

# Guidelines for Shariah-Compliant Investing on Pakistan Stock Exchange



**SECURITIES AND EXCHANGE COMMISSION OF PAKISTAN**

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SECP is pleased to issue these Guidelines under section 40B of the Securities and Exchange Commission of Pakistan Act, 1997. The purpose of these Guidelines is to facilitate the investors in undertaking Shariah-compliant investments through Pakistan Stock Exchange.

*Disclaimer: The Shariah treatments mentioned in these Guidelines are general. The investor should refer to a qualified Shariah advisor or scholar in order to obtain personalized Shariah advice.*

## I. Introduction to Pakistan Stock Exchange (PSX)

### 1. What is a stock exchange?

A stock exchange is a marketplace where securities are bought and sold. It allows companies to raise capital by offering their securities to investors who seek positive returns on their investments. A stock exchange provides an electronic platform for the trading of securities. It offers various types of investment products, and provides real-time price information to investors in order to enable them to make informed investment decisions. Stock exchanges, among others, are further responsible for ensuring fair dealing and efficient price discovery for the securities being traded thereon. The term 'stock exchange' is often used interchangeably with 'securities exchange'.

### 2. What are the different types of securities traded on an exchange?

A security is a financial asset that represents some form of financial value, typically in the form of a stock, bond, derivative, sukuk, or units of a collective investment scheme or trust fund. Any security that is traded on the basis of the tenets of the Quran and Sunnah is termed as a Shariah-compliant security.

A stock or share represents relative amount of ownership in a company, entitling its holders to periodic returns from the profits of the company in the form of dividends. The fluctuation in the price of a company's share affects the value of a stockholder's investment. In contrast, a bond represents a debt made by the investor to the issuing company. Bondholders are entitled to a fixed return on their investment and the repayment of principle on a specified date. A derivative is a contract which derives its value from an underlying financial asset, entered into for hedging, including risk mitigation, or speculative purposes. Options and futures are commonly encountered forms of derivatives. Sukuk are certificates of equal value representing undivided shares in ownership of tangible assets, usufruct, or services. Units of a collective investment scheme or a trust fund represent instruments of ownership of the respective fund such as a mutual fund or a Real Estate Investment Trust (REIT) scheme.<sup>1</sup>

### 3. How many stock exchanges are there in Pakistan?

The Pakistan Stock Exchange (PSX) is the only stock exchange operating in Pakistan. It became effective in 2016 through the integration of the three existing stock exchanges, namely

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<sup>1</sup> To understand these instruments in further detail, investors are encouraged to read the investor guide titled *Savings and Capital Markets* published by SECP and available here: <https://jamapunji.pk/sites/default/files/Savings%20%26%20Capital%20Markets.pdf>.

Karachi Stock Exchange (formed 1947), Lahore Stock Exchange (formed 1970), and Islamabad Stock Exchange (formed 1989) following the promulgation of the Stock Exchanges (Corporatization, Demutualization and Integration) Act, 2012 by the Government of Pakistan. PSX offers various types of equities, exchange traded funds, fixed income, and derivatives products, in addition to having several indices (or indexes) that serve as performance benchmarks. The companies listed on the PSX are categorized into various sectors or groups of industries based on their principal business activities.

#### 4. How can an investor open an account to carry out trading on PSX?

The following steps are involved to open an account for trading on PSX:

- (i) The investor approaches a TREC (Trading Right Entitlement Certificate) Holder brokerage firm (broker) recognized by PSX and licensed by Securities and Exchange Commission of Pakistan (SECP) for opening a **Brokerage Account** in the investor's name. This process can be done in person or via online onboarding service as may be offered by the brokers.
- (ii) The broker obtains the required information from the investor by performing the Customer Due Diligence (CDD) and Know Your Customer (KYC) of the investor. The investor then agrees to the terms and conditions prescribed in the **Standardized Account Opening Form** provided by the broker, and fills it up.
- (iii) The investor is assigned a **Unique Identification Number (UIN)** by the National Clearing Company of Pakistan Limited (NCCPL) which is necessary to maintain a traceable link of the trades carried out by the investor.
- (iv) A **CDC Sub Account** is opened with the Central Depository Company (CDC) through the broker. This is the account through which the investor settles the trades incurred in the stock market. It is optional for the investor to also open a **CDC Investor Account** which provides investors the individual custody of their shares independent of the broker.
- (v) The customer then signs the **CDC Setup Report** provided by the PSX Broker after verifying the correctness and completeness of the information stated therein.
- (vi) The account is finally activated, and the investor needs to deposit initial funds to commence trading.

