



**SECURITIES AND EXCHANGE COMMISSION OF PAKISTAN
POLICY AND REGULATION DEVELOPMENT DEPARTMENT
SPECIALIZED COMPANIES DIVISION
(MODARABA WING)**

No. SCD/M/SCSAM/2012-

Islamabad, 3rd February, 2012
10th Rabi-ul-Awwal, 1433 AH

Circular No.8 of 2012

Shari'ah Compliance and Shari'ah Audit Mechanism (SCSAM) for Modarabas

Section 10 of the Modaraba Companies and Modaraba (Floatation and Control) Ordinance, 1980 (the Modaraba Ordinance) provides that no Modaraba shall be a business which is opposed to the injunctions of Islam and the Registrar shall not permit the floatation of a Modaraba unless the Religious Board has certified in writing that the modaraba is not a business opposed to the injunctions of Islam.

2. The Registrar, on the basis of the business stated in the prospectus, after obtaining from the Religious Board a certificate to the effect mentioned in section 10 and on being satisfied that it is in the public interest so to do, grant a certificate in the prescribed form authorizing the floatation of modaraba on such conditions as he may deem fit. However, no mechanism is in place to ensure and verify that the business affairs of a Modaraba (after floatation) are being managed in accordance with the principles of *Shari'ah*.

3. The Religious Board in its meetings held on December 9, 2010 and June 13, 2011 deliberated upon this situation and directed to introduce a system to ensure and verify that the business transactions of Modarabas are being carried out in accordance with the injunctions of Islam.

4. In compliance with the directions of Religious Board and in consultation with the NBF & Modaraba Association of Pakistan (the Association) a formal mechanism namely *Shari'ah* Compliance and *Shari'ah* Audit Mechanism (SCSAM) has been prepared and is being implemented to eliminate the risk or possibility of any violation of *Shari'ah* principles by the Modarabas.

5. The SCSAM aimed to achieve the following objectives:

- (i) to ensure that the inflows and outflows of resources of Modarabas are free from the following:
 - a. *Riba* (interest, usury or any other form)

- b. *Qimar* (Gambling)
 - c. *Gharar* (Speculation)
 - d. Support from Business Prohibited by *Shari'ah* (e.g. *Drugs and Alcohol, Tobacco, Pork Related Items, etc.*)
- (ii) to introduce a mechanism which will strengthen the *Shari'ah* compliance by the Modarabas in letter and spirit and ensure that the systems, procedures and policies adopted by the Modaraba are in line with the *Shari'ah* principles;
 - (iii) to mitigate the reputational and operational risk and enhance the image and operational framework of Modaraba as Islamic Financial Institution and to ensure that the financial products or services being offered by Modarabas are in accordance with the *Shari'ah*;
 - (iv) to ensure that the agreements entered into by the Modaraba are *Shari'ah* compliant, all the financing agreements are executed on the formats as approved by the Religious Board and all the related conditions are met;
 - (v) to prescribe the screening process for the investments in shares and other securities;
 - (vi) to provide for the process for purifications of dividend income;
 - (vii) to introduce the mechanism for the management of charity;
 - (viii) to identify the avenues for the investment of surplus funds;
 - (ix) to prescribe procedure for appointment of *Shari'ah* Advisor;
 - (x) to introduce internal *Shari'ah* audit of the business transactions of Modarabas to ensure that the goals and objectives of Islamic Law i.e. *Maqasad Al-Shari'ah* are achieved and the financial products, instruments and transactions employed, are based on *Shari'ah* norms and principles; and
 - (xi) to prescribe any other ancillary matter that may be required for *Shari'ah* compliance and *Shari'ah* audit.

6. Now, therefore, in order to ensure effective *Shari'ah* compliance and to maintain the trust of the stakeholders on the Islamic Financial System, in terms of the certificate granted for authorization to float a Modaraba read with Section 11 of the Ordinance and rule 3 (2) (e) of Modaraba Companies and Modaraba Rules, 1981, the following *Shari'ah* Compliance and *Shari'ah* Audit Mechanism (SCASM) is hereby issued as an additional condition to the Modaraba Authorization Certificate:

Shari'ah Compliance and Shari'ah Audit Mechanism

Part – I - Shari'ah Compliance

I. Responsibilities of the modaraba company:- Every modaraba company shall ensure that:

- (i) the business of the Modaraba managed by it, is carried out strictly in accordance with the Prospectus approved by the Religious Board and the model Islamic financing agreements and the investment products approved by the Religious Board from time to time are followed;
- (ii) major changes in any of the existing product structures, financing agreements, terms and conditions have a prior written approval from the Religious Board;
- (iii) all material changes in the existing product structures, agreements, terms and conditions are properly communicated to the concerned stakeholders, clients/customers;
- (iv) monitoring and review system of *Shari'ah* compliance is introduced covering all activities and products of the Modarabas;
- (v) proper training is provided in the area of *Shari'ah* compliance to the relevant staff, responsible for the monitoring and review; and
- (vi) irregularities, if any, recorded and reported by internal *Shari'ah* Auditor are rectified under the guidance of the *Shari'ah* Advisor.

II. Investment in shares and other securities:- The investment by the Modaraba in the shares and securities shall only be made in the companies screened by the *Shari'ah* Advisor of the Association in accordance with screening procedure contained in clause III of this SCSAM and subject to the following conditions:

- (i) the purchase and sale of the same scrip on the same day shall not be made; and
- (ii) the shares shall not be sold before settlement i.e. their title and possession has been transferred to the Modaraba, in accordance with the settlement schedule of the Stock Exchange.

III. Screening Procedure:- (1) The screening test of the selected Investee Company (IC) for the purpose of investment in its shares or other securities shall be conducted by the *Shari'ah* Advisor of the Association who shall observe the following criteria before placement of the scrip in the list of *Shari'ah* compliant securities:

- (i) the business of the IC is *Halal* and in line with the *Shari'ah*;
- (ii) debt to asset ratio of the IC is less than 40%. Debt in this case is classified as any interest bearing debts. Zero coupon bonds and preference shares shall be considered as part of the debt;
- (iii) the ratio of non-compliant investments to total assets of the IC is less than 33%;
- (iv) the ratio of non-compliant income of the IC to total income is less than 5%. The income includes gross income plus any other income earned by the IC;
- (v) the ratio of illiquid assets to total assets is at least 25%;

Explanation: Illiquid asset means any asset that *Shari'ah* permits to be traded at value other than the par.

- (vi) The market price per share is greater than the net liquid assets per share calculated as: $(\text{Total Assets} - \text{Illiquid Assets} - \text{Total Liabilities}) / \text{No. of outstanding shares}$.

Provided that the investment in the Modaraba certificates of a Modaraba, shares of Islamic Banks and Takuful Companies and the units of Islamic mutual funds shall not be subject to screening process.

(2) The screening for each IC shall be performed on half yearly basis. The list of screened listed companies alongwith charity rate of the respective company shall be placed on the website of the Association and a printed copy duly signed by the authorized person of the Association with a confirmation of its placement on the website, shall be sent to the Registrar Modarabas on half yearly basis.

Explanation: Charity Rate means the ratio of non-compliant income of the IC to total income.

(3) The screening of unlisted companies shall be carried out by the *Shari'ah* Advisor of the Association on the requests made by Modarabas on case-to-case basis.

(4) The existing non-compliant investments in terms of clause III shall be divested within the period of one year from the date of this circular.

IV. Dividend Purification Process:- The dividend income shall be purified by deducting the amount equivalent to charity rate for the respective IC from the total dividend income received by a Modaraba.

V. Non-Shari'ah Compliant income not to form part of Modaraba's income:- (1) The income received by a Modaraba from non-Shari'ah compliant sources shall not be accounted for as part of income of a Modaraba, inter-alia the following:

- (i) late payment penalty or surcharge received from any client;
- (ii) the part of dividend income pertains to non-Shari'ah compliant business activities of IC as calculated in terms of clause IV; and
- (iii) any other income received by a Modaraba from any transaction which was not carried out in accordance with the principles of *Shari'ah*.

(2) All non-Shari'ah compliant income received by a Modaraba shall be deemed as a liability of the Modaraba and shall be transferred by the Modaraba Company to a separate account namely Charity Account.

VI. Management of Charity:- The amount credited in the charity account shall be used in the manner and subject to the conditions stated hereunder:

- (i) all contributions or donation from the charity account shall only be made to the approved charitable organizations registered under Pakistani law as charitable organization (trusts, Hospitals etc). The Income tax exemption certificate issued by the Government of Pakistan to that effect shall be considered as an approval for the purposes. Any exception shall be submitted for approval to the *Shari'ah* Advisor of the Association;
- (ii) the purpose of the donation shall be identified; and
- (iii) the amount available in charity account shall ideally be distributed within three months of its transfer. A summary of operations of the charity account shall be published in the Annual Accounts of the Modaraba.

