

Concept Paper



Provision of Shariah- Compliant Brokerage Service

MARCH 06, 2024

1. Preamble

Currently, Pakistan is progressing towards Islamization of its financial system, and capital markets, being an important pillar of our economy, are no exception. The Commission, as per its mandate and in line with the judgment of the Federal Shariat Court (FSC) dated April 28, 2022, is striving to facilitate the growth of Shariah-compliant financial services in its regulated sectors.

In view of the above, the Commission has recently issued the Guidelines for Provision of Islamic Financial Services (“the Guidelines”) in January 2023. These guidelines have primarily been made in light of international best practices, particularly those jointly recommended by the two leading international standard-setting bodies, i.e. Islamic Financial Services Board and the Accounting and Auditing Organization for Islamic Financial Institutions, and are expected to facilitate the development of Shariah-compliant financial products, support the development of Islamic financial institutions in regulated sectors and contribute to greater financial inclusion.

It is anticipated that by adopting an enabling and strategically designed Islamic capital market framework, a sizable segment of the population that currently eludes capital markets due to religious or ethical considerations can be encouraged to actively participate. With regards to the brokerage industry, Shariah-compliant brokerage services have the potential to offer sustained growth by providing products that are less speculative thereby promoting long-term investment in productive sectors of the economy.

Keeping in view the strategic importance of the brokerage industry, the Commission is considering options to pave the way for the introduction of Sharia-compliant brokerage houses. For this purpose, it is desirable to evaluate local and international best practices in operating specific Shariah-compliant entities especially the structure of Islamic brokerage houses so that the best-fit model is adopted in its nascency.

As the Guidelines have already been laid out to provide for structural and operational modalities of Shariah-compliant entities, they can be viewed in conjunction with the options proposed herewith to pave the way for a viable Islamization plan for the brokerage sector of Pakistan.

2. Possible Pathways for Introduction of Shariah-Compliant Brokerage Houses

Pakistan’s brokerage industry is presently dominated by conventional players. While other sectors of the financial system have established entities operating in the Shariah domain, there is an obvious dearth of exclusive Shariah-compliant brokerage operators.

Therefore, the Commission, to energize this critical area, is considering several possibilities to adopt an optimal Shariah-compliant brokerage services model by new entrants and existing brokerages. While onboarding of new entrants may be a relatively simpler process, the transition of existing players to establish Shariah compliance window operations or subsidiaries may require additional reforms in the existing framework.

In view thereof, the following options are being evaluated by the Commission for existing brokerage houses:

- i) Existing brokerage houses voluntarily undergoing a complete transition from conventional to Shariah-compliant operations.
- ii) Establishing a window offering Islamic brokerage services within a conventional brokerage house.
- iii) Establishing a subsidiary offering Shariah-compliant services, which is wholly owned by a conventional securities broker.

In addition, any new entrant, desirous of providing exclusive Shariah-compliant brokerage services may do so by obtaining a certificate of a Shariah-compliant company in terms of sub-section (1) of Section 451 of the Companies Act, 2017 read with the Shariah Governance Regulations, 2023 and adhering to Guidelines for Offering Islamic Financial Services issued by SECP

3. Industry Best Practices

A review of the financial sector practices in various international jurisdictions reveals that both window operations and standalone Islamic entities exist simultaneously. It has been observed that reliance on Islamic windows by banks has generally been more of a take-off platform for moving into the Islamic Financial industry. However, in many cases, for instance, in Kuwait, there has been a tendency to establish standalone Islamic Banks. In the UAE too, both structures appear prevalent with eight stand-alone Islamic banks in the UAE and 23 Islamic windows. In Malaysia, both models have been observed with 38 full Islamic banks and windows.

Likewise, in Pakistan's domestic banking sector, both window and subsidiary models are prevalent. Meezan Bank, Bank Islami, Al Baraka Bank, and Dubai Islamic Bank are a few of the pioneer banks that have operated exclusively as Islamic banks. Faysal Bank has recently undergone a complete transition from conventional to Islamic banking. Other banks such as MCB Bank have opened specialized Islamic banking subsidiaries. Meanwhile, Bank Alfalah is successfully running an Islamic Banking window.

A review of the prevalent practices in the brokerage sector depicts an allowance for both types of structures i.e. full-fledged basis or 'window' basis. For example, in the case of Bursa Malaysia, the window structure appears more dominant with 15 out of 16 registered brokers offering Shariah-based services through specialized windows.

However, in the case of a broker offering Islamic window services, additional conditions are usually applied in most jurisdictions including:

- i) It shall have systems and controls in place to ensure that Islamic stockbroking services are properly identified to differentiate them from conventional stockbroking services and other conventional businesses.
- ii) It shall ensure that all funds maintained in respect of Islamic brokerage services should be segregated from those funds in respect of conventional brokerage services;
- iii) The trading accounts of the clients are tagged and used for Islamic window services only, and controls are in place to ensure that Islamic trading accounts can only deal with Shariah-compliant securities.

4. Analysis of Possible Pathways

For brokerages undergoing transition, the option of either window-based operations or establishing distinct Shariah-compliant subsidiaries may be viable. Currently, the Guidelines also create an allowance for existing financial institutions to pursue both these models subject to the below-mentioned requirements that are generally applied to Shariah-compliant entities:

- i) Obtain a certificate of Shariah-compliant company in terms of sub-section (1) of Section 451 of the Companies Act, 2017;
- ii) Meet all applicable requirements of the Guidelines for the Provision of Islamic Financial Services issues by SECP;
- iii) Constitute and appoint a "Shariah Supervisory Board" to advise on matters concerning Shariah principles and rules and Islamic products;

In this regard, two options are proposed to be adopted by the conventional brokerage houses:

Option 1: Establishing a Wholly-owned Subsidiary of a Securities Broker:

A review of the applicable regulatory framework reveals that regulation 4 of the Securities Brokers (Licensing and Operations) Regulations, 2016 (the "Regulations") prohibits a securities broker and its sponsor from having a majority stake in another entity having a license as a securities broker. The relevant regulation is reproduced below:

“4. Eligibility criteria for licensing of a securities broker. - Subject to compliance with the provisions of the Act and the Futures Act, a company may apply to the Commission for licence as a securities broker, if-

(a)... (d) the applicant and its sponsors do not have controlling interest in any other company holding licence as a securities broker;”

The aforementioned regulation does not allow securities brokers to have wholly owned subsidiary providing the same nature of services. This restriction however does not account for differentiation of brokerage services when offered by a conventional broker versus a Shariah-compliant brokerage. Hence, necessary reforms may be stipulated to allow the establishment of wholly owned Shariah-compliant brokerage subsidiaries by an existing conventional brokerage house subject to the fulfilment of certain conditions as given below. Conditional allowance for the creation of a subsidiary shall mitigate the risk of market abuse.

- i. Opening of a brokerage subsidiary having a license of Trading Only or Online Only category
- ii. Opening of a brokerage subsidiary having a license of Trading and Self Clearing category with a definite sunset clause to merge both entities within a specified period.
- iii. A complete prohibition on proprietary trading by the subsidiary. Or allowing proprietary trading from either parent or subsidiary.
- iv. A subsidiary structure shall offer improved internal controls and segregation of funds. It shall be overseen by a separate compliance officer to ensure alignment with Shariah compliance regulations.
- v. The parent and subsidiary shall implement appropriate controls to prevent any sharing of information between the parent and subsidiary company, which can compromise customer interest or result in unfair trade practices.
- vi. There shall be full disclosure of the relationship between the parent and subsidiary brokerage company to the clients.
- vii. There shall be a policy to identify and address any conflict of interest arising due to parent and subsidiary relationships.

Option 2: Establishing an Islamic Window

This structure provides a convenient option for existing brokerage houses to engage in Shariah-compliant operations. However, considering the peculiar business and risk management requirements, the following additional requirements shall apply:

- i. There shall be appropriate controls to prevent any sharing of information between the conventional business arm and its Islamic window, which can compromise customer interest or result in unfair trade practices.
- ii. The Islamic window may ideally operate through a dedicated Islamic-only branch having dedicated staff.
- iii. There should be appropriate levels of asset/funds segregation between the two segments
- iv. A comprehensive Shariah governance mechanism shall be established to ensure ongoing compliance with Shariah principles and rules and effective Shariah supervision and reporting
- v. The Shariah supervisory board may be empowered to express an opinion in its report as to whether the Islamic window's funds were commingled with those of the parent financial institution during the reporting period;

5. Conclusion:

The Commission aims to facilitate the brokerage industry in making a smooth transition towards offering Shariah-compliant services. To materialize this vision, it is critical to seek and evaluate feedback from the relevant stakeholders to identify a suitable way forward in proceeding further with this commendable objective. Keeping this in view, your valuable input is requested to pursue the optimal organizational model for the provision of Islamic brokerage services as mentioned above and the necessary measures that may be adopted or conditions attached to ensure that these services are offered fairly and equitably without facing any conflict with the conventional mode.

Based on the parameters identified in response to this concept paper concerning the feasibility of each of these options, along with any risks involved, the Commission shall consider necessary reforms in its regulatory framework for the introduction of Shariah-compliant brokerage services.

The requested feedback shall be provided no later than March 13, 2024 at the following email address: oneeb.ahmed@secp.gov.pk