

# **Shariah Compliant Funds**

## **Guidance Note**

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## **Section 1      Introduction**

Collective Investment Schemes ('CISs') in Malta are regulated by the Malta Financial Services Authority ('MFSA') under a framework incorporated in the Investment Services Act (the Act).

The Act, together with applicable subsidiary legislation and Rules published by the MFSA, establishes a comprehensive framework for the authorisation and supervision of CISs. This regulatory framework applies varying degrees of oversight based on the sophistication of the target investors. Accordingly, regulatory obligations are proportionate to the level of investor protection deemed necessary for each category of fund.

The principal categories of CISs that can be set up under this framework are the following:

- Retail Schemes - which are in turn divided into:
  - Undertakings for Collective Investment in Transferable Securities ('UCITS')
  - Retail Alternative Investment Funds (Non-UCITS)
- Non-Retail Schemes - which are in turn divided into:
  - Non-retail Alternative Investment Funds ('AIFs')
  - Professional Investor Funds ('PIFs')
  - Notified Alternative Investment Funds ('NAIFs')
  - Notified Professional Investor Funds ('NPIFs')

The regulatory standards that underpin the regime as applied to the different types of CISs rely mainly on the principles of disclosure and transparency as a means of protecting investors' interests as well as on the investor's understanding of risk as a key motive for applying regulation in a proportionate manner. This Guidance Note is meant to illustrate how the current funds regime applies to CISs established under Shariah rules and clarifies a number of related issues for the benefit of fund promoters.

## **Section 2      Purpose**

- |      |                                                                                                                                                  |
|------|--------------------------------------------------------------------------------------------------------------------------------------------------|
| 2.01 | To provide guidance to fund promoters seeking to establish a Shariah-compliant fund under the Investment Services Act.                           |
| 2.02 | To outline the key issues which the MFSA expects Shariah-compliant funds established in Malta to address as part of their regulatory compliance. |

## Section 3      High Level Principles

- 3.01      Whilst Shariah-compliant funds are subject to the same regulatory treatment as conventional funds under the applicable fund framework; their investments and operations should be carried out in conformity with Shariah principles as well as standards issued by international standard-setting bodies specialising in Islamic finance. In this regard, such funds shall: (i) invest only in Shariah-compliant instruments in line with Islamic principles, including the prohibitions on *riba* (interest), *haram* activities, *maisir* (gambling), and speculative transactions; (ii) appoint a Shariah Board or Adviser responsible for advising on Shariah compliance; (iii) ensure that Shariah screening is conducted prior to investment and on an ongoing basis<sup>1</sup>; (iv) submit to an annual Shariah audit by the appointed Shariah Board or Adviser as part of the overall audit process; and (v) apply a mechanism to ensure that any non-compliant income received is appropriately identified and purified.
- 3.02      Shariah compliant funds are expected to follow the risk-spreading principle except when this can be waived in terms of the proviso to the definition of ‘collective investment scheme’ in Article 2 of the Act.
- 3.03      The management body of a Shariah-compliant fund (Board of Directors in the case of a corporate fund) shall be responsible for ensuring that the fund satisfies the relevant Shariah principles and requirements as disclosed in the fund’s prospectus and other investor information documentation.
- 3.04      Except for the applicability of this Guidance Note, Shariah-compliant funds set up as retail or non-retail funds shall be regulated in the same manner as non-Shariah compliant funds falling under the same category.
- 3.05      The Shariah-specific criteria, including any Shariah policy document<sup>2</sup> adopted by the fund, must fully comply with all applicable regulatory and statutory requirements. These criteria may be applied only to the extent that they are consistent with existing regulatory frameworks; in the event of any conflict, the existing regulatory requirements shall prevail.
- 3.06      Where the scheme is self-managed, any references to “Fund Manager” and/or “Manager” in the Guidance Note shall be construed as being a direct reference to Investment Committee of the scheme and, accordingly, any obligations incumbent upon the Manager shall *mutatis mutandis* apply to the Investment Committee of the scheme.
- 3.07      Service providers engaged by a Shariah-compliant fund, including Managers, Custodians, and Fund Administrators, are not themselves

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<sup>1</sup> It is pertinent for each fund to have its own internal screening process as well as appropriate benchmarking mechanisms, especially when it holds portfolios other than securities approved by Islamic indexes. The mechanisms should be made available to the potential investors in order to help them make an informed decision before participating in the fund.

