate competition reduces brokers' tendency for manipulation, market liquidity is infringed if competition becomes stiff.

<sup>13</sup> A counterargument holds that regulation of the capital market is indispensable due to the inadequacy of reputational and legal consequences in providing commensurate protection to investors, especially when compared with the great rewards arising from misconduct, and the unpredictability of litigation and its associated costs (Choi, 2004).

<sup>14</sup> Adewale and Haron (2016), p. 91; Nienhaus (2015), p. 6.

<sup>15</sup> Adewale and Haron (2016), p. 90.

to engage in manipulative activities.<sup>16</sup> In such cases, the clients of the ICM intermediary may have to bear the incidence of hidden costs, unfair trading and investment terms and conditions, as well as predatory selling practices.

The pivotal role of ICM intermediaries as the connecting link among other stakeholders in the capital market makes it expedient that their safety and soundness are also ensured for the preservation of financial stability.<sup>17</sup> Therefore, regulation of the business conduct of ICM intermediaries supplements product regulation by governing the interaction between intermediaries and other participants in the ICM ecosystem, and especially the individual investors.

Essentially, safeguarding the interests of the investors, maintaining stakeholders' confidence in the ICM, and ensuring that, due to increasing interconnectivity between the ICM and other sectors of the IFSI, risks are kept to an acceptable level, are the fundamental objectives of ICM-related prudential regulations. In a number of jurisdictions with ICM, cognisance has been taken of both the structural and functional transformation of the capital markets. ICM intermediaries, while responding to market dynamism by expanding and re-inventing their intermediation activities, would therefore also have to be guided by suitable and flexible regulations that preserve the stability of the financial ecosystem.

In view of the increasing importance of the ICM segment in the global IFSI, the activities of the intermediaries may propagate and transmit shocks to the entire financial system through asset liquidation, direct exposure, and common risk factor channels.<sup>18</sup> Moreover, as the functions of the ICM intermediaries become increasingly dispersed, the onus is on the regulatory and supervisory authorities (RSAs) to ensure that internal control mechanisms are strengthened towards commendable professionalism in its entire ramifications. This should be in relation to the conduct of ICM intermediaries in their fiduciary responsibilities and professional relationships with other stakeholders in the ICM segment in particular and the IFSI in general.

Consequently, there has been increasing regulatory activity, focusing especially on the practices of the ICM intermediaries, to ensure that systemic risk does not originate or propagate through their activities. While most jurisdictions are still operating a rule-based regime of regulatory and supervisory oversight, a few others are beginning to adopt a principle-based compliance regime.

The IFSB in 2018 issued a standard, IFSB-21: *Core Principles for Islamic Finance Regulation (Islamic Capital Market Segment)* (CPICM),<sup>19</sup> which contains four core principles with a specific focus on matters relating to the activities of intermediaries in the ICM. The standard sets out to achieve a tripartite objective of ensuring investor protection, promoting a fair, efficient and transparent market, and mitigating against

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<sup>16</sup> In addition to access to real-time information on general expectations about the movement in price and volumes of investments, the ICM intermediaries, like their conventional counterparts, may also leverage on their lower transaction costs to generate trade momentum as part of their manipulation strategy.

<sup>17</sup> Menon (2011), p. 6.

<sup>18</sup> Adewale and Nienhaus (2019).

<sup>19</sup> The main objective of IFSB-21 is to provide a set of core principles for the regulation and supervision of the ICM, taking into consideration the specificities of Islamic finance, while complementing the existing international standards, principally IOSCO's "Objectives and Principles of Securities Regulation and its Methodology" (May 2017).

the origination and propagation of systemic risks.<sup>20</sup> In view of the fact that the activities of the ICM intermediaries may either promote or impede the achievement of this triad of objectives, this study elicits the responses of such ICM intermediaries in the IFSB jurisdictions on pertinent related matters.

## 1.2 Objectives

The main objective of this working paper is to investigate the intermediation activities in the ICM based on the four related principles in the CPICM. Specifically, this working paper aims to:

- a. explore the licensing and entry requirements for listing as an ICM intermediary in IFSB jurisdictions;
- b. investigate the internal operations and risk management practices of ICM intermediaries in IFSB jurisdictions;
- c. explore the transparency, disclosure and client protection practices of ICM intermediaries in IFSB jurisdictions; and
- d. investigate the safety and soundness practices of the ICM intermediaries in IFSB jurisdictions.

## 1.3 Scope of the Paper

This working paper is an exploratory cross-sectional study on the activities of ICM intermediaries in the IFSB jurisdictions. The study is based on the four related principles in IFSB-21. The core principles (and their IOSCO counterparts) are:

- a. CPICM 30: Regulation should provide for minimum entry standards for market intermediaries [IOSCO 29].
- b. CPICM 31: There should be initial and ongoing capital and other prudential requirements for market intermediaries that reflect the risks the intermediaries undertake [IOSCO 30].
- c. CPICM 32: Market intermediaries should be required to establish an internal function that delivers compliance with standards for internal organisation and operational conduct, with the aim of protecting the interests of clients and their assets and ensuring proper management of risk, through which management of the intermediary accepts primary responsibility for these matters [IOSCO 31].
- d. CPICM 33: There should be procedures for dealing with the failure of a market intermediary in order to minimise damage and loss to investors and to contain systemic risk [IOSCO 32].

The paper takes a composite view and, as such, does not distinguish between the nature of intermediation activities. Only in a few instances does it focus on jurisdictional peculiarity.

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<sup>20</sup> The propagation of the systemic risks arising from the Global Financial Crisis of 2007–2008 could be linked to activities undertaken by both regulated and unregulated financial market intermediaries.

## 1.4 Structure of the Paper

This paper is divided into seven sections. Immediately following this introductory section is a brief description of the methodology in section 2. Analysis of the survey report based on the remaining four broad sections follows. Section 3 focuses on the licensing and entry requirements for ICM intermediaries in various jurisdictions. Specifically, the section focuses on which firms qualify as an ICM intermediary in a jurisdiction, as well as on the nature of regulation in terms of minimum requirements for capital, Shari'ah governance and internal control mechanisms.

Section 4 focuses on internal operations and risk management, particularly the existing practices with respect to authorisation and regulatory powers on ICM intermediation across jurisdictions. This section explores further the ongoing regulatory requirements for continuous intermediation activities in the ICM sector in the jurisdictions covered. Section 5 focuses on transparency, disclosure and client protection practices. Section 6 considers the safety and soundness practices of the ICM intermediaries and the implications for preserving systemic stability. The final section presents the conclusions.

## SECTION 2: METHODOLOGY

The data used in this study were collected via a questionnaire survey addressed to ICM intermediaries in various jurisdictions covered by the IFSB between June and July 2019. The survey was based on online distribution and comprised mainly closed-ended questions with codes to indicate the appropriate option for a respondent to select.

In some other instances, open-ended questions were also included for the respondents to freely express their opinion on related matters beyond the closed-ended options provided. This allowed for respondents to provide further insights in their own words, and a plausible explanation for the trend observed based on quantitative descriptive analysis.

The cooperation of the responding ICM intermediaries was sought especially in terms of ensuring that the responding officer was the person with the relevant responsibilities to do so, and that the permission of relevant superiors or authorities was obtained where necessary, as the responses provided by an institution would be assumed to reflect its perspectives on the issues raised. The respondents were assured of the confidentiality of the responses obtained. An access link to the online survey was provided in the email invitation, as well as the due date for submitting the completed survey.

Due to the exploratory nature of the research, data elicited from 60 ICM intermediaries from nine countries (shown in Table 2.1) were subjected to descriptive data analysis only and mainly based on simple percentage, frequency and (in a few instances) weighted mean scores to show relative importance.<sup>21</sup>

**Table 2.1: Respondent Islamic Banks by Region and Country**

<b>Countries where respondent Islamic bank is based</b>	<b>Number of ICMs</b>
Indonesia	34
Saudi Arabia	9
United Arab Emirates	8
Brunei-Darussalam	2
Turkey	2
United Kingdom	2
France	1
Germany	1
Malaysia	1
<b>9 countries</b>	<b>60 ICM intermediaries</b>

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<sup>21</sup> The analysis is based on pooled data which may conceal jurisdictional peculiarities. This concern is addressed in this paper in instances where such peculiarity is considered material and relevant information is available.