VII. Investment of surplus funds of Modaraba:- The surplus funds of the Modaraba shall only be placed in the accounts to be opened in the Islamic banks or Islamic branches of conventional banks or Islamic Mutual Funds or products offered by a Modaraba or any other *Shari'ah* compliant investment schemes.

Part – II – *Shari'ah* Advisor

VIII. *Shari'ah* Advisor: (1) Every Modaraba company shall have a *Shari'ah* Advisor of the Modaraba appointed on the terms and conditions as it may deem fit, having the qualification and experience and to perform the functions as specified hereunder. The term of office of the *Shari'ah* Advisor shall be three years, which shall be renewable by the Modaraba Company. The first *Shari'ah* Advisor shall be appointed on or before March 31, 2012. The Modaraba Company shall intimate to the Registrar Modaraba about the appointment of *Shari'ah* Advisor and submit his particulars supported with his relevant documents within 7 days from the date of his appointment.

(2) The casual vacancy caused by the resignation or termination of the *Shari'ah* Advisor shall be filled by the Modaraba Company within 30 days of the resignation or termination as the case may be and the intimation thereof shall be made to the Registrar Modaraba in the manner prescribed above.

IX. Qualification of *Shari'ah* Advisor.- (1) No person shall be appointed as *Shari'ah* Advisor unless he is deemed to be a person of acceptable reputation, character and integrity and has:

a. **Educational Qualification:**

Shahadat ul Aalmia Degree (Dars e Nizami) from any recognized Board of Madaris with minimum 70% marks and Bachelor's Degree with a minimum of 2nd Class and sufficient understanding of banking and finance.

OR

Post Graduate Degree in Islamic Jurisprudence/Usooluddin, L.L.M. (*Shari'ah*), etc. with a minimum GPA of 3.0 or equivalent from any recognized University with exposure to banking and finance.

b. **Experience and Exposure:**

Must have at least 4 years experience of giving *Shari'ah* rulings including the period of Takhasus fil Ifta; or at least 5 years post qualification experience in teaching or Research and Development in Islamic Banking and Finance.

c. good knowledge to understand English and make out the required reports;

d. exposure in the areas of business or finance specially Islamic Finance;

e. has not been terminated from any organization in any capacity; and

- f. does not hold any executive or non-executive position in any Modaraba or Modaraba company except as *Shari'ah* Advisor.

(2) The Registrar Modaraba may relax the requirement of educational qualification and experience in exceptional cases where the person is otherwise qualified for giving *Shari'ah* rulings on banking and financial matters.

X. Functions and responsibilities of the *Shari'ah* Advisor:- (1) The *Shari'ah* Advisor shall generally perform the following duties and functions in the Modaraba:

- i. to introduce a mechanism which will strengthen the *Shari'ah* compliance by the Modaraba, in letter and spirit and ensure that the systems, procedures and policies adopted by the Modaraba are in line with the *Shari'ah* principles;
- ii. to advise the Modaraba company so as to ensure that the inflows and outflows of resources of Modaraba are free from the following:
 - a. *Riba* (interest, usury or any other form)
 - b. *Qimar* (Gambling)
 - c. *Gharar* (Speculation)
 - d. Support from Business Prohibited by *Shari'ah* (e.g. *Drugs and Alcohol, Tobacco, Pork Related Items, etc.*)
- iii. to review on regular basis that the business conducted, the transactions carried out and the investments made by the Modaraba are in accordance with the Prospectus of the Modaraba, Islamic Financial Accounting Standards notified by the Securities and Exchange Commission of Pakistan, the principles of *Shari'ah* and goals and objectives of Islamic Law i.e. *Maqasad Al-Shari'ah* are achieved i.e. the financial products, services, related policies and the instruments are based on *Shari'ah* norms and principles;
- iv. to vet the new products and services before its submission to the Registrar for its final approval from the Religious Board;
- v. to make recommendations to the Modaraba company for potential improvements and the formulation of policies in line with the *Shari'ah* principles and to advise about the process of rectification of irregularities pointed out by him;
- vi. to advise on any matter referred to him by the chief executive or the board of directors of the Modaraba Company;

- vii. to conduct and arrange *Shari'ah* training programs for the board of directors/officers and the staff of the Modaraba; and
- viii. to determine the non-*Shari'ah* compliant income and ensure its transfer to the charity account.

