CHAPTER 2

AN OVERVIEW OF THE UNIT TRUST INDUSTRY IN MALAYSIA

2.1 INTRODUCTION

A unit trust fund is a collective investment scheme formed for the purpose of pooling the funds of investors with the intention that the funds be invested and managed for their mutual benefit. It is an investment mechanism which allows investors who share similar financial objectives to pool their money. A professional fund manager invests the pooled funds into a portfolio of investments which may include the asset classes such as cash, bonds and deposits, shares, properties, commodities and others. Depending on the nature of the unit trust product, the portfolio of investments may include all of the above asset classes or it may focus on one or a combination of two or more classes.

Unit holders do not purchase the securities in the portfolio directly. Ownership of the fund is divided into units of entitlement. As the fund increases or decreases in value, the value of each of unit increases or decreases accordingly. Each investor receives a certificate of entitlement, known as a unit trust certificate. The number of units held depends on the unit buying price at the time the investment was made and the amount of money invested by the investor. Today many unit trust management companies have
gone scrip less. Investors however, can request for a certificate for which a small fee is charged.

The return on investment for unit holders is usually in the form of dividends and capital appreciation, derived from the pool of assets supporting the unit trust scheme. Each unit is entitled to earn an equal amount of income, determined by the level of dividend and capital appreciation or depreciation in any one period.

2.2 THE STRUCTURE OF UNIT TRUST SCHEME

The operation of unit trusts is based on a tripartite relationship between 3 parties, namely, the unit holders, the management companies and the trustee. While there are many variations on the practices, the basic principles that will be discussed here will apply to most structures.

The operation of a unit trust scheme is governed by a legal document called a Trust Deed. It is effectively the constitution of the trust structure, and details the way in which the structure operates. Trustees, who are usually affiliated with major banks, are appointed to manage the operation of the Trust Deed. Trustees are not dissimilar to directors of ordinary companies, except that the extent of their rights and obligations is dictated by the terms and conditions of the Trust Deed.
Investors invest capital in the unit trust to obtain income and capital growth. Trustee owns all of the assets of the trust and also ensures that the manager acts in accordance with the Trust Deed. The management company has the responsibility for the day-to-day management of assets as well as the responsibility for the distribution of income and calculation of unit prices. The assets of the unit trust are held in the name of the Trustee. This is a legal safeguard, as it separates the management company's assets from that of the unit trust scheme. This important financial control safeguards the investors' funds.

A unit trust is normally open-ended, that is the size of the unit trust in terms of its units in circulation is flexible and will increase or decrease in size with every creation or cancellation of units made. The manager of the unit trusts can sell units continuously or as many units as is stipulated in the Trust Deed based on the initial offering price which is normally RM 1 a unit or the later valuation price. Similarly, the investors can buy units from the manager at the manager's 'selling price up to the limit stated in the Trust Deed. On the other hand, the manager is obligated to repurchase units at the manager's 'buying price if the unit holders choose to sell it later. The price of units in a unit trust is based on its underlying net asset value (NAV) calculated by the management company at the end of each business day.

The major responsibilities and roles of the various participants and legal documents involved in the operation of a unit trust structure are outlined below:
i. **Trust Deed**

A Trust Deed shows the rights and obligations of the Manager, the rights and duties of the Trustees and the rights of the unit holders. Also normally shown are the maximum fees payable, the extent of investments authorized and the value of the units, etc. The Trust Deed may have a finite life and will normally outline the way in which changes can be made to the Trust Deed. This will usually involve obtaining the consent of the unit holders via a voting mechanism. The auditor of the fund will also have to comply with various sections of the Trust Deed.

ii. **Management Company**

The Manager makes recommendations concerning the purchase, sale and portfolio administration of the assets of the unit trust scheme. The Manager also promotes the sale of units, services the unit holders and provides re-purchase facilities to buy back units from unit holders who want to liquidate their investment.

iii. **The Trustee**

When an investor acquires units in a unit trust scheme, the investor's funds are passed to the Trustee who is responsible for safeguarding those funds and ensuring that they are correctly invested according to the Trust Deed. In other words, the Trustee supervises the operations of the trust to ensure that the objectives of the unit trust scheme are followed. The Trust Deed will spell out the various responsibilities of the Trustee. Some major responsibilities are approving and monitoring all financial transactions, holding title documents of all assets, and collecting all income on behalf of the Trust.
iv. **The Unit Holders**

The unit holders may be individuals, companies or institutions which invest money in the fund with the hope of generating returns in the form of dividends and capital gains. The unit holders have no direct or indirect power in making management and investment decisions. Unit holders hold units, each unit ranking equally with all other units of the Trust. The value of the units is determined with reference to a formula, normally set out in the Trust Deed, usually by dividing the value of the assets by the number of the units currently in issue.