### SECTION 3: LICENSING AND ENTRY REQUIREMENTS

Notwithstanding the increasing globalisation of the capital markets in general, and of the ICM in particular, the regulatory regimes relating to the activities of the various stakeholders, including the ICM intermediaries, are still largely localised at either or both of the national or sub-national levels.<sup>22</sup> This fact, and the failure of legal and regulatory regimes in some instances to distinguish between conventional and ICM intermediaries, may add to regulatory inconsistency in determining which institutions qualify as ICM intermediaries across jurisdictions. An ICM intermediary may be viewed as either intermediating financial or information flow, or perhaps acting as an agent on transactions on behalf of clients. In addition to jurisdictional peculiarity in terms of market development, as the capital market transforms so also is the classification of which participants may be considered as an ICM intermediary in particular jurisdictions.

Based on the increasing dynamism and dispersal in their activities relating to bringing the capital seeker and capital provider together, entities in the ICM other than the issuers and investors may be conveniently termed “ICM intermediaries”. In other words, ICM intermediaries are a vital link between the regulators, issuers and investors. CPICM 30 of IFSB-21 generally describes intermediaries as those who engage in the business of managing investment portfolios, in either a proprietary way or on their own accounts, by receiving, transmitting or executing investment orders, providing investment advice, underwriting or distributing securities, and placing investment securities on a non-firm commitment basis.<sup>23</sup>

The first question in the survey is: “What qualifies an institution as an ICM intermediary in your jurisdiction?” As expected, the responses provided indicate that all jurisdictions, generally, have some form of licensing requirements that must be complied with by prospective and existing ICM intermediaries. In some jurisdictions, similar requirements are used for being licensed as either an Islamic or a conventional ICM intermediary. For instance, no specific regime for ICM intermediaries’ licensing and entry requirements applies in Germany.<sup>24</sup> In Turkey, the scope of activities of conventional banks licensed by the Banking Regulation and Supervision Agency (BRSA) extends to the provision of ICM activities if clients request to invest in non-interest-bearing funds. In Saudi Arabia, the Capital Market Authority issues no distinct licence to prospective ICM intermediaries; as such, intermediaries can deal in both conventional and Islamic securities.

In some other jurisdictions, before an ICM intermediary can operate there is a requirement of fulfilment of the Sharī‘ah supervisory board’s approval in addition to gaining the the RSA’s licence. For instance, in Brunei Darussalam, the Autoriti Monetari Brunei Darussalam (AMBD) issues a Capital Market Services Licence (CMSL) to an ICM intermediary to carry out specific regulated intermediation activities but with an additional requirement that it should appoint a Sharī‘ah advisory board and

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<sup>22</sup> McMillen (2018), p. 79.

<sup>23</sup> What constitutes an ICM intermediary may vary from one jurisdiction to another.

<sup>24</sup> The supervisory body is BaFIN, the Federal Financial Supervisory Authority; and the applicable rules are based on Markets in Financial Instruments Directive (MiFID II), which is an EU-harmonised regulation for investment services.



that the Brunei Shari'ah Supervisory Board grants approval that proposed ICM activities to be provided to investors are Shari'ah-compliant.

Somewhat similar practices are prevalent in, for instance, Indonesia, but with slight variations. The issuance of an operating licence to ICM intermediaries in Indonesia resides in the financial services authority Otoritas Jasa Keuangan (OJK). In addition, prospective ICM intermediaries must have internal personnel with sufficient knowledge of Islamic finance and approval of the national Shari'ah council (DSN-MUI), to ensure that activities carried out are indeed Shari'ah-compliant. A mutual fund-selling agent must obtain the Agen Penjual Reksa Dana/Mutual Fund Selling Agent (APERD) licence, which permits it to sell both Shari'ah-compliant and conventional funds.

In Malaysia, it is expected that a prospective ICM intermediary would have to obtain the CMSL issued by the Securities Commission Malaysia (Suruhanjaya Sekuriti) if a principal, or a Capital Markets Services Representative's Licence (CMSRL) if an agent. Such an intermediary – for instance, an Islamic fund manager – would be expected to carry on solely Islamic fund management, as doing otherwise would infringe on its recognition as such. Intermediaries are expected to have a Shari'ah board established at each institution's level that ensures Shari'ah compliance in adherence to the rulings by the Shari'ah Advisory Council of the Securities Commission Malaysia.

In the United Arab Emirates (UAE), the licensing requirements vary depending on the nature of the ICM intermediary, its activities, the classification of its intended clients, etc. Nonetheless, it is expected that a Shari'ah board and Shari'ah advisors/policies are in place. Specifically, in Dubai, the Dubai Financial Services Authority (DFSA) regulates investment activities in general based on the provisions in the DFSA rulebook.

The role of intermediaries in the ICM is crucial to the operational efficiency of the market in terms of facilitating liquidity and settlement mechanisms.<sup>25</sup> As the scope of intermediation widens, fostering innovation and managing the dynamism and diversity in the ICM would require that adequate arrangements are in place to ensure that licensing for and entering into the provision of ICM intermediation services are properly regulated to cater for the stability of the capital market.

In terms of the specific requirements for licensing, and the minimum requirements expected to be complied with by an ICM intermediary in various jurisdictions as per CPICM 30 of IFSB-21, Figure 3.1 shows the distribution of responses. In all cases, more than 90% of the respondent ICM intermediaries indicate that all the relevant minimum requirements are prevalent in their jurisdictional regulation of their activities.

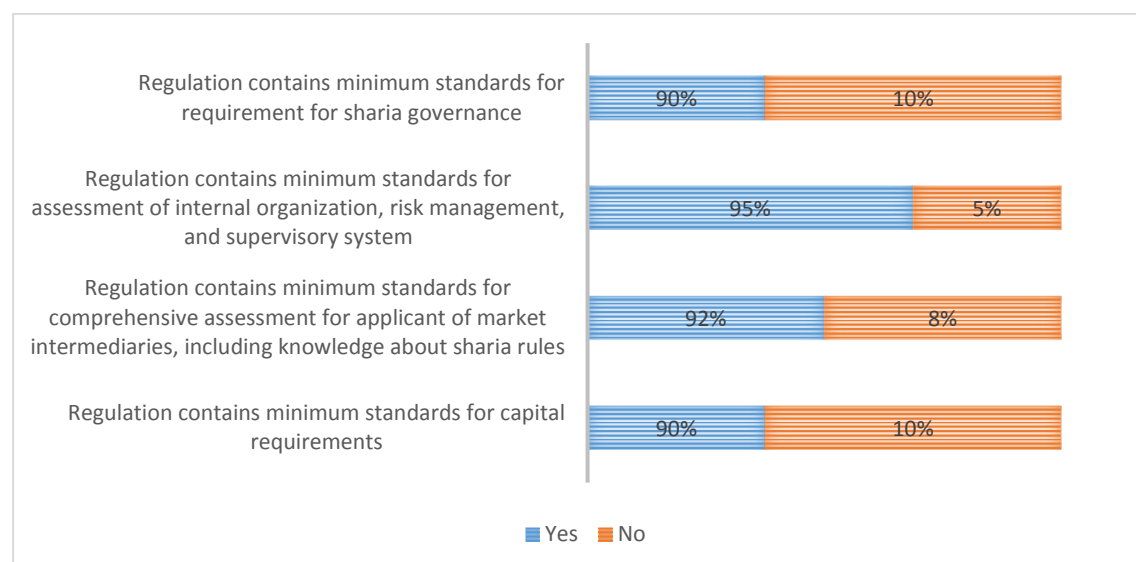
The prevalence of such minimum requirements provides a level playing field and consistent treatment for the intermediaries, as well as a basis to prove Shari'ah compliance of activities for which an operating licence has been granted. Compliance with such minimum requirements also provides evidence of Shari'ah governance and internal control to ensure the proper conduct of the intermediaries and their appointed agents.