(2) The *Shari'ah* Advisor shall prepare a report on the Modaraba's affairs, to be called as "the Annual *Shari'ah* Advisor's Report" which shall cover the overall *Shari'ah* compliance position of the Modaraba for the whole year and be prepared on the format attached as Annexure-A. The same shall be annexed by the Modaraba Company just after the statutory auditor's report of the annual audited accounts of the Modaraba, to be disseminated to the certificate holders.

(3) Notwithstanding the above, the first report of the *Shari'ah* Advisor shall be prepared and annexed with the half yearly accounts ending on December 31, 2012 and thereafter on annual basis starting from the annual accounts of the Modaraba ending on June 30, 2013.

XI. Powers of *Shari'ah* Advisor (1) Every *Shari'ah* Advisor shall have a right of access at all times to the books, papers, accounts, vouchers, record, information, agreements and reports of the Modaraba, whether kept at the registered office of the Modaraba company or elsewhere and shall be entitled to require from the directors and other officers of the Modaraba company, such information and explanation as he may require for the performance of his duties and the board of directors and all the employees of the Modaraba Company as well as the Modaraba shall be bound to provide the requisite access to the record and information to the *Shari'ah* Advisor.

(2) The *Shari'ah* Advisor shall have direct and regular communications with all levels of management.

(3) The fatwa and ruling of the *Shari'ah* Advisor in all business transactions, not being inconsistent with the ruling of the Religious Board, shall be binding on the Modaraba companies.

XII. Reporting of *Shari'ah* Advisor:- (1) The *Shari'ah* Advisor shall report to the Board of Directors of the Modaraba.

XIII. Dispute Resolution:-In case of any dispute or difference of opinion arises between Modaraba Company and the internal *Shari'ah* auditor on the matters relating to *Shari'ah* interpretation, the same shall be referred to the *Shari'ah* Advisor for the decision. In case of difference of opinion between the *Shari'ah* Advisor of the Modaraba and the Registrar Modaraba on any matter came to his knowledge, the matter shall be

referred by the Registrar Modaraba to the Religious Board, whose decision shall be final.

XIV. Performance review of the *Shari'ah* Advisor :- (1) The performance of *Shari'ah* Advisor shall be reviewed by the Registrar Modaraba from time-to-time.

(2) The Registrar Modaraba, after being satisfied that the *Shari'ah* Advisor is not performing his duties as required under this mechanism may direct the Modaraba Company to terminate the services of the *Shari'ah* Advisor before expiry of three years.

Part – III - Internal *Shari'ah* Audit

XV. Internal *Shari'ah* Audit: (1) Every modaraba shall strengthen its existing Internal Audit Department established in terms of regulation No. 1 of Part –IV of the Prudential Regulations for Modarabas, either by appointing a trained internal *Shari'ah* auditor having relevant qualification and experience of the *Shari'ah* audit or train at least one of its existing employees in the internal audit department for the purpose of internal *Shari'ah* audit, on or before March 31, 2012 so that internal *Shari'ah* audit functions becomes fully operational with effect from first day of April 2012.

(2) The training of the internal *Shari'ah* auditor shall be arranged from a well known *Shari'ah* training institute.

XVI. Duties of Internal *Shari'ah* Auditor:- (1) The internal *Shari'ah* auditor shall follow the same reporting norms, as are applicable on the internal auditor under the PRs and the Code of Corporate Governance implemented by the Stock Exchanges.

(2) The minimum required duties of the internal *Shari'ah* auditor shall be to verify on day to basis that the:

- (i) business transactions of the Modaraba are *Shari'ah* compliant;
- (ii) agreements entered into by the Modaraba are *Shari'ah* compliant and financing agreements executed on the formats as approved by the Religious Board, without any major change, and all the related conditions are met;
- (iii) investments of the Modaraba in the shares and other securities are as per list of the companies screened by the *Shari'ah* Advisor of the Association;

- (iv) process for purifications of dividend income has been carried out by the modaraba company;
- (v) non-*Shari'ah* compliant income has been transferred in Charity Account and distributed in accordance with the manner prescribed in this circular;
- (vi) surplus funds have been invested in the avenues prescribed in this circular; and
- (vii) to share his findings with the Chief Executive and *Shari'ah* Advisor in respect of all the above items including irregularities, inadequacy in risk management, governance and internal controls which are necessary to avoid non-*Shari'ah* compliant business transactions in the Modaraba.