#### 5. How are trades executed on PSX?

The investor gives an instruction to the broker for a buy or sell order in writing, verbally through phone, or online via internet-based trading systems. The investor who wants to trade only in a Shariah-compliant manner must inform the broker of his or her intention to do so. The broker places the order on the PSX trading system. If the order is executed, a confirmation of the trade is sent by the broker to the investor within 24 hours. An SMS or email alert is also sent to the investor by NCCPL at day end. In two days' time, the trade is cleared by NCCPL, and settled by CDC, implying that securities are transferred from the seller's account to the buyer's account while the money is transferred from the buyer to the seller. Every time the securities are transferred in or out of the investor's account maintained with CDC, the investor

is sent an SMS or email alert by CDC to confirm the movement of securities in or out of the account, as appropriate.

## II. Shariah-Compliant Trading on PSX

### **6. Why is there a need to check the Shariah permissibility of stock market products and trading practices?**

The Shariah lays down certain principles with regard to financial contracts, the conduct of business, and trading in general. In particular, Shariah prohibits any transaction that involves an element of interest (*riba*). In order to ensure Shariah compliance of a product or service, it must be free from such prohibited elements, and conform to other requirements of Shariah. Various stock exchanges, including PSX, have designed and launched products and services that cater to the specific requirements of Shariah.

### **7. What are the Shariah-compliant products offered on PSX?**

PSX lists Shariah-compliant shares, sukuk, Islamic Exchange Traded Funds (Islamic ETFs), and Islamic Real Estate Investment Trusts (Islamic REITs). It is also deemed permissible as per Shariah for investors to subscribe to the Initial Public Offerings (IPOs) of Shariah-compliant securities. In addition, PSX offers Shariah-compliant indices comprised of shares of listed companies that meet certain pre-defined Shariah and technical screening criteria. A Shariah-compliant facility to finance the purchase of shares is also available, through National Clearing Company of Pakistan Limited (NCCPL), called Murabahah Share Finance.

## III. Shariah-Compliant Indices

### **8. What is a stock exchange index?**

A stock market index represents a security market, a segment of a security market or a certain asset class. The stocks included in an index are often a sample of the total stocks in the respective market, segment, or asset class. The main purpose of an index is to understand the market sentiment by reflecting the performance of the market that it represents. An index also provides a historical perspective of the market performance, giving investors greater insight into their investment decisions. The value of an index changes with a change in the price of the underlying stocks, and is calculated on an ongoing basis. There are various equity, sectoral, and Shariah-compliant indices on PSX.

### **9. What is the purpose of having Shariah-compliant indices on PSX?**

The objective of a Shariah-compliant index (also called an Islamic index) is to serve as a gauge for measuring the performance of Shariah-compliant segment of the market. A Shariah-compliant index is, therefore, comprised only of those securities that meet the requirements for Shariah compliance as per pre-defined criteria. A Shariah-compliant index also acts as a research tool for strategic asset allocation process, and its construction is intended to increase investors' trust and enhance their participation in Islamic capital markets.

#### **10. Which Shariah-compliant indices are available on PSX?**

There are currently three Shariah-compliant indices on PSX: (1) PSX-KMI All Share Index; (2) KMI 30 Index; and (3) Meezan Pakistan Index. The PSX-KMI All Share Index is comprised of all securities that are deemed Shariah compliant based on their fulfillment of the Shariah screening criteria and the technical criteria. KMI 30 Index and Meezan Pakistan Index are comprised of the top 30 and top 12 ranked Shariah-compliant securities, respectively.

#### **11. What is the selection process for securities' inclusion in the Shariah-compliant indices?**

During the selection process, each company's financial reports are thoroughly reviewed by research analysts to ensure that the company meets benchmarks or thresholds for Shariah-compliance screening. Those that are found to be Shariah non-compliant are screened out. The industries that are Shariah non-compliant, as defined in the eligibility criteria, are also not considered. All companies deemed Shariah compliant as per the eligibility criteria are included in PSX-KMI All Share Index. For inclusion in KMI 30 Index, Shariah-compliant securities are ranked such that those with the highest free float and the lowest impact cost receive the highest rank. The top 30 ranked companies are then included in KMI 30 Index. Meezan Pakistan Index includes 12 Shariah-compliant securities – those having the highest average traded value and free float market capitalization – among KMI 30 index securities.