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<sup>25</sup> McMillen (2018), p. 91.

For instance, while compliance with the minimum capital requirement provides some level of assurance of investor protection and systemic stability and integrity, compliance with prudential requirements signals adequacy of internal procedures and the effectiveness of risk management mechanisms. In addition, compliance with minimum standards for Sharī'ah governance also provides an indication that any peculiar Sharī'ah compliance issues that may arise from the ICM intermediaries' activities are catered for.

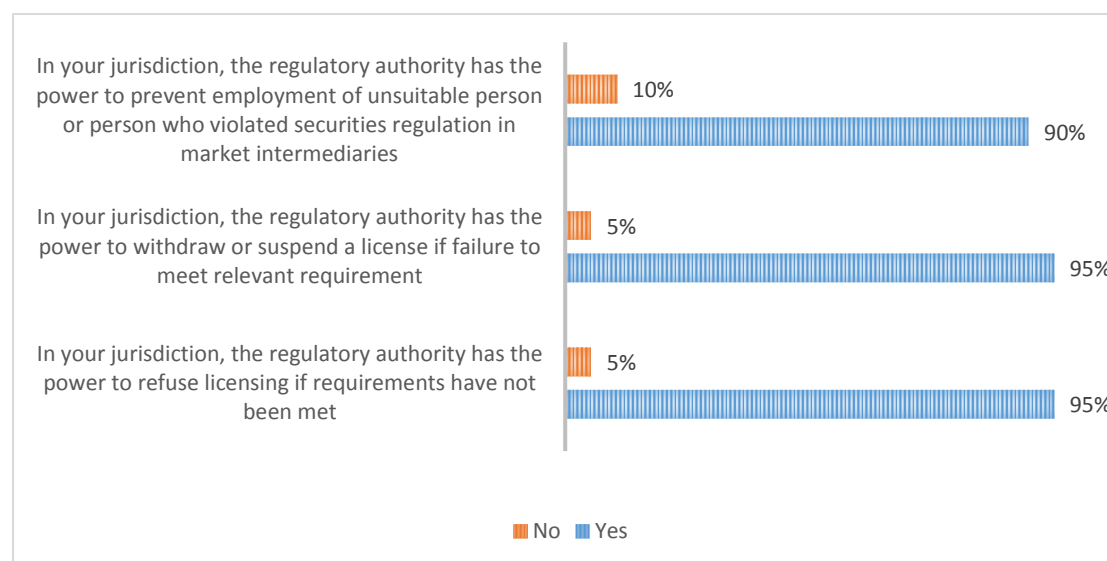
**Figure 3.1: Jurisdictional Minimum Requirements for ICM Intermediaries**



The survey probed further into the nature of ICM intermediary regulation in terms of the power granted to the RSA on licensing, reporting requirements, type, structure, etc. The responses obtained indicate that, in general, market players across jurisdictions note the power of the RSA either to refuse to issue an operational licence or to revoke a licence if conditional requirements have not been met.

Furthermore, even where such licensing requirements have been met and licences have been issued to the ICM intermediaries, effective regulation would require that RSAs are vested with the power to inspect, investigate, monitor, discipline and enforce sanctions on erring institutions. For example, as shown in Figure 3.2, the RSA has further powers to ensure that the ICM intermediary complies with expected regulatory fit-and-proper criteria vis-à-vis the employment of key personnel, as well as with other prudential requirements.

**Figure 3.2: Regulatory and Supervisory Authority’s Power to Issue or Revoke an ICM Intermediary’s Licence**



Specifically, CPICM 30, in line with the related IOSCO principle on “fit-and-proper” assessment,<sup>26</sup> provides the requisite guidelines that ensure persons who hold key responsibilities in an ICM intermediary are not bereft of the requisite skills, and possess detailed knowledge of Islamic finance in general and ICM in particular with specific regards to the structure, purpose and risks of the ICM products offered.

In addition, there should be adequate demonstration of the general competence and reputation that the position occupied demands. This is with the intent of reducing the risks that may arise if such persons are the weak link in the operations of the ICM.

Such a comprehensive assessment of the fitness and capability of the staff of the ICM intermediary should be conducted both at the initial time of applying for an operational licence as well as on an ongoing basis to ensure continuous assessment of the conduct of the ICM intermediaries and its staff.

Based on the open-ended responses provided by the market players, due cognisance is given by their respective RSAs to ensure that the specificities of the ICM are factored into their human resource composition.<sup>27</sup> For instance, in Brunei Darussalam, it is expected that an ICM intermediary that holds the capital markets services licence in compliance with the Securities Markets Order shall, among other requirements, appoint a Shari‘ah advisory body whose membership would require meeting a specific level of being fit and proper for the purpose.

In Indonesia, an ICM intermediary needs to have in its employment at least a director and an investment manager who are experienced and well versed in the operations and regulations of the IFSI, particularly the ICM. This is in addition to meeting the provisions stipulated in the Financial Services Authority’s regulations governing the

<sup>26</sup> *Fit and Proper Assessment — Best Practice, Final Report*, Report of the Emerging Markets Committee of IOSCO, December 2009, available at: [www.iosco.org/library/pubdocs/pdf/IOSCOPD312.pdf](http://www.iosco.org/library/pubdocs/pdf/IOSCOPD312.pdf)

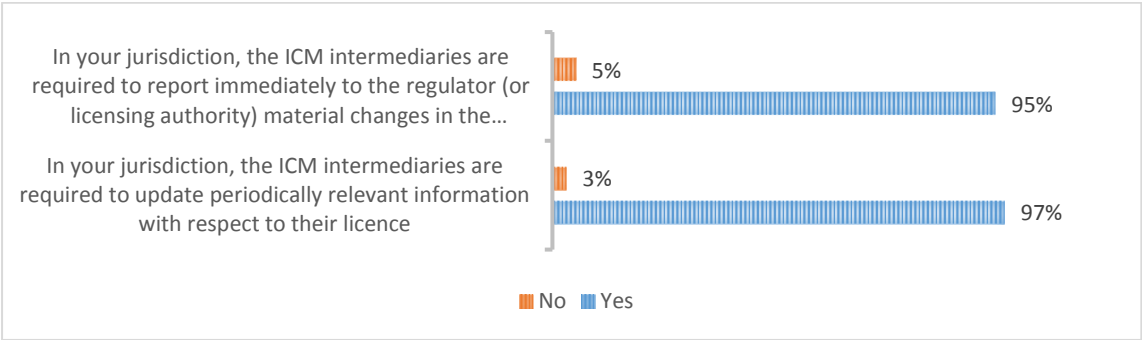
<sup>27</sup> As noted in IFSB-21, the principles provided offer a general guideline given that each jurisdiction may have additional requirements as necessary.

composition of the investment committee and/or the investment management team, and the Sharia Investment Committee. Similarly, in Dubai, UAE, in order to secure Sharī'ah endorsement, it would be necessary to have in place a Sharī'ah board and Sharī'ah advisors/policies.

In Malaysia, it is expected that an ICM intermediary ensures that, at all times, it has in its employ personnel with requisite understanding and knowledge of the primary business. This is in addition to being well versed in the operations and procedures of the ICM and having a fundamental knowledge of the Sharī'ah.

As RSAs have the power to revoke the operating licence of an ICM intermediary, the intermediary is required, as per CPICM 30, to give timely notification to the RSA of significant events that may infringe on compliance with its licensing conditions. For instance, on an ongoing basis, the DFSA would also expect there to be Sharī'ah audits and reports on certificates issued and also regular reporting to the board and the DFSA on the activities undertaken by the firm. As per Figure 3.3, most market player respondents indicate that there are similar requirements in their various jurisdictions, in which case there is a periodic and often continuing reporting requirement regarding matters pertinent to investors' protection and systemic integrity.