(3) The Internal *Shari'ah* auditor shall submit his report on quarterly basis to the board of directors with a copy of the Report to the *Shari'ah* Advisor of the Modaraba.

(4) The Internal *Shari'ah* auditor shall maintain a liaison with the *Shari'ah* Advisor and seek his guidance and help in case of any difficulty in ensuring *Shari'ah* compliance of any particular transaction.

XVII. Compliance on the internal *Shari'ah* Auditor's Report:- The board of directors of the Modaraba company, in consultation with the *Shari'ah* Advisor, shall take necessary steps on the observations/recommendation of the internal *Shari'ah* Auditor and prepare an action plan with a timetable for compliance. The audit committee of the Modaraba shall monitor the compliance/implementation of the action plan.

7. Since the *Shari'ah* review system is imperative in ensuring such compliance and an effective *Shari'ah* framework will harmonize the *Shari'ah* interpretations, strengthen the regulatory and supervisory oversight of the Modaraba sector and nurture a pool of competent *Shari'ah* auditors, the implementation of SCSAM will help the management of modaraba companies to achieve the objectives of *Halal* business as enshrined in the *Shari'ah* and emerge as a responsible member of the Islamic financial regime.

8. The provisions contained in the SCSAM are the minimum requirements for *Shari'ah* compliance to be followed by the modaraba companies and Modarabas in the course of their operations. The Modaraba and the Modaraba Companies may include additional requirements and control in their procedures for the sake of more effective *Shari'ah* compliance and prudence.

9. All the modaraba companies are directed to ensure the implementation of the SCSAM in letter and spirit and initiate necessary action for its compliance with immediate effect.

(Jawed Hussain)

Registrar

Modaraba Companies and Modaraba

Distribution:

1. Chief Executives of all Modaraba Companies.
2. NBFIs and Modaraba Association of Pakistan.
3. Institute of Chartered Accountants of Pakistan.
4. Institute of Cost and Management Accountants of Pakistan.
5. P.S. to all Commissioners, SECP.
6. Executive Director (PRDD-SCD).
7. Executive Director (SD-SCD).
8. Office Copy.

Note: For any query or further assistance the following team members may be contacted:

Name	Designation	Email Addresses
Imran Hussain Minhas	Joint Registrar	imran.hussain@secp.gov.pk
Shahid Mahmood	Joint Registrar	shahid.mahmood@secp.gov.pk
Hafiz M. Wajid Wahidi	Assistant Registrar	wajid.wahidi@secp.gov.pk

Specimen of Annual *Shari'ah* Advisor's Report

I have conducted the *Shari'ah* review of _____ Modaraba managed by _____ Modaraba Management Company for the financial year ended _____ in accordance with the requirements of the ***Shari'ah* Compliance and *Shari'ah* Audit Mechanism for Modarabas** and report that except the observations as reported hereunder, in my opinion:

- i. the Modaraba has introduced a mechanism which has strengthened the *Shari'ah* compliance, in letter and spirit and the systems, procedures and policies adopted by the Modaraba are in line with the *Shari'ah* principles;
- ii. following were the major developments that took place during the year:
 - a) Research and new product development (Brief on the research and new product development, if applicable)
 - b) Training and Development (detail of training conducted by the *Shari'ah* Advisor of the Modaraba management and staff, if any).
- iii. the agreement(s) entered into by the Modaraba are *Shari'ah* compliant and the financing agreement(s) have been executed on the formats as approved by the Religious Board and all the related conditions have been met;
- iv. to the best of my information and according to the explanations given to me, the business transactions undertaken by the Modaraba and all other matters incidental thereto are in conformity with the *Shari'ah* requirements as well as the requirements of the Prospectus, Islamic Financial Accounting Standards as applicable in Pakistan and the *Shari'ah* Compliance and *Shari'ah* Audit Regulations for Modarabas
- v. profit sharing ratios, profits and charging of losses (if any) relating to any deposit raising product conform to the basis and principles of *Shari'ah*.
- vi. the earnings that have been realized from the sources or by means prohibited by *Shari'ah* have been credited to charity accounts.

Observation(s)

Recommendation(s)

Conclusion

Signature

Stamp of the *Shari'ah* Advisor

Dated: