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FINANCIAL CENTRE

REGULATORY AUTHORITY

Islamic Finance Rulebook (ISFI)

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TABLE OF CONTENTS

	Background	3
1	Application	4
	1.1 Application.....	4
2	Endorsement.....	5
	2.1 Endorsement Requirement in relation to Islamic Financial Business.....	5
	2.2 Application for an Endorsement.....	5
	2.3 Endorsement	6
3	Disclosure	8
	3.1 Disclosure Requirements in Relation to Islamic Financial Business.....	8
4	Constitutional Documents.....	10
	4.1 Islamic Financial Institutions.....	10
5	Systems and Controls	11
	5.1 General Requirement.....	11
	5.2 Policy and Procedures Manual.....	11
6	Shari’a Supervisory Board.....	13
	6.1 Appointment and Operation of a Shari’a Supervisory Board	13
	6.2 Shari’a Reviews.....	14
	6.3 Internal Shari’a Review	15
7	Conduct of Business Standards.....	16
	7.1 Conduct of Islamic Financial Business	16
	Endnotes.....	17

Background to this Rulebook

The *Regulatory Authority* considers that the proper regulation of *Islamic Financial Business* is essential to the pursuit of its *Objectives* of securing the financial stability of, developing market confidence in, and developing the international reputation of, the *QFC* and promoting and maintaining efficient and transparent markets.

1 Application

1.1 Application

- 1.1.1** (1) Chapters 1 and 2 of this rulebook (*ISFI*) apply to every *Authorised Firm*.
- (2) Chapters 3, 5, 6 and 7 of this rulebook apply to every *Authorised Firm* which has an endorsement on its *Authorisation* allowing it to conduct *Islamic Financial Business* as an *Islamic Financial Institution* or by operating an *Islamic Window*.
- (3) Chapter 4 of this rulebook applies to every *Authorised Firm* which has an endorsement on its *Authorisation* allowing it to conduct *Islamic Financial Business* as an *Islamic Financial Institution*.

2 Endorsement

2.1 Endorsement Requirement in Relation to Islamic Financial Business

2.1.1 An *Authorised Firm* must not hold itself out as conducting *Islamic Financial Business* unless its *Authorisation* includes an endorsement from the *Regulatory Authority* authorising it to conduct *Islamic Financial Business*:

- (A) as an *Islamic Financial Institution*; or
- (B) by operating an *Islamic Window*.

Glossary

The expressions *Islamic Financial Business*, *Islamic Financial Institution* and *Islamic Window* are defined in the *Glossary* and have the following meanings:

Defined Terms

Islamic Financial Business means the business of carrying on one or more *Regulated Activities* in accordance with Shari'a

Islamic Financial Institution means an *Authorised Firm* whose entire business operations are conducted in accordance with Shari'a

Islamic Window means an *Authorised Firm* which conducts *Islamic Financial Business* as a part of its business operations

2.2 Application for an Endorsement

- 2.2.1** (1) An application for an endorsement authorising an *Authorised Firm* to conduct *Islamic Financial Business* may be made to the *Regulatory Authority* by any applicant for *Authorisation* under Article 27 of the *Financial Services Regulations*.
- (2) An *Authorised Firm* may apply to the *Regulatory Authority* for an endorsement to conduct *Islamic Financial Business* or to vary such an endorsement.
- (3) The *Regulatory Authority* may refuse to grant an application for an endorsement or for a variation to an endorsement.
- (4) Upon refusing to grant an endorsement or a variation to an endorsement, the *Regulatory Authority* must without undue delay inform the applicant in writing of such refusal and, if requested by the applicant, the reasons for such refusal.
- (5) Any decision made by the *Regulatory Authority* pursuant to Article 29 of the *Financial Services Regulations* may be referred to the *Appeals Body* by the *Applicant* or the *Authorised Firm* to which the decision relates.