#### **12. How frequently are securities in the Shariah-compliant indices reviewed to determine their Shariah-compliance status?**

Both Shariah-compliant indices are recomposed on a semi-annual basis. The first revision takes place on 15<sup>th</sup> May on the basis of the data pertaining to 31<sup>st</sup> December of the previous year. The second revision takes on 15<sup>th</sup> November on the basis of 30<sup>th</sup> June data. To minimize the impact of corporate actions implemented between the revision date and review period, the 15<sup>th</sup> May revision uses the prices and free float as on 31<sup>st</sup> March, while the 15<sup>th</sup> November revision uses the prices and free float as on 30<sup>th</sup> September.<sup>2</sup>

### **IV. Shariah-Compliant Shares**

#### **13. How should investors treat securities reclassified from Shariah-compliant to Shariah non-compliant status?**

The investors must review the updated PSX-KMI All Share Index on each date of index reconstitution in order to determine the Shariah compliance status of the securities they own. If any owned security is reclassified from Shariah-compliant to Shariah non-compliant status, then the investor must immediately sell off the security if its price on the reconstitution date exceeds or is equal to the original investment cost. Any capital gain arising from the sale may be kept by the investor. If, however, the price on the reconstitution date is less than the

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<sup>2</sup> To download the index brochures and the most recent revisions in the Shariah-compliant indices, please refer here: <https://www.psx.com.pk/psx/product-and-services/indices#islamic-indices>.

original investment cost, the investor may hold the stock until the price becomes at least equal to the original investment cost.

#### **14. Why is there a need to purify the dividend received on a Shariah-compliant stock?**

One of the criteria for inclusion of securities in the PSX-KMI All Share Index is that the ratio of Shariah non-compliant income to total revenue should be less than 5%. Hence, it is possible that a company, deemed Shariah-compliant, earns some amount of Shariah non-compliant income. This income contributes to the profit of the company which is, in turn, used to pay dividends to shareholders. Hence, the investors are liable to “purify” the dividend they receive by excluding the element of impermissible income from the dividend earned.

#### **15. How is dividend purification performed on a Shariah-compliant share?**

The dividend purification process involves calculating the proportion of dividend that is derived from impermissible income and giving it in charity to approved charitable institutions. There are various ways to compute the income required to be purified, such as the one based on the following calculation:

$$\text{Income to be purified} = (\text{Non-Compliant Income} / \text{Total Revenue}) \times \text{Dividend Received}$$

Total revenue, in the above formula, is the sum of gross revenue and other income of the company. The ratio of Shariah non-compliant income to total revenue, also known as the income ratio, is provided for each Shariah-compliant company in the semi-annual notice issued by PSX announcing the re-composition of PSX-KMI All Share Index. The ‘income to be purified’ figure represents the amount required to be given as charity to complete the dividend purification process.

#### **16. What is Murabaha Share Financing?**

The Murabaha Share Financing (MSF) is a system that enables investors to finance the purchase of shares in a Shariah-compliant manner. All shares that are included in the PSX-KMI All Share Index are eligible for MSF. Murabaha refers to selling a commodity as per the purchasing price with a defined and agreed profit mark-up. This mark-up may be a percentage of the selling price or a lump sum. MSF is also based on this concept.

MSF involves two parties: the MSF Finantee, which is a securities broker or its customer (the investor), and the MSF Financier, which can be another securities broker, a banking company, or an eligible financial institution. The MSF Financier purchases shares through the UIN of MSF Finantee, and the shares are transferred to its house account. Thereafter, a Murabaha agreement is executed between MSF Financier and MSF Finantee, and the said shares are transferred to MSF Finantee’s CDC-blocked sub-account on a deferred payment basis.

## **V. Sukuk**

#### **17. What are sukuk?**

Sukuk are defined as certificates of equal value representing undivided shares in ownership of tangible assets, usufruct, or services. Sukuk are a Shariah-compliant alternative to

conventional bonds. There are various types of sukuk, each having its own structure, inherent risks, and form of return. Sukuk may be issued through a financial intermediary that acts as an agent of the issuer to facilitate in administrative matters.

#### **18. How are Sukuk different from conventional bonds?**

Unlike a conventional bond, which represents a contractual obligation in the form of debt, sukuk represent proportionate ownership in an underlying asset. An issuer of a bond is obligated to make periodic interest payments to the bondholders. In contrast, sukuk holders are typically entitled to revenue generated by the underlying asset. Moreover, bonds are priced based on the creditworthiness of the issuer and the interest rate implicit in the transaction whereas the fair value of sukuk is based largely on the market value of the underlying asset.

#### **19. How can participants invest in sukuk on PSX?**

Investors can subscribe to newly listed sukuk on PSX similar to the manner in which the initial public offerings of equity stocks are subscribed to. However, the ownership of sukuk, and their trading in particular, is typically subject to additional Shariah rulings depending on the structure of the sukuk. For instance, Salam and Murabaha Sukuk are generally not tradable, whereas Wakalah, Mudaraba, and Musharaka Sukuk may be traded subject to the tradability requirements defined by the issuer.