2.3 **TYPES OF UNIT TRUSTS**

In some countries where unit trusts are very popular as an investment vehicle, the number and types of unit trust investment options available are almost endless. In Malaysia, the number and types of unit trust scheme are also developing quickly. Examples include savings, high growth, dynamic, property and bond funds.

There are numerous ways in which unit trusts and other related products can be classified. Each country, due to different investor requirements and unique regulatory regimes, seems to have its own types of funds, and in turn, its own classification systems and terminologies.

In the United Kingdom for instance, there are 24 separate categories of unit trusts, as specified by the Association of Unit Trusts and Investment Funds (AUTIF).
Their classification system revolves basically around the investment destination, e.g. UK Equity, Japan Money Market etc. In the United States, the term mutual fund is used to represent unit trust-type investment structures. They have a very broad classification system, which combines investment objectives and investment destinations.

Currently, the range and type of unit trusts available in Malaysia is not as extensive as what might be available in other developed markets. These are some of the popular types of unit trust scheme available in the Malaysian unit trust industry, which are basically characterized by their nature of investment objectives and asset classes associated with them.

I. Growth funds

These funds tend to assume significant risk by investing heavily in emerging companies in anticipating substantial capital appreciation or companies that give promise of showing steadily rising earnings records that encourage large price earning ratios.

II. Income funds

The primary objective of these funds is to invest in common stocks, preferred stocks, and bonds that pay good cash dividends and coupon interests. Risky stocks offering higher potential capital gains tend to be avoided in favor of blue chip stocks. Although they are somewhat out of favor with common stock investors, they have become more popular with persons seeking current income, generally the retired or well
to do without salaries or wages. This group has turned to bonds and debentures, which give substantially secured and stable returns.

iii. Growth and income funds

These funds seek to combine long term capital growth and current income. In order to achieve the objective, such funds invest in the common stock of companies whose share value has increased and that have displayed a solid record of paying dividend.

iv. Balanced funds

Balanced funds divide their holdings between fixed income and low-risk common stocks in order to avoid the risk of loss due to the future that is hardly predictable. Balanced funds seek to maintain certain levels of speculative and conservative common stocks and different classes of fixed income securities. If the stock market goes up, the common stock part of the portfolio will rise with it. If the market goes down, the defensive part of the portfolio that is the bonds and preferred stock will produce income and shield shareholders against serious losses.

v. Saving funds

The objective of the funds is to achieve steady growth in income over medium to long-term investment in the strong economic growth of the country. For example, a monthly deduction scheme from individual saving accounts to invest in this fund.
vi. **Property trust funds**

Property trusts invest in real property such as retail and commercial office properties, and provide the investors with an opportunity to participate in the cycles to the property market in a way, which is normally impossible for small investors. Returns from property unit trusts are generated from the rental income of the property, plus any capital appreciation that comes with holding the property over the period.¹

vii. **Bond funds**

Bond funds are investment trust with the objective of lending money to industries, utilities, states, cities or other public bodies. Some of the funds try to invest in issues that permit conversion into common stock. If the latter rises they get not only reasonably assured income but also capital gains as their holdings rise with the common stock. However, these funds also invest in the corporate bonds that have low bond quality rating to earn high interest rates.

viii. **Equity Index funds**

Equity index funds focus on index-linked stocks of a selected benchmark market index usually KLSE Composite Index. The funds invest in diversified portfolio of component stocks of a selected benchmark market index in its efforts to replicate the selected index composition and performance.

¹ Because of the nature of property, that it is a highly illiquid asset as compared to other investment types, most property units are listed on a stock exchange. This ensures that the fund manager has sufficient funds over the life of the Trust Deed and fully invested as possible in property, without having the need to maintain a pool of liquidity to handle repurchase of units.
ix. **Islamic funds**

The main objective of an Islamic Unit Trust is to invest in a portfolio of *halal* stocks, which are in accordance with the principles of the *syariah*. Such *halal* stocks will exclude companies involved in activities, products or services related to conventional banking, insurance and financial services, gambling, alcoholic beverages and non-*halal* food products\(^2\).