**Figure 3.3: Regulatory and Supervisory Requirements for ICM Intermediary Reporting on Licence Status**



## SECTION 4: INTERNAL OPERATIONS AND RISK MANAGEMENT

### 4.1 Capital Adequacy Regulation of ICM Intermediaries

In addition to serving as an early warning signal for the need to refocus its risk management strategy, an ICM intermediary needs to have sufficient capital to protect itself, as well as its customers and counterparties, against a myriad of risks they are confronted with. This will help to enhance stakeholders' confidence in the stability and resilience of the ICM, as intermediaries can demonstrate their ability to meet commitments as they become due. In addition, it may help to protect against systemic risks origination and propagation through the activities of the ICM intermediaries given the possible systemic linkages of the various sectors in the IFSI.<sup>28</sup>

While it is indicated in the survey responses that meeting a minimum capital requirement is a fundamental criterion for obtaining a licence to operate as an ICM intermediary in all jurisdictions, the practice varies from one jurisdiction to another. All jurisdictions view it as a capital requirement specified by the RSA, with possible amendments as and when required, that must be complied with by all intermediaries operating in their respective capital market. In some jurisdictions, a risk-based capital adequacy approach is adopted, which gives due cognisance to the peculiar nature of ICM intermediation, firm size, complexity and business risks.<sup>29</sup>

Fundamentally, regulatory minimum capital requirements are designed to ensure the safety and soundness of the financial system. Nonetheless, such a need addresses different concerns in both the banking sector and the non-banking sector such as the ICM. In the former, the need for capital requirements stems from the fact that banks operate in a principal capacity and thus need to comply with capital requirements to mitigate against failure arising from unexpected losses. As such, risks arising from the failure of a banking institution are borne by its equity owners, thus providing an incentive for prudence. Activities in the capital markets, on the other hand, are based on risks taken by investors and institutions in the expectation of a higher but probable return on investments. As such, minimum capital requirements are put in place to manage failure in a manner that can ensure intermediaries' orderly liquidation and transfer of investors' assets in the event of a crisis.

As per CPICM 31, the initial and ongoing capital and other prudential requirements for market intermediaries should reflect the risks the intermediaries undertake (IOSCO 30). In Figure 4.1, based on the responses obtained from ICM intermediaries, the level of compliance with the 14 specified items in the questionnaire is above average in most instances, with the mean score obtained on a scale of 1 to 5 being greater than the median score of 3. However, scores indicated in Figure 4.1 are weighted to show the relative importance of each item.<sup>30</sup>

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<sup>28</sup> IFSB, *IFSI Stability Report 2016*, pp. 115–26.

<sup>29</sup> The CPICM permits the use of more than one technique in the computation of capital requirements. See paragraph 621 of IFSB-21.

<sup>30</sup> The data from the questionnaire in relation to this section were generated on a scale of 1 to 5. In isolation and at varying percentages, responses to all 15 items were indicated as either "Always" or "Often", except in a few instances when the "Sometimes" option was indicated. Explaining each item would require many tables to indicate what percentage is "Always = 5", "Often = 4", "Sometimes = 3", "Rarely = 2", or "Never

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= 1". However, the interpretation reflected in Figure 4.1 is based on weighted scores. The figures are absolute and are interpreted based on their degree. Each item is given an equal weight of 1, then multiplied by responses obtained from each RSA and Islamic bank respondent. The graph shows a weighted score based on total respondent scores for each question. In this case, an item with 1.02, albeit marginal, is considered more important than an item with 1.00, though both items are considered important in isolation.

**Figure 4.1: ICM Intermediaries' View on Capital Adequacy Regulation**



From the perspective of ICM intermediaries, with a weighted mean score of 1.79, there seems to be a relatively strong view that the regulatory requirements in their respective jurisdiction make adequate provision in line with the principle that in the event of the need to wind down its business, an ICM intermediary should be allowed to do so within a short period of time in a manner that neither infringes market stability nor makes its customers incur catastrophic losses.

In addition, the capital adequacy regulation takes a progressive stance in which an intermediary is expected to beef up its capital as the risks it undertakes increase (weighted mean score of 1.57), as well as to cater for the risks that may crystallise due to activities of its unlicensed affiliates or any off-balance sheet activities it undertakes (weighted mean score of 1.59). It is important to note that the intermediaries also indicated that the RSAs exercise to a commendable extent their regulatory powers as per these principles.

The items that are relatively least complied with relate to subjecting the financial information of their financial position to further assessments by independent auditors, as well as the detail, format, timeliness and frequency of reporting significant deterioration in the capital level to the relevant RSA (weighted mean score of 1.31). These items perhaps align with the relatively lower weightage scores obtained for items relating to how regularly the RSAs review the ICM intermediaries' capital levels and the provision of adequate capital and other prudential requirements for the latter vis-à-vis the level of risks they undertake (weighted mean score of 1.34). This may suggest that there is the need to have mechanisms at both the operational and regulatory levels to ensure that the existing capital adequacy framework works effectively even though evidence is provided that the RSAs exercise authority regularly (weighted mean score of 1.57).

#### 4.2 ICM Intermediaries' Internal Operation

As per CPICM 32, ICM intermediaries should be required to establish an internal function that delivers compliance with standards for internal organisation and operational conduct, with the aim of protecting the interests of clients and their assets and ensuring proper management of risk, through which management of the intermediary accepts primary responsibility for these matters (IOSCO 31).

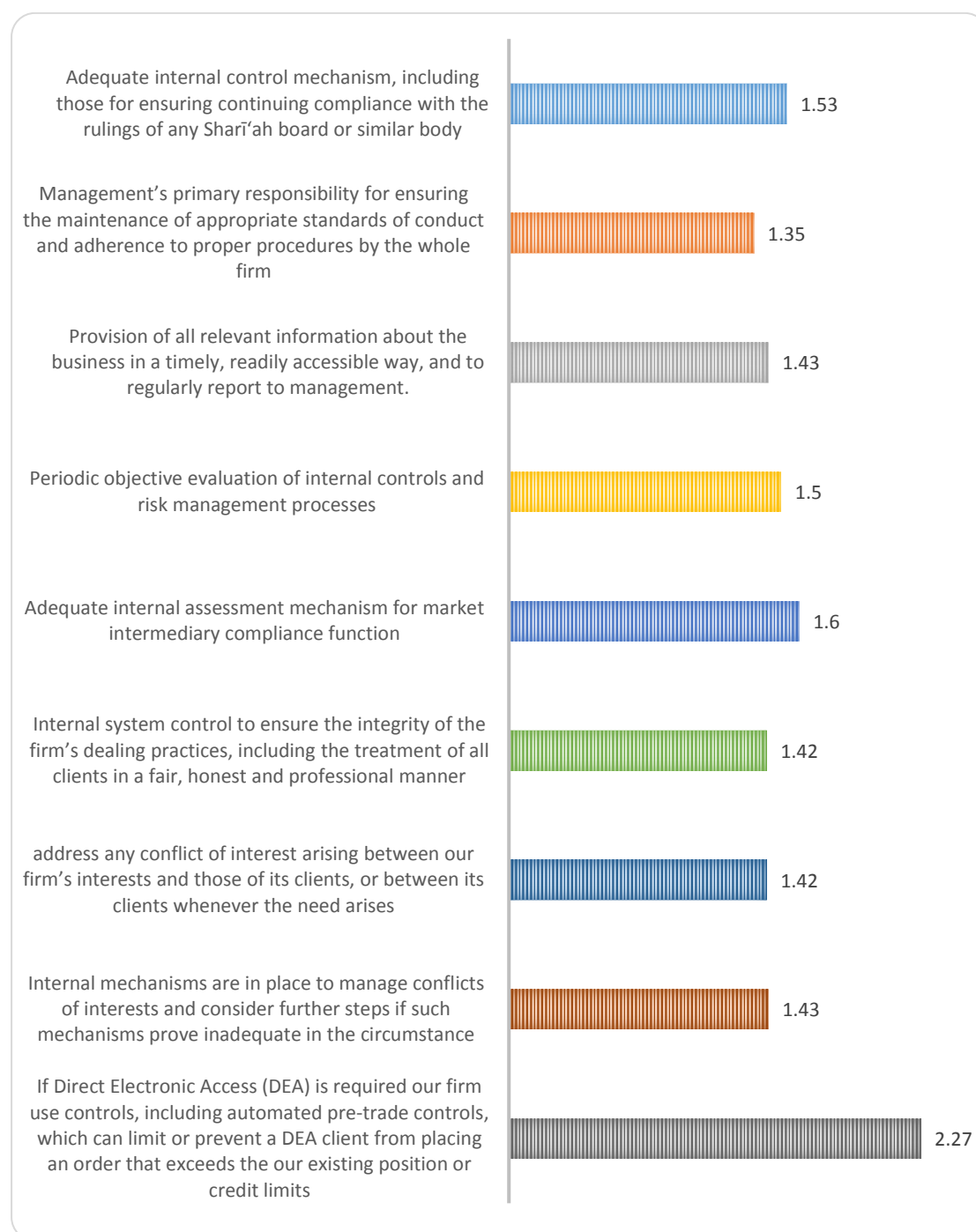
CPICM 32 is hinged on the reality that ICM intermediaries would inevitably encounter conflicts of interest and other regulatory issues arising from their conduct, but they should demonstrate sufficient incentive to correct such. The essence of the principle is to ensure that ICM intermediaries put in place internal mechanisms that facilitate rule observance and adequate compliance with the laws and regulations that govern their roles in the ICM. In fact, arguments could be made in favour of less interventionist regulation of the activities of the capital market intermediaries where there is evidence that there is enough market incentive to correct intermediation anomalies as and when they arise.<sup>31</sup>