2.3 Endorsement

- 2.3.1 (1) The *Regulatory Authority* may endorse the *Authorisation* of an *Authorised Firm* authorising it to conduct *Islamic Financial Business* as an *Islamic Financial Institution* or by operating an *Islamic Window* and will notify the *Authorised Firm* in writing of the terms of that endorsement.
- (2) Subject to (3) and (4) below, the *Regulatory Authority* may at any time by written notice to an *Authorised Firm*:
- (A) impose conditions and restrictions or additional conditions and restrictions in relation to an endorsement;
 - (B) vary or withdraw conditions and restrictions imposed in relation to an endorsement; or
 - (C) remove an endorsement.
- (3) The *Regulatory Authority* may act under (2) on its own initiative or at the request of an *Authorised Firm*.
- (4) Subject to (5), the *Regulatory Authority* may only impose conditions and restrictions or additional conditions and restrictions, or vary or withdraw conditions and restrictions in relation to an endorsement or remove an endorsement where it has beforehand provided the relevant *Authorised Firm* with an adequate opportunity to make representations to the *Regulatory Authority* in relation to the proposed changes and has given due consideration to those representations.
- (5) The requirement imposed on the *Regulatory Authority* under (4) shall not apply:
- (A) in relation to the imposition of conditions and restrictions when an *Authorisation* is first endorsed;
 - (B) where the relevant person has requested the imposition, variation or withdrawal of conditions and restrictions under (3);
 - (C) where the *Regulatory Authority* concludes that any delay likely to arise as a result of the requirement to allow representations contained in (4) is prejudicial to the interests of the clients or customers of the *Authorised Firm*, or the *Financial System* (provided in such case that the *Regulatory Authority* shall provide the *Authorised Firm* with an opportunity to make such representations promptly after such powers have been exercised or steps taken and shall give due consideration to such representations); or
 - (D) where the powers to be exercised or steps to be taken follow a determination by the *Regulatory Authority* pursuant to Part 9 (disciplinary and enforcement powers) of the *Financial Services Regulations* or a decision by the *Appeals Body* or *Tribunal* relating to or affecting the *Authorised Firm* in question.

- (6) Any decision made by the *Regulatory Authority* pursuant to this *Rule* may be referred to the *Appeals Body* by the *Applicant* or *Authorised Firm* to which the decision relates.

3 Disclosure

3.1 Disclosure requirements in relation to Islamic Financial Business

3.1.1 An *Authorised Firm* must disclose the following information to each *Client* with whom or on behalf of whom it conducts, or proposes to conduct, *Islamic Financial Business*:

- (A) the members of the *Authorised Firm's Shari'a Supervisory Board*; and
- (B) if the *Client* requests, the manner and frequency of Shari'a reviews.

3.1.2 An *Authorised Firm* must disclose the information referred to in Rule 3.1.1 to its relevant *Clients*:

- (A) prior to conducting *Islamic Financial Business* with or on behalf of that *Client*; and
- (B) thereafter, whenever the information changes.

Guidance

An *Authorised Firm* may include the information required by Rule 3.1.1 in the *Terms of Business* provided to a *Client*.

3.1.3 An *Authorised Firm* which effects or carries out *Contracts of Insurance* must disclose in its financial statements:

- (A) those matters set out in AAOIFI FAS 12, in the manner required by AAOIFI FAS 12; and
- (B) those matters set out in AAOIFI FAS 13.

Guidance

1. One of the important matters required to be disclosed by an *Authorised Firm* pursuant to Rule 3.1.3(B) is the basis applied by the *Authorised Firm* in treating any insurance deficit or surplus. Appendix B to AAOIFI FAS 13 provides some guidance as to how such a deficit or a surplus may be treated.
2. That appendix states that there are a number of ways to address an insurance deficit, including:
 - a. settling the deficit from the reserve of policyholders, if any;
 - b. borrowing from the shareholders funds or from others the amount of the deficit which should be paid back from future surpluses;
 - c. asking the policyholders to meet the deficit pro rata; and
 - d. increasing the future premium contribution of policyholders on a pro rata basis.
3. That appendix also states that there are a number of ways to allocate an insurance surplus, including:
 - a. allocating the surplus to all policyholders, regardless of whether or not they have made claims on the policy during the financial period;

- b. allocating the surplus only among policyholders who have not made any claims during the financial period;
- c. allocating the surplus among those who have not made any claims and among those who have made claims of amounts less than their insurance contributions, provided that the latter category of policyholders should receive only the difference between their insurance contributions and their claims during the financial period;
- d. allocating the surplus between policyholders and shareholders; and
- e. allocating the surplus by using other methods.

4 Constitutional Documents

4.1 Islamic Financial Institutions

- 4.1.1** *An Islamic Financial Institution* must ensure that its constitutional documents state that its business operations will be conducted in accordance with Shari'a.

5 Systems and Controls

5.1 General Requirement

5.1.1 *An Islamic Financial Institution* must establish and maintain systems and controls which ensure that its entire business operations comply with Shari'a.

5.1.2 *An Authorised Firm* operating an *Islamic Window* must:

- (A) identify which part or parts of its business operations are to be carried on in accordance with Shari'a; and
- (B) establish and maintain systems and controls which ensure that those parts of its business referred to in (A) are conducted in accordance with Shari'a.