The unit trust industry in Malaysia is still new, but over time, it is expected that the range and number of products will increase, as investors become better informed of their investment choices and as unit trust schemes develop new products to cater to investor’s needs.

### 2.4 DEVELOPMENT OF UNIT TRUST INDUSTRY IN MALAYSIA

The concept of a unit trust is quite an old one, with the world’s first unit trust, *The Foreign and Colonial Government Trust* established in London in 1868. The concept and basic structure was then used in other parts of the world during the early part of this century but did not become a popular form of mass investment until the early 70’s in countries like the United Kingdom, Australia and the United States.

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\(^2\) The returns of the Islamic Unit Trust will also avoid the incidence of *riba* or usury interest through the process of cleaning or purification by the removal of such amounts representing the interest element. Such proceeds are normally donated to charities.
Malaysia introduced the concept relatively early compared to its Asian neighbors. In 1959, a company called Malayan Unit Trust Ltd first established a unit trust. The unit trust industry in Malaysia has therefore only a short history of around four decades or so. The first two decades (1959-1979) in the history of the unit trust industry were characterized by slow growth in the sales of units and a lack of public awareness in the new investment product. Several parties including Bank Negara Malaysia (BNM), Registrar of Companies (ROC) and The Public Trustee also regulated the industry.

The first unit trust fund to be established was the First Malayan Fund managed by the Malayan Unit Trust Limited. The fund had a limited life span of ten years. Following the departure of Singapore from Malaysia, the operations of Malayan Unit Trust Limited were divided into two parts: a Singapore based company called Singapore Unit Trust Limited took over the Singapore operations, while the Malaysian entity went to Asia Unit Trust Berhad, a subsidiary of South East Asia Development Corporation Bhd (SEACORP). Asia Unit Trust Berhad launched the first totally Malaysian unit trust fund, Malaysian Investment Fund, on 2 December 1966. It was then followed by the establishment of the first Bumiputera owned management company namely Amanah Saham Mara Berhad (AMSB). On 24 June 1967, AMSB launched the First Mara Bumiputra Fund to cater the needs of Bumiputra investors.

Other development in this period of time is the establishment of Amanah Saham Pahang Berhad, the first state-owned unit trust Management Company, Kuala Lumpur Mutual Fund Berhad, and MIC Unit Trust Bhd, which was later, renamed MIC-TPG Unit Trust Bhd. However, the industry remained insignificant until the end of 1980 with only
five managing companies managing twenty-one unit trusts totaling 75.9 million units with a value of RM 162.00 million.

The most important milestone in the development of unit trust industry in Malaysia is when the government decided to utilize the unit trusts as a vehicle to achieve its goal of redistributing national wealth under the New Economic Policy (NEP). Through the unit trust scheme, the government intended to achieve the NEP objective of increasing Bumiputras’ shareholding in the public and private limited companies to 30% of total equity ownership. In materializing this objective, PNB was established in 1978 as a wholly owned subsidiary of the Bumiputra Investment Fund (Yayasan Pelaburan Bumiputra).

In 1981, Permodalan Nasional Berhad (PNB) launched the first national Bumiputra unit trust fund called the Amanah Saham Nasional (ASN), which was sold at the opening price of RM1.00.

This trust fund with an initial issuance of 540 million units and government backing, not only being significant in size compared to the other existing funds, but also expanded rapidly to become the nation’s premier unit trust fund, with a size of 11 billion units valued at RM 10.8 billion at the end of 1990.

The ASN units were transacted under a fixed price scheme irrespective of the underlying market value of the portfolio held. Such an arrangement expired on December 31, 1990. In order to provide a continuing opportunity for Bumiputra
individuals who still prefer a fixed price, the Amanah Saham Bumiputra (ASB) unit trust fund was established in October 1989. The ASB scheme became operational on January 1, 1990 and investors were allowed the option to transfer their ASN units to the ASB. Both Bumiputra funds constitute 90 percent of the total fund in the industry as at June 30 1994.

The period of 1990s witnessed the fastest growth of the unit trust industry in terms of the number of new management companies established, and growth in funds under management. The NAV of total funds under management grew more than three-fold from RM15.72 billion at the end of 1992 to RM59.95 billion at the end of 1996. The introduction of ASB as the second national unit trust fund and the great success of ASN in particular and unit trust investment as a whole had brought great popularity to unit trust as a successful means of investment. The phenomenon attracted enormous amount of interest by many parties to set up management companies and unit trust funds to capture the rapidly growing demand of the Malaysian public to put their money in unit trust investment. For instance, 1995 saw an unprecedented launch of 13 new funds with six new management companies setting up operations in the year.