<sup>2</sup> Shariah policy document refers to an internal governance document adopted by the fund which defines how it ensures Shariah compliance.

required to be Shariah-compliant entities. However, in providing their services, they shall act in a manner that does not breach Shariah principles as adopted by the fund.

- 3.08 Shariah-compliant funds' agreements with service providers shall clearly outline the scope of service providers' responsibilities in relation to Shariah compliance.

## **Section 4 Authorisation Framework**

- 4.01 Where a fund intends to hold itself out as being a Shariah-compliant fund, it shall during the licencing or notification process, inform the Authority of its intention to operate as such. The licence or notification of a Shariah-compliant fund will include a reference confirming that, in addition to the applicable MFSA Investment Services Rules for Retail Collective Investment Schemes, Alternative Investment Funds, Professional Investor Funds, Notified Alternative Investment Funds, or Notified Professional Investor Funds, the fund is also expected to comply with this Guidance Note.

As a general principle, Shariah-compliant investment funds may be established as either retail or non-retail schemes in Malta. However, the classification and authorisation of such funds will ultimately depend on the nature of the underlying investments and the structuring methodologies employed. The following outlines the permissible regulatory frameworks under which certain widely recognised categories of Shariah-compliant funds may be authorised in Malta, although the list is illustrative and does not encompass all possible categories or regulatory options:

### **(a) Shariah-Compliant Equity Funds**

These funds, which invest in equities that meet Shariah screening criteria, may be structured under a range of regulatory frameworks. Specifically, they can be established as:

- Maltese UCITS Schemes, where retail investor access and higher regulatory safeguards are required;
- Maltese Non-UCITS Retail Schemes, allowing for greater investment flexibility while remaining accessible to retail investors; or
- Non-Retail Schemes, suitable for professional and/or qualifying investors.

### **(b) Ijarah Funds**

Ijarah funds typically invest in assets structured around Shariah-compliant lease-based contracts, representing ownership interests in tangible, income-generating assets. Due to their specific characteristics and risk profile, Ijarah Funds would typically be authorised in Malta as **Non-Retail Schemes**. Such

schemes would be designed for investors with a higher risk tolerance and the ability to assess complex structures.

(c) **Commodity Funds**

These funds invest primarily in physical commodities or commodity-based contracts, which similarly fall outside the scope of conventional financial instruments. Given their alternative nature, Commodity Funds may typically be authorised in Malta under as **Non-Retail Schemes**.

(d) **Murabaha Funds**

Murabaha-based structures involve cost-plus financing arrangements compliant with Shariah principles. Funds utilising Murabaha transactions for asset acquisition or trade financing purposes may typically be authorised in Malta as **Non-Retail Schemes**.

(e) **Shariah-Compliant Private Equity Funds**

These funds invest in unlisted or privately held companies that meet defined Shariah screening and business activity criteria. Shariah-compliant private equity strategies may involve direct ownership stakes, management buyouts, or development capital investments, structured without recourse to interest-based financing.

Shariah-compliant Private Equity Funds will typically be authorised in Malta as **Non-Retail Schemes**, targeting professional and qualifying investors.

## **Section 5      The Shariah Governance**

### **Appointment of the Shariah Advisory Board/Shariah Adviser**

5.01

The Manager of the fund shall appoint a Shariah Advisory Board, subject to approval of the fund's governing body (Board of Directors in the case of a corporate fund), to ensure that the fund complies with Shariah principles and relevant standards in the management of its assets. The Shariah Advisory Board must meet the following requirements:

- a) the Shariah Advisory Board is composed of at least three members who are of good repute and possessing demonstrable expertise in Islamic jurisprudence, particularly in matters pertaining to Islamic finance;
- b) members of the Shariah Advisory Board are to be independent of the Manager and the fund; and

Provided that any changes with respect to the composition of the Shariah Advisory Board are also to be approved by the Management Body of the fund.

5.02 Where the fund invests exclusively in securities which are already subject to recognised Shariah screening processes such as:

- a) securities included in, or referenced to, an Islamic index;
- b) Sukuk, or other securities issued by a Shariah-compliant financial services provider; or
- c) treasury bills issued by a central bank in accordance with Shariah principles.

the Manager does not need to appoint a Shariah Advisory Board in accordance with 5.01 and may rely on such screening for the purposes of ensuring Shariah compliance. Notwithstanding such reliance, the Manager shall appoint a Shariah Adviser who shall review, endorse, and periodically confirm the appropriateness of the reliance on such screening methodologies.

5.03 A Shariah Adviser, to be appointed in accordance with 5.02, shall satisfy the same requirements as set out for members of the Shariah Advisory Board in 5.01 above, and may be any of the following:

- a) a natural person;
- b) a Shariah advisory firm; or
- c) a Shariah committee of an entity licensed by the relevant regulatory authority to carry out Islamic financial activities.

## **Role of the Shariah Advisory Board/Shariah Adviser**

5.04 The Shariah Advisory Board/Shariah Adviser shall:

- (a) provide guidance to the fund's management on the steps to be followed to meet Shariah compliance in the management of its assets, rather than being an investment adviser which issues specific investment recommendations to the fund or its Manager;
- (b) prior to the launch of the fund, approve the fund structure and the investment methodology of the Investment Manager, including the Shariah policy document which it will be following to manage the fund in order to be Shariah compliant. This policy document may be amended from time to time. In the event of any changes, subject to the Board's prior approval, investors shall be notified thereof before such changes come into effect. Any changes should only become effective after all pending redemptions linked thereto have been satisfied. Any applicable redemption fees would also need to be waived accordingly;

- (c) review the fund's contractual relationships with relevant parties;
- (d) exercise independent authority over all Shariah-related matters and ensure the fund's adherence to Shariah principles, whilst the Manager remains responsible for the investment management and operational implementation of such Shariah decisions;
- (e) provide ongoing services to the fund, including supervising and monitoring the operations of the fund to aid in its ongoing compliance with the Shariah policy document;
- (f) report to investors, annually, in the fund's audited financial statements expressing its objective opinion regarding the extent of Shariah compliance of the fund.

## **Section 6      Treatment of Non-Shariah-Compliant Investments**

- (a) where any investment of a Shariah-compliant fund is found to be in breach of Shariah principles, the Manager shall, upon becoming aware of such non-compliance, take steps to dispose of the investment within a period not exceeding 3 months;
- (b) if, within the 3-month period, the investment is reclassified as Shariah-compliant based on subsequent assessments, the fund shall not be required to dispose of such investment;
- (c) in cases where the said investment is illiquid, the Manager shall document the circumstances and take all necessary steps to complete the disposal at the earliest practicable time;
- (d) any income derived from the non-compliant investment during the period of non-compliance shall be purified in accordance with Shariah principles (such as channelling to charities), whilst the fund is permitted to retain the original cost (the principal) of investment. The entities benefiting from the fund's purification process should be independent of the fund and its Manager to prevent any actual or perceived conflict of interest;
- (e) where the market value of a non-compliant investment falls below its original cost, the fund may continue to hold the investment. Income received during the holding period may also be retained until the combined total of the income received and the current market value equals the original investment cost, at which point the fund shall dispose of its holding.

## **Section 7      Disclosures in Prospectus or Offering Memorandum**

7.01

Disclosure about the fund should assist investors in understanding the nature of the investment vehicle and the relationship between risk and return, so that investors evaluating fund performance do not focus solely

on return, but also on the risk assumed to produce the return.

The Offering documentation of the fund shall include the following disclosures:

- (a) the profiles of members of the Shariah Advisory Board (or the Shariah Adviser, if applicable), including details of qualifications and relevant experience in Islamic finance, terms of appointment as well as their roles and responsibilities;
- (b) details of any actual or potential conflicts of interest relating to the fund, including any relationship between the Shariah Advisory Board (or Shariah Adviser), the Manager, or other service providers, together with the measures to safeguard the independence of the Shariah governance function and related mitigating measures, if applicable;
- (c) details of the recognised Shariah screening methodologies adopted, if the fund relies on such methodologies to ensure the Shariah compliance of its investment decisions;
- (d) fees and other charges that may be levied under the fund. Information on fees and charges should be disclosed to both prospective and current investors in a way that enables the investors to understand their nature, structure and impact on the fund's performance;
- (e) reference to the main features of the Shariah policy document to be followed by the fund setting out:
  - (i) the asset classes which the fund will be permitted to invest in;
  - (ii) the investment strategy/ stock screening methodology to be adopted, as well as the frequency of review;
  - (iii) any leverage restrictions;
  - (iv) where applicable, the possible distribution of income to third parties who are not fund investors, such as charities, and the nature of such income and the criteria for determining when this can be done, to whom and a maximum permitted limit on such distributions together with disclosure of any tax implications for investors/ full disclosure of all Shariah related processes and potential outcomes (e.g. purification or cleansing of dividends received);
  - (v) the requirements related to Shariah compliance vetting and certification by the Shariah Advisory Board both following the launch of the fund.
- (f) a disclaimer that the fund Directors and Manager are responsible for ensuring the fund satisfies the relevant Shariah principles and requirements as disclosed in the Prospectus or Offering Memorandum and that the MFSA has not assessed the

competence or otherwise of the members of the Shariah Advisory Board; has made no assessment or value judgement on the accuracy or completeness of statements made or opinions expressed with regard to the compliance of the fund with Shariah principles, and shall not be monitoring the extent of compliance of the fund with such principles on an on-going basis;

(g) details on risks associated with Shariah compliance, including:

(i) Risks related to limitation of investment universe:

reference to the fact that the fund shall operate within the requirements of Shariah as interpreted by the Shariah Advisory Board. The interpretation of Shariah by the Shariah Advisory Board may limit certain investment opportunities and may impose structural requirements that could increase costs and taxes, and that, due to the restricted nature of the permitted investment of Shariah compliant investments universe, a risk warning that returns of the fund may be lower and with higher volatility than a non-restricted fund.

(ii) disclaimer that prospective investors should not rely solely on the pronouncement of the Shariah Advisory Board regarding the fund's compliance with Shariah principles, and to note that the fund's investments are deemed to be in compliance with Shariah based on such pronouncements. Prospective investors should consult their own Shariah Adviser, where necessary, before making an investment decision;

(iii) disclosure of increased susceptibility of the fund to fluctuations in value resulting from adverse economic or business conditions affecting the particular issuer, security or market to the extent that the Manager concentrates the fund's investments in particular industries or market sectors in view of the limitations imposed by Shariah;

(iv) risks related to changes in Shariah compliant rules - changes to the Shariah compliant investment rules may result in a reduced opportunity to sell in certain cases and higher costs of trading;

(v) increased counterparty risk due to the possible use of limited prime brokers and administrators in the marketplace offering the required level of Shariah compliance as well as risk of increased cost from lack of a competitive marketplace;

(vi) disclaimer on possible increased costs to be incurred by a Shariah-compliant fund compared to a non-compliant

one;

- (vii) risks associated with limited Shariah-compliant cash management tools and techniques – risk of lower returns compared to those generated by conventional cash management methods;
  - (viii) risks associated with possible decreased opportunities for financing and increased costs of financing given that the fund would need to utilise financing in a Shariah-compliant manner;
  - (ix) increased liquidity risk due to borrowing restrictions and illiquid investments) and potential foreign exchange risk in view of hedging restrictions;
  - (x) liquidation risk with respect to any investment that ceases to be Shariah compliant.
- (h) Disclosures regarding the treatment of the fund's investments which in the opinion of the Shariah Advisory Board/Adviser are no longer Shariah compliant and the time within which the fund is permitted to liquidate such positions.
- (i) Any purification mechanism adopted by the fund, and its impact on the basis of the fund valuation, should also form part of the disclosure.

Material changes that may affect the Shariah compliance of the fund's investments should be notified to all investors without undue delay.

## **Section 8      Disclosure in Annual Report of a Shariah-Compliant Fund**

8.01

In addition to the disclosure requirements ordinarily applicable to conventional funds in terms of their authorisation, the audited financial statements of Shariah-compliant funds shall also include:

- (a) A report by the Shariah Advisory Board expressing its opinion on whether the fund complied with Shariah principles and its Shariah policy document during the period under review. The report should include a signed attestation stating the scope of its review, the standards applied, and any limitations;
- (b) A disclosure of the amount of tainted income received, reasons for receiving such income, to what entities purification payments have been channelled, and the amounts paid to each entity.

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