A brief overview of Islamic investment funds in the State of Kuwait

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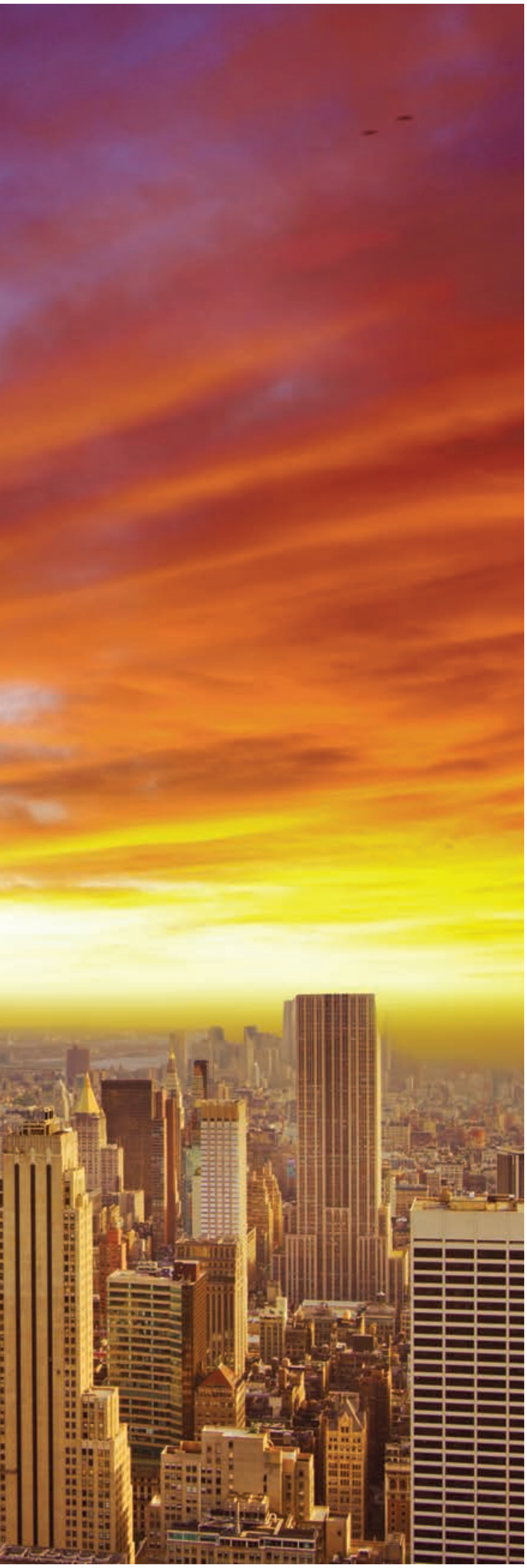

INTRODUCTION

In recent years, the financial markets in the State of Kuwait have shown an affinity towards investments in Shari'ah-compliant products. In 2014 and 2015, the Capital Markets Authority (CMA) approved and licensed several new Islamic funds. From a practitioner's point of view, it appears that the process of licensing funds in general, and Islamic funds in particular, has proven to be one of the most streamlined processes for the young regulator. This is evident when compared to the licensing and approval procedures associated with other Islamic products, as these procedures have yet to be streamlined or published, such as those of Sukuk.

THE REGULATOR

Historically the regulation of investment funds used to be handled by the Central Bank of Kuwait. However, as of 13th September 2011 and after the promulgation of Law No. 7 of 2010 (the CML) - which regulated securities activities and created the CMA - the regulation of investment funds has been overseen by the CMA.

The CMA currently regulates all aspects and matters relating to investment funds in the State of Kuwait, whether locally established or foreign funds; this includes the marketing of the funds and the offering and sale of units. This article aims to shed some light on how the specific rules imposed on investment funds that choose to be Shari'ah-compliant (i.e. Islamic funds) interplay with the general rules regulating investment funds.

TYPES OF FUNDS

The CML has two categories for investment funds. The first is an open-ended fund which has a variable capital that increases by new unit issuances and decreases by redemption. The second category is closed-ended funds with fixed capital and no opportunity for redemption before a specific date of maturity.