In addition to that also, we can see that the state sponsored funds became more significant following the tremendous success of the public sector trust. Almost all of the state funds that are currently available in the market such as Amanah Saham Johor, Amanah Saham Selangor, Amanah Saham Sarawak, Amanah Saham Kedah and others were launched after 1990.
This period also witnessed a number of important events and developments that put the industry in the right gear for acceleration. In a move to further encourage the growth of the unit trust industry, stamp duty on transfer of units was waived. In addition to that, in 1991, the Guidelines on Unit Trust Funds were introduced to provide clear operational procedures and regulations to govern the unit trust industry. To further promote the development of the industry, The Securities Commission Act was passed in March 1993. This Act established the Securities Commission (SC) and vested it with the responsibility to regulate all matters relating to the unit trust industry. At around the same time, the fund managers have also formed a Federation of Malaysian Unit Trust Managers (FMUTM) on 20 September 1993. This Federation basically acts as a representative body of the fund managers on matters relating to the unit trusts. Members of FMUTM as of July 2002 are attached as Appendix 1.

The introduction of Guidelines on Unit Trusts, the establishment of the Securities Commission and FMUTM brought about greater awareness in the unit trust industry and contributed towards the tremendous growth of the industry. From time to time, SC revises its policies and guidelines to strengthen and stimulate the industry. These include the effort to streamline the procedures and to ensure a fair and consistent application of policies in considering proposals by management companies of unit trust funds in 1994 and allowing management companies to invest up to 10% of total NAV of a unit trust fund in foreign securities in 1995. In an effort to open up the industry even further, the SC revised its guidelines again in 1996 and issued a number of measures including:
1. Stock broking houses with a minimum RM100 million paid-up capital were allowed to set up unit trust Management Company.

2. Foreign fund management companies (FFMC) were also allowed to set up operations under these new guidelines.

3. Employees' Provident Fund (EPF) contributors were also allowed to withdraw part of their money from their retirement account (Account One) to invest in approved financial institutions including unit trust funds.

These stimulative efforts had brought about rapid growth in the industry in the second half of the 1990s. Revisions after revisions were continuously made by the SC to liberalize and at the same time keep grasp of the industry's integrity, credibility and systemic stability.

Another important event in the unit trust industry in Malaysia is when PNB launched the three billion ringgit Wawasan 2020 Fund which was opened to all Malaysians including non-Bumiputras, between the ages of 12 to 30. Like the ASB and the ASN earlier, the Wawasan 2020 Fund would also remain at RM1.00 until further notice from PNB. Table 2.1 below summarizes the development of the Malaysian unit trust industry and provides key statistics of the industry until 30 June 2002.
Table 2.1: The Unit Trust Industry in Malaysia

<table>
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</tr>
</thead>
<tbody>
<tr>
<td>No. of management companies</td>
<td>10</td>
<td>11</td>
<td>32</td>
<td>34</td>
<td>34</td>
<td>17</td>
<td>37</td>
</tr>
<tr>
<td>No. of approved fund</td>
<td>77</td>
<td>84</td>
<td>95</td>
<td>107</td>
<td>127</td>
<td>184</td>
<td>168</td>
</tr>
<tr>
<td>Total approved size (billion units)</td>
<td>47.11</td>
<td>55.52</td>
<td>61.88</td>
<td>74.38</td>
<td>90.35</td>
<td>110.02</td>
<td>119.31</td>
</tr>
<tr>
<td>Unit in circulation (billion units)</td>
<td>38.98</td>
<td>45.25</td>
<td>48.54</td>
<td>52.63</td>
<td>63.85</td>
<td>71.39</td>
<td>76.65</td>
</tr>
<tr>
<td>Net asset value (NAV) (RM billion)</td>
<td>59.96</td>
<td>33.57</td>
<td>38.73</td>
<td>43.26</td>
<td>43.30</td>
<td>47.34</td>
<td>53.81</td>
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<tr>
<td>No. of accounts (million)</td>
<td>7.98</td>
<td>8.26</td>
<td>8.59</td>
<td>8.91</td>
<td>9.58</td>
<td>9.99</td>
<td>10.22</td>
</tr>
<tr>
<td>% of NAV to KLSE market capitalization</td>
<td>7.4</td>
<td>8.93</td>
<td>10.34</td>
<td>7.83</td>
<td>9.74</td>
<td>10.18</td>
<td>10.64</td>
</tr>
</tbody>
</table>