5.2 Policy and Procedures Manual

5.2.1 (1) *An Authorised Firm* must implement and maintain an *Islamic Financial Business* policy and procedures manual which addresses the following matters:

- (A) the manner in which the compliance function will be undertaken, in respect of Shari'a compliance;
- (B) the manner in which the *Shari'a Supervisory Board* will oversee and advise in regard to the *Islamic Financial Business* conducted by the *Authorised Firm*;
- (C) the manner in which *Shari'a Supervisory Board* fatwas, rulings and guidelines will be recorded, disseminated and implemented and the internal Shari'a review undertaken;
- (D) the manner in which disputes between the *Shari'a Supervisory Board* and the *Authorised Firm* in respect of Shari'a compliance will be addressed;
- (E) the process for approving those internal systems and controls which are in place to ensure not only that the *Islamic Financial Business* is carried out in compliance with Shari'a, but that information is disseminated to investors in an appropriate manner;
- (F) the manner in which conflicts of interest and potential conflicts of interest will be identified and managed; and
- (G) in respect of an *Authorised Firm* operating an *Islamic Window*, the systems and controls in place to ensure the appropriate separation of the *Islamic Financial Business* from the conventional business of the *Authorised Firm*.

- (2) If an *Authorised Firm* manages a *Profit Sharing Investment Account* the policy and procedures manual must also contain the following matters:
- (A) the basis upon which a *Profit Sharing Investment Account* will be deemed restricted or unrestricted;
 - (B) procedures to ensure that the *Authorised Firm* manages the accounts of *Profit Sharing Investment Account* holders in accordance with their instructions;
 - (C) the basis for allocation of profit or loss to the *Profit Sharing Investment Account*;
 - (D) the basis for allocation of expenses to the *Profit Sharing Investment Account*;
 - (E) the manner in which an *Authorised Firm's* own funds, funds of restricted *Profit Sharing Investment Accounts* and funds from unrestricted *Profit Sharing Investment Accounts* are to be controlled;
 - (F) the manner in which the funds of each type of investment account holder will be managed;
 - (G) the manner in which the *Authorised Firm* will determine priority for investment of own funds and those of holders of unrestricted *Profit Sharing Investment Accounts*;
 - (H) how provisions and reserves against equity and assets in accordance with AAOIFI FAS 11 are to be applied; and
 - (I) the manner in which losses incurred as a result of the misconduct or negligence for which the *Authorised Firm* is responsible will be dealt with.

6 Shari'a Supervisory Board

6.1 Appointment and Operation of a Shari'a Supervisory Board

6.1.1 An *Authorised Firm* must:

- (A) appoint a *Shari'a Supervisory Board*; and
- (B) ensure that:
 - (i) its *Shari'a Supervisory Board* consists of at least three members;
 - (ii) the members appointed to the *Shari'a Supervisory Board* are competent to perform their functions as *Shari'a Supervisory Board* members taking into account their qualifications and previous experience;
 - (iii) any appointments, dismissals or changes in respect of members of the *Shari'a Supervisory Board* are approved by the *Governing Body* of the *Authorised Firm*; and
 - (iv) no member of the *Shari'a Supervisory Board* is a director or controller of the *Authorised Firm*.

6.1.2 An *Authorised Firm* must document its policy in relation to:

- (A) how appointments, dismissals or changes will be made to the *Shari'a Supervisory Board*;
- (B) the process through which the suitability of *Shari'a Supervisory Board* members will be considered; and
- (C) the remuneration of the members of the *Shari'a Supervisory Board*.

Record Keeping

6.1.3 An *Authorised Firm* must establish and retain records of:

- (A) its assessment of the competence of the *Shari'a Supervisory Board* members; and
- (B) the agreed terms of engagement of each member of the *Shari'a Supervisory Board*

for at least six years following the date on which the individual ceased to be a member of the *Shari'a Supervisory Board*.

6.1.4 The records of the assessment of competence of *Shari'a Supervisory Board* members in Rule 6.1.3(A) must include at a minimum:

- (A) the factors that have been taken into account when making the assessment of competence;
- (B) the qualifications and experience of the *Shari'a Supervisory Board* members;
- (C) the basis upon which the *Authorised Firm* has deemed that the proposed *Shari'a Supervisory Board* member is suitable; and
- (D) details of any other *Shari'a* supervisory boards of which the proposed *Shari'a Supervisory Board* member is, or has been, a member.

6.1.5 An *Authorised Firm* must take reasonable steps to ensure that the members of the *Shari'a Supervisory Board* are independent of and not subject to any conflict of interest with respect to the *Authorised Firm*.

6.1.6 An *Authorised Firm* must provide the *Regulatory Authority*, upon request, with information on its appointed or proposed *Shari'a Supervisory Board* members with regard to the qualifications, skills, experience and independence of the *Shari'a Supervisory Board* members.

6.1.7 An *Authorised Firm* must take reasonable steps to ensure that it and its *Employees*:

- (A) provide such assistance as the *Shari'a Supervisory Board* reasonably requires to discharge its duties;
- (B) give the *Shari'a Supervisory Board* right of access at all reasonable times to relevant records and information;
- (C) do not interfere with the *Shari'a Supervisory Board's* ability to discharge its duties; and
- (D) do not provide false or misleading information to the *Shari'a Supervisory Board*.