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<sup>31</sup> Choi (2004).



**Figure 4.2: ICM Intermediaries' Views on Internal Control**



In Figure 4.2, based on the responses obtained from the ICM intermediaries, the level of compliance with the nine specified items in the questionnaire is above average in most instances, where the mean score obtained on a scale of 1 to 5 is greater than the median score of 3. However, scores indicated in Figure 4.2 are weighted to show the relative importance of each item.

The responses obtained indicate that the item relating to the use of direct electronic access (DEA) when it is made available to a client has the highest weighted mean

score of 2.27. In this regard, the ICM intermediaries indicate that there is an internal control mechanism to ensure that their trading limit is not exceeded. The relative importance of this could be viewed from the perspective that while technological advancements have transformed the intermediary–client relationship, and enhanced the operational efficiency of ICM intermediaries vis-à-vis the increased trade routing, executing and booking permutations, they have also increased opportunities for abuse in a manner that attenuates traditional fiduciary and self-regulatory duties.

A key distinction between an ICM intermediary and its conventional counterpart is the fact that the activities of the former should ideally be in compliance with the Sharī'ah. This fact perhaps explains why, in some jurisdictions, there is an additional requirement for approval by the Sharī'ah supervisory board in that jurisdiction before an operating licence is granted to an ICM intermediary.

Based on the responses obtained, the ICM intermediaries also indicate that, as part of their internal control mechanism, there is an adequate internal provision to ensure continuous compliance with the rulings of the Sharī'ah board or similar body in their respective jurisdiction (weighted mean score of 1.53). This view very much complements the response indicated against the item that relates to the adequacy of the internal assessment mechanism for the ICM's compliance function, which also had a relatively high weighted score of 1.6.

Other items relate to the adequacy of the internal control mechanisms for addressing conflicts of interest as and when they arise, and to the provision of periodic evaluation and review of the ICM intermediaries' internal risk management process. The pertinence of having an adequate internal mechanism to ensure compliance with Sharī'ah vis-à-vis the activities of the ICM intermediaries is apparent, for example, in the fact that many Sharī'ah-compliant investments are structured based on the *muḍārabah* model.<sup>32</sup> The profit-sharing/loss-bearing feature of *muḍārabah* implies that even though an ICM intermediary has an economic interest in an investment due to efforts exerted, it will only contribute to financial losses in the rare event of proven negligence or misconduct. There may be an incentive for an unrestricted ICM intermediary in this regard to engage in excessive risk taking at the expense of the investor.

While the weighted average scores obtained (as shown in Figure 4.2) would suggest sufficient compliance with CICPM 32 in many regards, Given their expected role to protect the interests of investors, one might not expect the view of the ICM intermediaries to be particularly self-critical.<sup>33</sup>

### 4.3 Risk Management Practices

Since the development of regulatory guidelines and policies for risk management is influenced by the level of risk tolerance and expectations of the various stakeholders in the ICM, it is pertinent to ensure that no regulatory vacuum is created. Nonetheless, there is a limit to the efficacy of regulatory oversight, as it is meant to ensure there is an adequate internal mechanism to mitigate the crystallisation and propagation of risks, rather than removal of risks from the marketplace. This is so, particularly in

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<sup>32</sup> McMillen (2018), pp. 92–93.

<sup>33</sup> RSAs are not included in the survey.

regards to the activities of ICM intermediaries, wherein they are expected to have in place a risk mitigating mechanism as part of their internal control systems.

In the survey, a few open-ended questions were posed to the ICM intermediary respondents on what they consider to be key risk areas pertaining to their intermediation activities. The responses obtained indicate that, generally, ICM intermediaries are faced with the same sorts of risks as their conventional counterparts.<sup>34</sup> A brief explanation of these various risks, and the responses obtained from the ICM intermediaries, follows.

#### 4.3.1 Market Risk

The ICM intermediaries may be exposed to market risks due to changes in market prices, as well as to execution risk which may impede a quick-enough action to avoid incurring loss.<sup>35</sup> Market risks could also arise due to marking to market, which may not have arisen in the course of taking a position in an investment but may nonetheless be publicly recorded in an ICM intermediary's accounts. This is in addition to a model risk that may manifest as another form of market risk due to the ICM intermediaries' use of models<sup>36</sup> in their trading in illiquid or thinly traded assets.

#### 4.3.2 Credit Risk

The ICM intermediaries' exposure to credit risk may also be due to a failure of the counterparty to honour obligations as they fall due. Operationally, credit risk can also manifest either as clearing risk or custodial risk. In the case of the former, an ICM intermediary fails to accurately record trades executed in its books. In terms of the latter, an ICM intermediary as a custodian may be exposed to such risk in the event that it co-mingles its cash and securities with investors' funds which may not be available in the event of insolvency.

In some cases, based on the responses to the open-ended questions, credit risk arising from balances with investee companies is managed by placing funds with such companies having appropriate reputation and credit ratings, which are monitored periodically. Credit risk arising from outstanding receivables for the provision of services is managed by accepting service engagements from only well-known and highly reputable entities and counterparties, whose liquidity is also subjected to continuous monitoring to mitigate against credit risk arising from outstanding receivables for monitoring services rendered by the ICM intermediaries for the clients.

#### 4.3.3 Operational Risk

Operational risk is also mentioned by the ICM intermediaries as being prevalent in their intermediation activities. As is the case with conventional capital market intermediaries, operational risk occurs as result of losses incurred due to inadequate

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<sup>34</sup> Such risks identified include, but are not limited to, credit, market, operational, legal, reputational, regulatory, Shari'ah non-compliance and cyber risks.

<sup>35</sup> For instance, a stop-loss risk arises where an ICM intermediary cannot exit a trade at the worst price it is willing to accept.

<sup>36</sup> Models may be susceptible to data limitation or omission, or even to wrong parameterisation.

or failed internal processes, people and systems<sup>37</sup> on the one hand, or to exposure of the ICM intermediaries to external events on the other.<sup>38</sup> For instance, the online/investment platform could be down. This may have implications in relation to execution of transactions and their settlements, publicity, and legal implications from any dealings between ICM intermediaries and third parties.

In most instances, the ICM intermediaries indicate that an internal control mechanism is in place which accentuates ensuring that there are duly documented processes, appropriate segregation of duties, proper monitoring and reconciliation of transactions and balances, and a carefully considered maker-checker incorporated in each process. An ICM intermediary indicated that, in addition to an oversight function by its internal audit and risks committee, it also engages external independent auditors. All these mechanisms are intended to keep in tune with best practices and to take into consideration lessons learnt from publicised operational failures within the financial services industry.

#### 4.3.4 Liquidity Risk

Liquidity risk is also mentioned as manifesting in the lack of depth of the ICM. As such, assets may have to be kept to maturity in some instances, which may exacerbate their exposure to concentration risks.<sup>39</sup> In some other instances, ICM intermediaries monitor liquid assets and their requisite cash requirements on a periodic and regular basis – for instance, monthly.<sup>40</sup>

#### 4.3.5 Sharī'ah Non-compliance Risk

Most respondent ICM intermediaries also noted their susceptibility to reputational risks<sup>41</sup> that may crystallise from many sources, but mainly from their inability to mitigate against another important risk – Sharī'ah non-compliance risk.<sup>42</sup> Such risk may arise in instances of status transformation due to continuous updating by the RSA, in which case a stock previously categorised as being Sharī'ah-compliant may be otherwise classified as non-Sharī'ah-compliant after funds have been committed to it by an ICM. Another instance highlighted in the survey is where an investee company takes on a non-Sharī'ah-compliant financing or funding, or where an issuer of a previously Sharī'ah-compliant security has its status revoked due to its acquisition of a non-Sharī'ah-compliant business.

#### 4.3.6 Other Risks

Other general risk types mentioned include legal risk, which, in Basel taxonomy, may also be viewed as a form of operational risk. It may arise in the event that an ICM is

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<sup>37</sup> While it is incontrovertible that technological advancements have positively enhanced operational efficiency in intermediation activities in the ICM, it also exposes the intermediaries to operational risks that may arise from attenuated fiduciary and less-self-critical regulatory assessments.

<sup>38</sup> Basel Committee (2011).

<sup>39</sup> Investing in a single or limited number of counterparty or assets

<sup>40</sup> An ICM indicated that it also ensures that its liquid assets at all times exceed its expenditure-based capital minimum (EBCM) – that is, at least 13 weeks of expected expenditure. The cash position and requirements are reported and considered by the regulators on a monthly basis.

<sup>41</sup> Potential damage to an ICM intermediary's goodwill or brand.

<sup>42</sup> Sharī'ah-compliance determination resides in the national Sharī'ah authority in various jurisdictions, or in Sharī'ah boards at the institutional level, depending on what practice is prevalent in a jurisdiction.

sued for its inability to effect its own part of a contractual agreement or for practices that infringe on the rights of a counterparty. In addition, a few ICM intermediaries noted their susceptibility to money laundering and financing of terrorism risks, in which case transaction flows may be diverted to opaque venues.<sup>43</sup>

#### 4.4 Types and Adequacy of Risk Assessment Criteria Used

The survey probed further into whether the ICM intermediaries have established criteria for assessing the various risks they are faced with and whether those criteria are adequate for the purpose. In response to the first question, all the ICM intermediaries answered in the affirmative, albeit with varying risk-assessment criteria in practice, especially depending on whether the risk can be classified as arising either from Sharī'ah non-compliant activities or otherwise.

In most cases, there exist internal risk assessment policies and processes that involve the establishment of a dedicated risk management committee, headed by a risk management officer usually as part of the internal investment and evaluation procedures. Essentially, the committee helps the management or board of directors to ensure that the risk management policies are fully complied with.<sup>44</sup> In most instances, a comprehensive post-completion report is also prepared, detailing financials, key performance indicators, and risk metrics based on the risks inherent in each investment, to serve as a guide in determining the worthwhileness of similar investments in future.

In addition, a risk assessment matrix is used to depict the likely degree of impact of a risk incident, as well as the likelihood of occurrence. From the assessment matrix, the risk incident can be categorised into three types. The first category is high risk or unacceptable risk, which requires urgent attention such as immediate investigation and action to be taken to mitigate origination, propagation or transmission.

The second category relates to a medium risk or tolerable risk, but for which action is required to avoid it becoming a high risk by investigating and considering various mitigating options to be taken within a specified time period. The third category is low risk, for which mitigating strategies are employed to prevent escalation. In most cases also, the ICM intermediaries indicated that periodic reporting<sup>45</sup> of their risk assessment and management process is made internally to their board, and in some instances to the RSA in their jurisdiction.

In terms of money laundering and financing of terrorism risks, the ICM intermediaries adopt various risk mitigation strategies. For example, most respondent ICM intermediaries have an internal know-your-client (KYC) and customer due diligence (CDD) procedure which ensures that all prospective clients are properly and comprehensively screened, and that adequate information and documentation are requested for and obtained until it is proven beyond a doubt that the prospective client

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<sup>43</sup> Financial Action Task Force (FATF) Recommendation 7.

<sup>44</sup> Each new investment is considered in the context of the existing portfolio risk exposures. If investment is considered to be value-adding on a risk-weighted basis by the investment committee, recommendation is made to the board for approval.

<sup>45</sup> Some ICM intermediaries stated that periodic reporting is done annually, while some others indicated that they prepare and submit such reports to their board and the RSA on a semi-annual basis. A few others indicated they do so on a quarterly basis.

is not engaged in money-laundering activity. Additionally, all clients are continuously vetted on a sanctions screening tool to ensure that they are not engaged in any illegal activity that may expose the firm to risks.

Specifically to control for Sharī'ah non-compliance risks, the respondent ICM intermediaries indicated that they have also put in place a number of other risk mitigating practices. For example, a Sharī'ah compliance monitoring program might include all the relevant regulatory requirements pertaining to ensuring strict compliance with the Sharī'ah rules. These include relevant Sharī'ah policies and procedures, appointment of the Sharī'ah board, frequency of Sharī'ah meetings, Sharī'ah reviews and reporting, assessment of the products by the board, etc.

In most cases, there is an internal control system whereby stocks are subjected to Sharī'ah-compliant screening based on the approved internal guideline as per the Sharī'ah advisory body in the jurisdiction. Any peculiar instances warranting a deviation from the guideline must also be with the prior notification of and approval from the Sharī'ah advisory board. In instances where automation is used in the screening, there are established and approved parameters which the fund manager has to input into the system to give notification of any Sharī'ah-violating fund.<sup>46</sup>

For *ṣukūk*, Sharī'ah advisors in a number of jurisdictions pre-approve all *ṣukūk* investments prior to investment to ensure their Sharī'ah compliance. However, where the ICM intermediary relies on external screening of stocks for Sharī'ah compliance, a regular periodic monitoring of the equities listed in the Sharī'ah index is conducted. If the equities exit the Sharī'ah index, the fund manager will make the necessary adjustment accordingly. An ICM also indicated that for an investment in Sharī'ah-compliant stock, a shadow Sharī'ah non-compliant account is also created so that such stocks may be transferred to the latter account in the event of a change in status to being non-Sharī'ah-compliant.

A further probe for details pertaining to overall assessment of Sharī'ah non-compliance risks faced by ICM intermediaries and its weightage in their overall risk profile indicates that it is low, on average, compared to other risks. Plausible reasons adduced include the fact that there is a fundamental presupposition that there should be zero tolerance for Sharī'ah non-compliance risks due to the possibility of such a risk triggering reputational and regulatory risks.

There seems also to be a strict adherence among the ICM intermediaries to the Sharī'ah investment guidelines from the Sharī'ah advisory board, as they indicate sufficient due diligence done internally on potential investments. Some ICM also apply dividend purification methods, such that if there is any Sharī'ah stock that generates a low percentage of non-permissible income, such relevant amount is deducted from the income generated from the stock.

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<sup>46</sup> One ICM intermediary retorted that: "any breaches in Sharī'ah compliance are identified by [the] Investment Compliance Department using automated controls within the Charles River Investment Management System. Franklin Templeton uses Ideal Ratings as its equity Sharī'ah security screener. Any non-Sharī'ah compliant stocks based upon this screen are flagged within Charles River."

## SECTION 5: TRANSPARENCY, DISCLOSURE AND CLIENT PROTECTION PRACTICES

IFSB-4, IFSB-22 and FAS 11 of AAOIFI<sup>47</sup> all offer a number of recommendations aimed at improving transparency and enhancing market discipline<sup>48</sup> in the IFSI. This is through enhanced transparency and comprehensive disclosure – in this case, by the ICM intermediaries to their clients – with the intent of enhancing the latter's protection.<sup>49</sup> By so doing, the ICM intermediaries would not only be demonstrating good disclosure practices, but are also leveraging on the economic benefits such practices offer, such as avoidance of regulatory sanctions. The relative importance of proper disclosure is hinged on the fact that it facilitates professional scrutiny of the activities of the stakeholders in the capital market, especially the issuers and the intermediaries, thus minimising the vulnerability of individual investors as a result of taking poor decisions.

In the survey, ICM intermediaries were asked: “Based on your intermediation practices, on a scale of 1 to 5, where 1 = Never, 2 = Rarely, 3 = Sometimes, 4 = Often, and 5 = Always, kindly indicate the frequency of compliance of your firm with the following recommendations in protecting clients.” The responses provided are shown in Figure 5.1. The scores are provided on a weighted average basis, as previously explained in footnote 20.

As shown in Figure 5.1, the item with the highest weighted mean score of 1.45 is that relating to providing protection for the investors' assets in the event that an ICM intermediary may be winding up due to financial insolvency. This implies that in the view of the ICM intermediaries, the ownership rights to assets belonging to their clients are adequately safeguarded through proper segregation and identification and protection against defalcation, notwithstanding severe market disruptions that may impede orderly winding-up of an intermediary's activities. The maintenance of accurate and timely records of clients' accounts, as well as provision of adequate disclosure of information relating to clients' assets held overseas, further strengthens the argument that an audit trail of who owns what may be enhanced even in instances where ICM intermediaries co-mingle their own assets with clients', as they are wont to do.

The issue of protecting clients and providing transparent and full disclosure of who owns what investments as part of good practice to mitigate money laundering and financing of terrorism also seems well catered for by the ICMs. As a manifestation of their due diligence, it is indicated that as much as possible the ICMs ensure full compliance with KYC requirements by providing adequate means of verifying prospective clients' identity. This is also in line with compliance with Recommendation 7 of the FATF Standards, which demands that countries should enforce targeted

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<sup>47</sup> In jurisdictions where there is no Sharī'ah law in place, the IFRS and the national accounting standards are used instead.

<sup>48</sup> Zaheer (2013), p 19.

<sup>49</sup> According to Adewale and Archer (2019), the regulatory and supervisory framework for investor protection has been reinforced to protect clients against fraudulent and predatory practices by financial service providers, as well as to seek recourse and restitution as and when needed.

financial sanctions under the United Nations Security Council Resolutions (UNSCRs) to mitigate proliferation financing<sup>50</sup> by capital market intermediaries.<sup>51</sup>

While there seems to be provision of avenues to address investor complaints, as indicated by a weighted score of 1.26, most items on providing investment information to clients are relatively low based on weighted mean scores. For instance, the least weighted means score of 1.18 is recorded for the item that indicates ICMs' regular provision to clients of statements of account containing details of the assets held by the former on the latter's behalf, as well as information relating to transparency in charges and fees payable, and investor literacy.

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<sup>50</sup> According to the FATF, proliferation financing is the act of providing funds or financial services which are used, in whole or in part, for the manufacture, acquisition, possession, development, export, transshipment, brokering, transport, transfer, stockpiling or use of nuclear, chemical or biological weapons and their means of delivery and related materials (including both technologies and dual-use goods used for non-legitimate purposes), in contravention of national laws or, where applicable, international obligations.

<sup>51</sup> The Securities Commission Malaysia published in April 2018 a set of guidelines for this purpose.



**Figure 5.1: ICM Intermediaries' Views on Transparency, Disclosure and Clients Protection Practices**



## **SECTION 6: SAFETY AND SOUNDNESS**

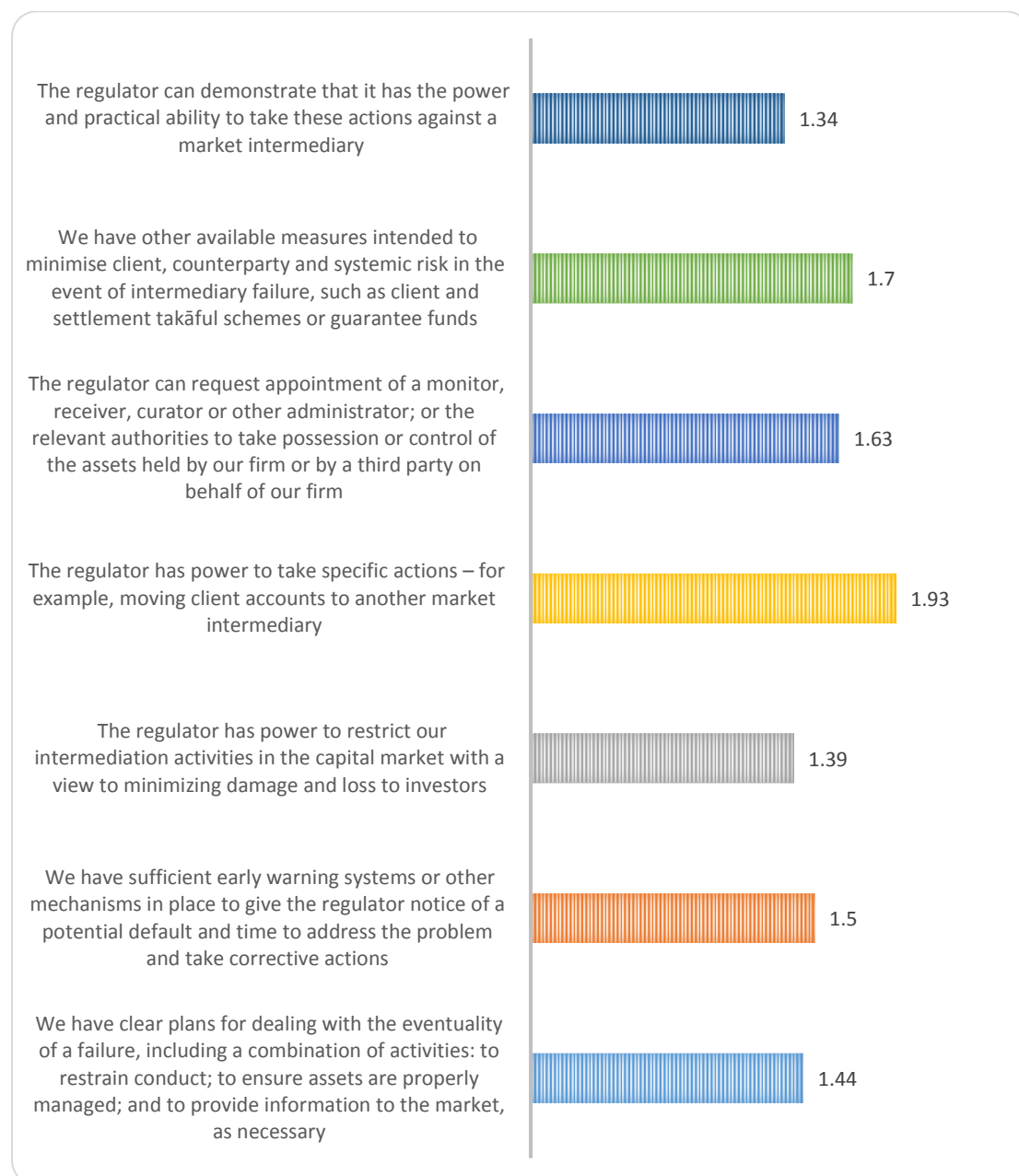
The prime objective of regulation of the activities of the ICM intermediaries, in addition to ensuring their proper conduct, should be to ensure their safety and soundness. This is pertinent to preserving the systemic stability of the financial ecosystem given the interconnecting roles of these ICM intermediaries.

If and when an ICM intermediary fails, the consequence may have to be borne by other stakeholders, including clients and counterparties. In this regard, regulators should ensure that adequate plans that are flexible enough to be deployed to the unpredictable manifestation of such failures should be in place to forestall likely infringement of the financial system.

As per CPICM 33, there should be procedures for dealing with the failure of a market intermediary in order to minimise damage and loss to investors and to contain systemic risk (IOSCO 32). Based on their intermediation practice, and on a scale of 1 to 5, where 1 = strongly disagree, 2 = disagree, 3 = neutral, 4 = agree, and 5 = strongly agree, ICM intermediaries were requested to show their level of agreement with any of the statements shown in Figure 6.1.

The responses obtained from the ICM intermediaries on related questions in the survey indicate that, in addition to the powers vested in the RSAs in various jurisdictions to take appropriate action, there seem to be procedures in place that provide early warning of potential failure of an ICM prior to infringing on the soundness and safety of the capital market.

**Figure 6.1: Safety and Soundness Practices of ICM Intermediaries**



In specific terms, the item with the highest weighted mean score of 1.93 is that relating to the power of the RSA in various jurisdictions to take decisive and pre-emptive actions to mitigate the amplification of the effect of the failure of an ICM intermediary. In addition, a higher mean weighted score of 1.7 on the item relating to provision of other means such as *takāful* schemes or guarantee funds would suggest that, in most jurisdictions, minimising clients' losses and forestalling the origination of systemic risks are a priority.

Viewed together, items relating to early warning signals and to having adequate plans for dealing with eventual failure (with a weighted mean score of 1.50 and 1.44,

respectively) provide ample evidence of both extant ex-ante prevention and ex-post negative impact minimisation mechanisms to cater, in a timely manner, for the susceptibility of the clients of ICM intermediaries to the latter's vulnerability to potential default.

With a weighted mean score of 1.63, the responses obtained would suggest that even though the RSAs may not be able to prevent the failure of an ICM intermediary, there should be sufficient will and means to ensure that winding-down processes are clear-cut and easily implementable. For instance, ensuring that there is proper identification and segregation of funds belonging to an ICM from those of its clients can facilitate safeguarding of the latter's funds in the event of failure. This would allow for implementation of the requisite process to appoint third-party independent custodians of assets and fund valuation companies.

Notwithstanding the foregoing, it is pertinent to know that the least weighted mean score of 1.34 is for the item relating to the RSAs' practical demonstration that the powers vested in them to ensure the safety and soundness of the ICM are actually being put to use.

The last question in the survey sought to know, from the viewpoint of the ICM intermediary respondents, what they consider to be any other area of concern related to their intermediation activities in their various jurisdictions. Generally, the views expressed suggest that the ICM also leverages on the extant conventional capital market infrastructure in many jurisdictions and, as such, cognisance may only be given to the specificities of the ICM.

In this regard, two main themes are identified. The first theme relates to enhancing customer financial education about ICM products and services in a way that distinguishes them significantly from the conventional alternative. The second issue relates to the very limited investment opportunities that are both Sharī'ah-compliant and provide competitive returns.

The implication is that, while the investors whose protection is one of the prime objectives of regulating the activities of the ICM intermediary require financial education that helps them to understand the complexity of the investment products offered to them, the intermediary would also require a broader Sharī'ah-compliant platform for liquidity management purposes to sort through the tough competitive terrain in which they have to compete with their conventional counterparts.

## SECTION 7: CONCLUSION

Basically, this paper investigates the activities of ICM intermediaries based on four related principles, CPICM 30–33, in IFSB 21: *Core Principles for Islamic Finance Regulation (Islamic Capital Market Segment)*. The perception of the ICM intermediaries across various IFSB jurisdictions is elicited on their activities relating to market conduct, client protection, and the safety and soundness of the Islamic capital markets. The pertinent role of the ICM intermediaries as a crucial link among the other stakeholders within the capital market and between it and other sectors of the IFSI is well noted.

As per CPICM 30, the results of the survey conducted indicate that in the various jurisdictions from which responses have been obtained, there are requisite regulations in place (albeit they vary) in relation to the licensing and entry requirements of the ICM intermediaries. Explicit minimum requirements exist regarding the capital requirement, as well as clear-cut regulations on the fit-and-proper criteria for those who hold critical positions in running the affairs of the ICM intermediaries. Such criteria in most cases would require an ICM intermediary to have in their employ personnel with the requisite knowledge of the Sharī'ah law, especially in relation to ICM products, rules, principles and operation.

To ensure compliance, there is, in some instances, a national Sharī'ah board that serves as an additional layer of oversight both during initial licensing and ongoing operation of the licensed ICM intermediary. The Sharī'ah board also ensures that an internal control mechanism caters for the sufficiency of the Sharī'ah governance processes of the intermediaries and that compliance is satisfactory. In the respective jurisdictions, the national Sharī'ah authority also plays a prominent role in the screening of stocks for Sharī'ah-compliance purpose.

In relation to CPICM 31, responses obtained also indicate that in the jurisdictions sampled there is an ongoing requirement that the ICM intermediaries demonstrate the adequacy of their capital to reflect the risk they undertake. Thus, while there exists an initial capital requirement that must be complied with, the nature and size of the business undertaken by the ICM intermediaries subsequent to their licensing may have implications for the safety and soundness of the ICM.

Notably, as per the responses obtained, there also seems to be commendable compliance of the ICM intermediaries with the requirement for timely reporting to the RSAs of developments relating to the former's capital requirements in the event of significant deterioration which may trigger appropriate early regulatory intervention by the latter.

CPICM 32 states that ICM intermediaries should have adequate internal mechanisms that promote proper operational conduct to basically safeguard the investment interests of clients and protect the integrity of the capital market. The ICM intermediaries are susceptible to conflict-of-interest risk, but generally have an internal mechanism to cater for the consequences arising therefrom. Moreover, the ICM intermediaries indicated compliance with Recommendation 7 of the FATF in relation to prevention of usage of their intermediation activities to propagate proliferation financing.

Also, the various risks that the ICM intermediaries are faced with and how risk management practices are carried out indicate a similarity with what obtains in the conventional sphere. However, the ICM intermediaries are also exposed to Sharī'ah non-compliance risk, which may also trigger reputational risk. In most instances, various options include continuous monitoring of the Sharī'ah status of investments based on the screening methodology prevalent in that jurisdiction to ensure that investee companies are engaged in Sharī'ah-compliant activities and practise some form of income purification in the event that income earned is from a non-Sharī'ah-compliant investment.

The safety and soundness of the capital market as one of the prime objectives of regulation is well noted, based on the responses obtained to questions relating to CPICM 32. Basically, RSAs have put in place in their jurisdictions sufficient measures to cater for the safety of the investments of their clients, as well as for the soundness of the market in the event of failure of the ICM intermediaries. While noting that they comply with proper funds segregation and reporting that allows for easy winding-down and minimisation of losses to their clients in the event of failure, the practical application of the powers vested in the RSAs to implement the requisite regulations in this regard received a relatively lower weighted mean score.

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