Source: Securities Commission Annual Report, various publications and the SC's Trust Funds and Investment Management Department

It is therefore notable from the table that the unit trust industry in Malaysia had experienced a healthy continuous trend of growth despite the financial crisis in mid-1997 followed by the nation’s second economic recession in 1998 with almost all of the key statistics of the industry showing positive growth. However, despite the continuous growth in the number of funds launched and size of funds approved, the total net asset value (NAV) of the industry as of 30 June 2002 is still well below the total NAV of the industry at the end of 1996. The July 1997 Asian financial crisis had plunged the Kuala Lumpur Stock Exchange index and in tandem shrank the unit trust industry by almost 45 per cent. The economic recovery as well as the rebound and stabilization of stock prices in the KLSE had subsequently brought back stability and confidence in the industry.

The most important development, in this context, that attracts our highest interest was the debut of the first Islamic unit trust fund in Malaysia in 1993. Arab Malaysian Unit Trust Berhad has the distinction of being the first Malaysian company to launch a fund, Tabung Ittikal Arab-Malaysian, based on Islamic principles on 12
January 1993. Since the commencement of the first Islamic unit trust, the sector continues to grow rapidly. It was followed by the launching of Tabung Amanah Bakti by Asia Unit Trust and Tabung Pertama by Bank Islam Management Berhad that operates under the same principles. All these funds were opened to the public investors irrespective of religious belief. To comply with Islamic principles, its investment portfolios cannot include companies that pay interest, companies which are involved in the gambling business or alcoholic drinks production and other products, which are deemed 'haram' in Islam. We will discuss this in a greater detail in the following sections.

2.5 THE ISLAMIC UNIT TRUST SCHEMES

The Islamic unit trust schemes are the group of collective investment funds, which offer investors the opportunity to invest in a diversified portfolio of securities, which are managed by professional managers in accordance to the syariah. The main objective of an Islamic unit trust fund is to invest in a portfolio of halal stocks that comply with the principles of the syariah. Such halal stocks will exclude companies involved in activities, products or services related to conventional banking, insurance and financial services, gambling, alcoholic beverages and non-halal food products.

A unit trust that is managed under the Islamic system must strictly avoid the incidence of riba or interest. In addition from riba, the other negative elements such as al-Gharar (uncertainty), al-Maysir (gambling) and extreme profit taking should be
avoided. The returns of an Islamic unit trust funds will also have to undergo a process of cleansing or purification from any interest elements and proceeds or dividends of permissible securities that originate from mixed sources with non-halal or doubtful revenues by removing the amount that represents such elements. Furthermore, the returns originated from securities which were formerly permissible but had been declared non-halal and removed from the updated list of approved syariah securities but cannot be disposed or sold due to market conditions, are also cleansed out. The proceeds from the cleansing process will be donated at the end of each financial year to charitable organizations approved by the trustee and the management company, and as agreed upon by the Syariah Advisory Council (SAC) of the Securities Commission.

As at 30 June this year, there are 31 Islamic unit trust funds available in the market with 3 other funds had been approved but not yet launched.

2.6 SYARIAH ADVISORY COUNCIL (SAC) OF THE SECURITIES COMMISSION

In ensuring the continuous development of the Islamic capital market and in this context, the Islamic unit trust schemes in particular, initiatives in setting-up and providing the necessary infrastructure for research, discussion and dialogue are crucial. The commitments of the Securities Commission as the regulatory as well as a developmental body of capital market of the country were reflected in the setting up of a dedicated Islamic Capital Market Unit within its Research and Development Division. This unit is staffed by researchers who are well versed in conventional capital market practices as well as others who are trained in figh muamalat. The mandate of this unit is
to carry out research activities in areas, which are related to Islamic financial products and Islamic jurisprudence.

Recognising that the development of this aspect of the capital market in particular, requires input from and constant dialogue and discussion with, not merely industry participants but also Islamic scholars, the SC in 1994, established an informal group called the Islamic Instruments Study Group (IISG). This was done with the objective of facilitating a process whereby through discussion and debate, Islamic scholars and industry participants can examine existing capital market instruments and guide market participants on matters pertaining to Islamic capital market issues. The IISG comprised renowned Malaysian fiqhi scholars, corporate figures who were active in the area of Islamic banking and Islamic securities as well as academicians.