## **VI. Islamic Exchange Traded Funds**

#### **20. What is an Exchange Traded Fund?**

An Exchange Traded Fund (ETF) is a collective investment scheme offered by Asset Management Companies (AMCs). It consists of a basket of securities which tracks the returns of a certain index, and the investors are entitled to “units” of an ETF which is collectively owned by them. ETFs trade like any other stock with real time pricing during trading hours. ETFs offer investors the advantage of providing access to a diversified portfolio of securities, and being less expensive than investing in multiple individual securities. Depending on the policy of the ETF as described in the Offering Document, the unitholders may also be entitled to dividends from the securities included in the ETF basket after the deduction of management fee by AMCs.<sup>3</sup>

#### **21. How can an investment in Islamic ETFs be made?**

An ETF may be Shariah compliant or Shariah non-compliant depending on the constituents included in the fund. PSX maintains a list of Islamic ETFs on its website for the benefit of investors. The Offering Document of an Islamic ETF also reveals that it complies with the requirements of Shariah and has duly been approved by the Shariah Advisor. The Offering Document further discloses other important information such as the fund’s index, objectives,

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<sup>3</sup> To learn more about ETFs, please refer to the FAQs published on PSX website by following this link: <https://www.psx.com.pk/psx/product-and-services/products/exchange-traded-funds-etfs>.



fund manager's background, management fees, and the risks of investing in the fund. A new investor on PSX needs to open a trading account with a brokerage firm in order to become eligible to invest in ETFs while an existing investor can simply buy and sell ETF units through their existing brokerage account.

## VII. Islamic Real Estate Investment Trusts

### **22. What is a Real Estate Investment Trust?**

Real Estate Investment Trusts (REITs) are investment schemes that own, and most often actively manage, income-producing real estate. Through such schemes, investors may own, operate or finance income-generating property across various real estate categories, such as commercial plazas, residential buildings, industrial complexes, and so on. A REIT invests in physical real estate and distributes profits from rental income and/or capital gains to its unit holders. A REIT investor owns real estate backed units that sell like any other units or listed security, enabling the holder of the units to invest directly in real estate.

A REIT can be engaged in buying, developing, operating, or selling real estate assets. A Developmental REIT is formed to develop real estate through construction or refurbishment and to earn a return through its subsequent sale while a Rental REIT purchases property for the purpose of leasing it out and earning rental income. A Hybrid REIT combines the investment strategies of Developmental and Rental REITs. For any type of REIT, the investors can also earn returns if the value of the property owned by the REIT Scheme appreciates. REITs may be listed on stock exchanges to facilitate trading of their units.

### **23. When is a REIT considered Shariah compliant?**

In order to be considered Shariah compliant, the usage of the property owned by the REIT and the underlying lease agreement, where applicable, must be in accordance with Shariah principles and approved by the Shariah Advisor. Furthermore, any financing arrangements by the REIT Scheme must also comply with Shariah principles. Under an Islamic REIT, the fund management is carried out on the basis of a Mudaraba or Wakalah agreement. In case of Mudaraba, the issuer is entitled to a pre-defined percentage of the profit accruing to the fund over a specific period. Under Wakalah, a fixed management fee is paid to the issuer who makes the investment in the capacity of an agent of the investors. The website of PSX contains a list of Islamic REITs whose units are available for trading on PSX. Further, the Offering Document of an Islamic REIT reveals that it complies with the requirements of Shariah.

## VIII. Miscellaneous

### **24. Is Zakat payable on the shares owned by an investor?**

The ownership of shares in a company literally means to be the owner of the assets of that company to the extent of the proportion of shares owned. Further, the assets of a company include those on which Zakat is payable (such as tradable stocks and cash) as well as those on which Zakat is not payable (such as land and buildings). It, therefore, follows that if an investor buys shares in a company to earn dividend only, the investor is only required to pay Zakat on

the percentage of the value of the shares owned that represents the company's assets on which Zakat is due. In this instance, the investor is not required to pay Zakat on the full value of the shares owned.

For example, if a person owns shares in a company worth Rs 100 and the balance sheet of the company shows that Zakat is payable on only 60% of the company's assets, then the shareholder is required to pay Zakat on Rs 60 and not on the entire amount of Rs 100. However, as a precaution, it is preferred that the investor pays Zakat on the full market value of the shares owned. If the investor buys shares in a company with the intention of reselling them, then Zakat is payable on the full market value i.e. Rs 100.

**25. What are some of the products and practices that investors adhering to Shariah principles must not utilize?**

It is not permissible to invest in, or utilize, the following products and practices as per Shariah:

- Conventional derivative products, including futures and options
- Margin financing
- Short selling
- Day trading
- Dealing in preferred stock
- Trading subscription rights of listed securities
- Units of Shariah non-compliant REIT schemes