6.2 Shari'a Reviews

6.2.1 An *Authorised Firm* must ensure that all *Shari'a* reviews are undertaken by the *Shari'a Supervisory Board* in accordance with the AAOIFI Standards on Governance (GSIFI No 2).

6.2.2 (1) An *Authorised Firm* must commission an annual report from the *Shari'a Supervisory Board* which complies with the AAOIFI Standards on Governance (GSIFI No 1).

- (2) An *Authorised Firm* must submit a copy of the annual report of the *Shari'a Supervisory Board* to the *Regulatory Authority* within 4 months of the *Authorised Firm's* financial year end.

6.3 Internal Shari'a Review

- 6.3.1** An *Authorised Firm* must perform an internal Shari'a review to assess the extent to which the *Authorised Firm* complies with fatwas, rulings and guidelines issued by the *Authorised Firm's Shari'a Supervisory Board*.
- 6.3.2** An *Islamic Financial Institution* must perform the internal Shari'a review in accordance with the AAOIFI Standards on Governance (GSIFI No. 3).
- 6.3.3** (1) An *Authorised Firm* which operates an *Islamic Window* must, to the extent possible, perform the internal Shari'a review in accordance with the AAOIFI Standards on Governance (GSIFI No. 3).
- (2) If an *Authorised Firm* cannot conduct its entire internal Shari'a review in accordance with the requirements of (1), it must document the manner in which it will conduct that part of the internal Shari'a review that is not conducted in accordance with (1).
- 6.3.4** An *Authorised Firm* must ensure that:
- (A) the internal Shari'a review is performed by the internal audit function or the compliance function of the *Authorised Firm*; and
- (B) the individuals or departments involved in performing the review are competent and sufficiently independent to assess compliance with Shari'a.

Guidance

For the purposes of assessing competency of personnel or departments which perform the internal Shari'a review, *Authorised Firms* should consult the AAOIFI Standards on Governance (GSIFI No. 3).

7 Conduct of Business Standards

7.1 Conduct of Islamic Financial Business

Profit Sharing Investment Accounts

- 7.1.1** Where a transaction will involve a *Client* becoming a *Profit Sharing Investment Account* holder, an *Authorised Firm* must warn the *Client* in writing that the risk of loss rests with the *Client* and that the *Authorised Firm* will not share in the losses, unless there is negligence or misconduct for which it is responsible.
- 7.1.2** An *Authorised Firm* must ensure that *Terms of Business* provided to a *Client* in accordance with the *Rules* in the *COND Rulebook* contain, in addition to those matters referred to in the *COND Rulebook*, the following information:
- (A) how the monies of the *Client* will be managed and invested including details of its policy on diversification of the portfolio;
 - (B) the basis for the allocation of profit between the *Authorised Firm* and the *Client*; and
 - (C) confirmation of the investment objectives of the *Profit Sharing Investment Account* holder, including details of any restrictions requested by the *Client*.
- 7.1.3** (1) *COND* section 13.3 applies to an *Authorised Firm* as if the *Authorised Firm* is an investment manager in respect of those *Clients* who are *Profit Sharing Investment Account* holders.
- (2) An *Authorised Firm* must ensure that a periodic statement provided to a *Client* in accordance with *COND* section 13.3 contains, in addition to those matters referred to in *COND* section 13.3, the following information:
- (A) details of the performance of the *Client's* investment; and
 - (B) the allocation of profit between the *Authorised Firm* and the *Client*.

Islamic Window

- 7.1.4** An *Authorised Firm* that operates an *Islamic Window* must ensure that the disclosures required by AAOIFI FAS 18 are made to all *Clients* with or on whose behalf it conducts *Islamic Financial Business*.

Financial Communication

- 7.1.5** Before an *Authorised Firm* issues or approves a *Financial Communication*, it must ensure that, in addition to the information required by the *Rules* in the *COND Rulebook*, the material states which *Shari'a Supervisory Board* has reviewed the products or services to which the material relates.

Endnotes

1 Abbreviation key

a	=	after	om	=	omitted/repealed
am	=	amended	orig	=	original
amdt	=	amendment	par	=	paragraph/subparagraph
app	=	appendix	prev	=	previously
art	=	article	pt	=	part
att	=	attachment	r	=	rule/subrule
b	=	before	renum	=	renumbered
ch	=	chapter	reloc	=	relocated
def	=	definition	s	=	section
div	=	division	sch	=	schedule
g	=	guidance	sdiv	=	subdivision
hdg	=	heading	sub	=	substituted
ins	=	inserted/added			

2 Rulebook history

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