The Islamic Capital Market Unit provides extensive research and secretarial support to the IISG. The success of the IISG and its ability to fill the absence in the area of Islamic capital market expertise prompted the SC to propose the establishment of a more formal body with the responsibility of not only evaluating specific capital market instruments but also ensuring that the operation of the Islamic capital market fulfils all syariah principles. Hence, in 16 May 1996, syariah Advisory Council (SAC) of the Securities Commission was officially established. syariah Advisory Council (SAC) of Securities Commission is the body with the responsibility of ensuring the operation of the Islamic Capital Market in Malaysia fulfills the syariah principles. The members of the body consist of muftis, Islamic scholars, academicians and Islamic finance experts. The council is also aimed to advise the SC on all matters pertaining to the systematic
development of a comprehensive Islamic capital market and to serve as the focal point of reference on all issues relating to the Islamic capital market and *syariah*.

2.7 **SYARIAH COMMITTEE / SYARIAH CONSULTANT**

The revised guidelines on unit trust of 1997 had imposed management companies that manage Islamic unit trust funds or intends to offer one to set up their own *syariah* consultant or *syariah* committee to ensure and monitor all investment decisions as well as funds operation are at all time in compliance with the Islamic principles as laid down by the *Syariah* Advisory Council (SAC). Thus, while the SAC provides overall guidelines of the sector, the *syariah* consultant or *syariah* committee of the respective funds will be only responsible on the operations and investment decisions of the fund concern.

In general, the appointed members of the panel consist of academicians and practitioners, as well as *'Ulama* (Islamic Scholars) that have understanding in regards to the Islamic financial instruments and system.

Among others, the roles of the *syariah* committee / *syariah* consultant of the scheme are:

i) To ensure that the scheme is managed and administered in accordance with the *syariah* principles.
ii) The *syariah* committee / *syariah* consultant of the scheme should provide expertise and guidance for the scheme in all matters relating to the *syariah* principles, including on the scheme's Trust Deed and prospectus, its structure and investment, and other operational and administrative matters.

iii) Where there is any ambiguity or uncertainty as to an investment, instrument, system, procedure and/or process, the *syariah* committee / *syariah* consultant of the scheme must consult the SC who may consult the Syariah Advisory Council.

iv) The *syariah* committee / *syariah* consultant of the scheme must comply, and ensure that the scheme complies, with any guideline, ruling or decision issued by the SC.

v) The *syariah* committee / *syariah* consultant of the scheme should act with due care, skill and diligence in carrying out its duties and responsibilities.

2.8 SYARIAH APPROVED SECURITIES AND SOME RELATED ISSUES

Through the Islamic Capital Unit and the IISG and of later the SAC, the SC has, since its inception, undertaken continuous developmental activities. Among others, by identifying existing conventional capital market instruments that are acceptable to Islam. Irrespective of their origin, financial instruments that are by their very nature consistent with the teachings of Islam, or where elements that are unIslamic can be removed without affecting the utility of the instruments or impose undue cost burden, can be used.
In looking at existing conventional instruments and verifying whether they are acceptable to Islam, the approach taken by the SC is to dissect the instrument and analyse each component to see if they contain elements that are not acceptable in Islam.

One of the most valuable efforts done in the field is the review of counters on the Kuala Lumpur Stock Exchange (KLSE) and the identification of permissible counters from amongst the companies listed on the KLSE, followed by continuous monitoring of business activities of these companies. Prior to the establishment of the SC, Bank Islam Malaysia Berhad, in responding to the need to identify such counters, has reviewed the activities of companies listed on the KLSE and has identified a list of companies deemed to be permissible counters for investment. However, given the establishment of Securities Commission as the institution responsible of regulating and developing the capital market as well as the exponential growth in the number of companies listed on the KLSE, the task was further strengthened, updated and continued by the Syariah Advisory Council (SAC) of the Securities Commission.

In classifying securities as approved ones, the SAC has applied a standard criterion in focusing on the core activities of the companies listed on the KLSE. Hence, companies whose core activities are not contrary to the syariah principles are classified as approved securities. The securities that are excluded from the list of approved securities are based on the following criteria:
i) Operations based on *riba* (interest) such as activities of financial institutions like commercial and merchant banks and finance companies;

ii) Operations involving gambling;

iii) Activities involving the manufacture and/or sale of *haram* (forbidden) products such as liquor, pork, and meat not slaughtered according to Islamic rites; and

iv) Operations containing elements of *gharar* (uncertainty) such as the conventional insurance business.

For companies with activities comprising both permissible and non-permissible elements, the SAC applied several additional criteria, which are:

i) the core activities of the company must be activities which are not against the principles of *syariah* as outlined in the four criteria above. Furthermore, the *haram* element must be very small compared with the core activities

ii) the public perception or image of the company must be good and

iii) the core activities of the company are important and considered *maslahah* ('benefit' in general) to the Muslim *Ummah* (nation) and the country, and the *haram* element is very small and involves matters such as *`umum balwa* (common plight), *`uruf (custom) and the rights of the non-Muslim community which are accepted by Islam.

The SAC also takes into account, the level of contribution of interest income received from conventional fixed deposits by the company, as part of the criteria in the analysis of approved securities.
Apart from ordinary stocks in companies that do not partake in non-
halal activities, the SAC in using this approach has endorsed call warrants as acceptable
provided the mother shares themselves are halal. This is based on the Islamic concept
of haq tamalluk, which is a right that can be sold and transferred. Similarly transferable
subscription rights (TSRs), which do not fundamentally differ from call warrants, are
acceptable provided they involve the right for subscription to stocks of companies
carrying out permissible activities. Besides that, contrary to the conventional preference
shares, the non-cumulative preference share was also endorsed.

Asset securitisation which reflects very closely the concept of bai' al-dayn in
Islam has also been pronounced as acceptable. These enable bonds and loan stocks
that are issued based on Islamic principles such as zero-coupon Khazanah bonds
deemed permissible. SAC also approved derivatives instruments such as crude palm oil
future contract and the concept of index future contract as permissible.

In classifying these securities, the SAC received input and support from the SC.
The SC gathered information on the companies from various sources such as company
annual financial reports, company responses to survey forms and through inquiries
made to the respective company's management. The SC, through the SAC, continues
to monitor the activities of all companies listed on the KLSE to determine their status
from the syariah perspective. It will update the list twice a year that is the last Friday of
the months of April and October every year.
For example, Securities Commission (SC) had released the updated list of securities approved by its Shariah Advisory Council (SAC) effective from 26 April 2002. Nineteen companies, newly classified by the SAC as approved securities, have been added to the list while nine companies, which were in the previous list, have been excluded. The complete list of the 652 approved securities as well as the breakdowns of these securities according to sector are provided in Appendix 2. Table 2.2 summarises the components and breakdowns of the Shariah Approved Securities in KLSE.

Table 2.2: Shariah Approved Securities According To Sector as of 26 April 2002

<table>
<thead>
<tr>
<th>Sector</th>
<th>Approved No of Securities</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Main board</strong></td>
<td></td>
</tr>
<tr>
<td>Consumer Products</td>
<td>53</td>
</tr>
<tr>
<td>Industrial Products</td>
<td>99</td>
</tr>
<tr>
<td>Mining</td>
<td>4</td>
</tr>
<tr>
<td>Construction</td>
<td>31</td>
</tr>
<tr>
<td>Trading / Services</td>
<td>65</td>
</tr>
<tr>
<td>Properties</td>
<td>55</td>
</tr>
<tr>
<td>Plantations</td>
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</tr>
<tr>
<td>Technology</td>
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</tr>
<tr>
<td>Hotel</td>
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</tr>
<tr>
<td>Infrastructure Project Companies (IPC)</td>
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</tr>
<tr>
<td>Finance</td>
<td>4</td>
</tr>
<tr>
<td>Trusts</td>
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<tr>
<td>Close End Funds</td>
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<tr>
<td><strong>Total</strong></td>
<td><strong>365</strong></td>
</tr>
<tr>
<td><strong>Second Board</strong></td>
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<tr>
<td>Consumer Products</td>
<td>55</td>
</tr>
<tr>
<td>Industrial Products</td>
<td>134</td>
</tr>
<tr>
<td>Construction</td>
<td>28</td>
</tr>
<tr>
<td>Trading / Services</td>
<td>53</td>
</tr>
<tr>
<td>Properties</td>
<td>2</td>
</tr>
<tr>
<td>Plantations</td>
<td>2</td>
</tr>
<tr>
<td>Technology</td>
<td>4</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>278</strong></td>
</tr>
<tr>
<td><strong>MASDAQ</strong></td>
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<tr>
<td>Consumer Products</td>
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<tr>
<td>Industrial Products</td>
<td>1</td>
</tr>
<tr>
<td>Technology</td>
<td>3</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>5</strong></td>
</tr>
</tbody>
</table>

Source: Securities Commission Press Release on 26 April 2002
As a guide to investors, the SAC also laid down some guidelines on the timing for the disposal of securities which have been classified as *syariah* non-approved.

i) **Approved securities which are subsequently considered non-approved**

This refers to those securities which were earlier classified as approved securities but due to certain reasons, such as changes in the companies operations, are subsequently considered non-approved. In this regard, if on the date the updated list takes effect (for example 26 April 2002), the value of the securities held exceeds the original investment cost; investors who hold such non-approved securities must liquidate them. Any capital gains arising from the disposal of the non-approved securities made at the time of the announcement can be kept by the investors. However, any excess capital gains derived from the disposal after the announcement day at a market price that is higher than the closing price on the announcement day should be channeled to charitable bodies.

On the other hand, investors are allowed to hold their investment in the non-approved securities if the market price of the said securities is below the original investment costs\(^3\). It is also permissible for the investors to keep the dividends received during the holding period until such time when the total amount of dividends received and the market value of the non-approved securities held equal the original investment cost. At this stage, they are advised to dispose of their holding.

In addition, during the holding period, investors are allowed to subscribe to:

\(^3\) Original investment cost may include brokerage cost or other related transaction cost
a) Any issue of new securities by a company whose non-approved securities are held by the investors, for example rights issues, bonus issues, special issues and warrants (excluding securities whose nature is non-approved e.g. ICULS); and

b) Securities of other companies offered by the company whose non-approved securities are held by the investors,

On condition that they expedite the disposal of the non-approved securities. For securities of other companies [as stated in (b) above], they must be Syariah-approved securities.

II) Non-approved securities

The SAC advises investors who invest based on syariah principles to dispose of any non-approved securities, which they presently hold, within a month of knowing the status of the securities. Any gain made in the form of capital gain or dividend received during or after the disposal of the securities has to be channeled to charitable bodies. The investor has a right to only obtain the original investment cost.

2.9 ISLAMIC INDEX AS A BENCHMARK

The tremendous growth of the Islamic capital market and specifically unit trust sector in Malaysia as well as other Islamic countries in the world has urged the need for an Islamic index that comprises the securities which are in compliance with the syariah
and approved as permissible in Islam as a benchmark. The availability of such index will enable the players in the Islamic capital market to gauge performance more accurately with respect to the securities concerned.

In Malaysia, RHB Securities had pioneered the effort by introducing the RHB Islamic Index in May 1996. This value-weighted index uses 1992 as a base year and helps institutions especially Islamic unit trust funds that invest according to Islamic principles track performance more accurately. With this Islamic index, investors with Islamic portfolios have a benchmark portfolio for the purpose of comparison. From time to time, the constituents of the index will be regularly monitored to ascertain their eligibility in the index based on the conditions and requirements that have been laid down. For example, effective 3 June 2002, 153 counters will be added as component stocks of the RHB Islamic index. Simultaneously, 166 counters in the RHB Islamic Index will be excluded from the index, as they do not meet the requirements of liquidity, universe, suspension and eligibility under the rules of the RHB Islamic Index. The RHB Islamic Index is currently comprises 345 stocks listed on the KLSE. Only common stocks are included in the index with other shares such as preferred shares, income securities, convertible notes, warrants, rights, mutual funds and closed end fund shares being non-eligible. The list of all stocks included in the RHB Islamic Index as of 3 June 2002 is attached as Appendix 3.

Another Islamic index introduced in Malaysia is the KLSE Syariah index (KLSI). KLSI is an indicator for the performance of the Syariah approved securities. It was introduced on 17 April 1999 by the KLSE. It includes all Main Board shares that are on
the list of SC’s Syariah approved securities. The component of KLSI will be updated as and when the updated list of SC’s Syariah approved securities is released. The list of the components of KLSI as of 26 April 2002 is represented by the constituents of the KLSE Main board segment of the Syariah Approved Securities as attached in Appendix 2(A).

In the global arena, there are quite a number of Islamic indices being used whether in a particular domestic capital market or the international Islamic capital market. The most popular and especially for the global Islamic fund managers are the Dow Jones Islamic Market (DJIM) and the FTSE Islamic Index.