The CMA also mandates specific rules depending on the activity of the fund, which are governed by specific regulations for each type of activity. The CML bylaws specify several types of funds based on activity, such as securities, real estate, money markets, debt instruments, private equity or funds of funds (or any other type the CMA may approve and regulate from time to time).

Shari'ah-compliant investments are not considered a specific activity, as the differentiating factor that deems a fund Islamic are the limitations on certain investment activities in addition to the governance, auditing procedures, and purifying activities that such funds have to undertake.

ISLAMIC FUNDS

The CML does not specify any distinct rules for Islamic funds; references thereto are located in the CML bylaws. The procedures of establishing Islamic funds follow, in the most part, the same procedures mandated on conventional investment funds. Primarily a person must be licensed by the CMA to carry on the activity of establishing and managing collective investment schemes.

Additionally, and specifically for Islamic funds, there is a further layer in the internal decision making processes of the CMA. Islamic fund applications are referred to the "Advisory Council for Shari'ah Supervision" (Shari'ah Council) which has been established by the CMA to be the "reference in all matters related to the Authority's resolution in Shari'ah-compliant activity.

Therefore, prior to the funds' establishment the Shari'ah Council would "express the Shari'ah opinion on products and new Islamic financial instruments launched in the market or approved by the Authority". There are certain practical points which would streamline such decision and preempt any potential points that might provide the Shari'ah Council grounds to recommend the rejection of an application to set up an Islamic fund" .

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Furthermore, an Islamic fund's articles of association must include proof of all the necessary minimum requirements needed to assist investors to make "well-considered decisions". The minimum requirements for Islamic funds include the need to designate a Shari'ah Supervision Board. The Board must consist of practitioners that satisfy criteria and qualifications stipulated in the code of practice of the Shari'ah auditing and review profession.

The Shari'ah Board is required to supervise the investment activities of the funds, ensuring that they are Shari'ah-compliant, as well as issuing binding decisions (Fatwas) whenever necessary, and publishing annual reports which are normally shared along with the year-end financial statements.

The Islamic fund prospectus or, in case of private placement, the private placement memorandum (hereinafter Offering Documents) must also include references to the Shari'ah Board members and mention them by name. The Offering Document language must declare that the fund will be precluded from investing in instruments which are not compliant with Shari'ah principles as specified by the Shari'ah Board.

EXAMPLE AND PRACTICAL NOTES

In addition, the rule of thumb for Islamic funds is to limit fund investment activities to Shari'ah-compliant avenues. Let us take a look at a specific example.

If a fund is to invest in securities, the fund managers, based on the recommendation of their Shari'ah Board and independent advisors, must ensure that issuers of such securities are Shari'ah-compliant. This meant that that they must at least:

1. Provide for an obligation on the issuer to carry out its activities in compliance with Shari'ah principles in the constitutive documents of issuers.
2. Have internal regulations and professional audit systems that are up to the standards set by the CMA.
3. Have sound and independent external Shari'ah auditors.
4. Have a code of ethics with streamlined investment and operational rules that are commensurate with the principles of Shari'ah.
5. Check the issuers' statement of Shari'ah opinion approving the securities' compliance with that of a well substantiated Shari'ah opinion.

CHALLENGES

Even though we began this piece by stating that there is an affinity towards investing in Islamic products in the state of Kuwait, there are still deterring factors and challenges to overcome.

It remains evident that setting up and managing Shari'ah-compliant funds adds other regulatory and financial implications. Various practitioners contend, that even though subscriptions in such funds may exceed their conventional counterparts, going through another layer of internal CMA approvals and satisfying the specific rules mentioned above is challenging.

The costs associated with setting up the mandatory Shari'ah boards and appointing the Shari'ah external auditors also add another element in Islamic funds which is not found in similar conventional structures.

CONCLUSION

The Shari'ah-compliant financial services sector is maturing in the State of Kuwait; there are many banks, investment companies, insurance providers and support professions that exclusively practice their activities based on the principles of the Islamic Shari'ah. However, a number of challenges still face the sector.

In the past we have called for a uniform code of practice and standardised guidelines for such practices. The CMA has partially solved this issue by creating a Shari'ah Council and making it the reference on all Shari'ah related matters under the authority of the CML. We patiently await the introduction of further specific rules and regulations for Islamic funds and other Shari'ah products.