

# Legal implications of structuring and offering *Shari'a*-compliant investment products

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## Introduction

While further integration of Islamic financial institutions into the international banking community is required, significant progress has been made in recent years in structuring and marketing *Shari'a*-compliant investment products within the existing frameworks of various legal systems.

The body of this chapter addresses the structuring and marketing of *Shari'a*-compliant investment funds and includes an elementary discussion of certain of the *Shari'a*-compliant legal structures under which a number of investment products have been, and continue to be, offered. It also discusses the need for a multidimensional structuring effort on the part of bankers, *Shari'a* consultants and lawyers in order to achieve the substantive objectives relevant to the underlying investments in a *Shari'a*-compliant investment structure.

This chapter also highlights the recent growth in the Islamic banking industry, which has resulted in greater exposure to a variety of legal systems and compliance requirements. The accreditation of *Shari'a*-compliant investment products and Islamic financial institutions constitutes a major challenge in many of these jurisdictions, particularly in the United States and the European Union (EU).

## Structuring *Shari'a*-compliant investment funds

In recent years, the Islamic banking industry has launched a series of *Shari'a*-compliant investment funds, ranging from relatively straightforward long-only equity funds to the more challenging private equity, venture capital and short-selling funds. The incorporation of *Shari'a*-compatible investment schemes under funds of funds, and the tying of such schemes to *takaful* (Islamic insurance) products, have also gathered pace. The general intention has been to mirror structures familiar to Western bankers and investors. This is true with respect to both the form the investment product takes and the underlying substantive investment objectives sought to be achieved for the investor.

Deciding on an appropriate *Shari'a*-compliant investment structure requires an analysis of issues of both form and substance. The bankers and their legal advisers must consider aspects such as the

structure of the fund, the investment objectives of the underlying products, regulatory compliance issues and marketability.

The significance of form under *Shari'a* requires that certain timing and mechanical requirements be adhered to in order for an investment or finance structure to be declared *Shari'a*-compliant. It is imperative, for example, for an Islamic *ijarah* (lease) fund to enter into, and in many respects, fully perform its obligations under the purchase agreement with respect to an asset before it can enter into the lease agreement with respect to that asset. In an *ijarah* fund, specific rights and obligations must be adhered to by the lessor and the lessee because some benefits of the leased asset belong naturally to the lessee while others belong to the lessor under Islamic law. For example, Islamic law does not permit a binding future sale or option to be incorporated into the lease contract. Such a sale would have to be concluded at the end of the lease by way of a stand-alone legal document even if the intention of the parties from the outset is for such future sale or option to constitute an integral part of their arrangement.

In any discussion of Islamic law, it is essential to emphasise that Islamic law is the arbiter of not only legality but also virtue and vice. In analysing Islamic rulings, whether issued by jurists, judges or *Shari'a* advisers, it is sometimes difficult to separate what constitutes a legal obligation from what is ethical in nature. The legal implication of the foregoing is that establishing structures that have no purpose other than to circumvent the requirements of *Shari'a* is arguably not permissible. Therefore, great care must be taken in structuring investment vehicles to ensure that they operate in compliance with *Shari'a* precepts.

## Role of financial institutions and fund promoters

The analysis of the legal implications of *Shari'a*-compliant investment products should start with the identification of financial institutions that are permitted, in the first instance, to offer Islamic investment products.

From a *Shari'a* point of view, it is well established that almost any financial institution is permitted to offer Islamic investment products, unless that financial institution is prohibited for regulatory reasons from doing so. A non-Islamic bank or a non-Muslim can engage in trading or investing in a *Shari'a*-compliant manner. A conventional financial institution in London or New York can, therefore, develop financial products that cater to the needs of its Muslim customers. In many instances, this does not require the formation of an independent subsidiary. Typically, a separate department within an institution can develop and offer *Shari'a*-compliant products. Some jurisdictions, however, may require that Islamic banking licences be independent from conventional licences, with the obvious result that the banking industry in such a jurisdiction provides for two parallel systems, namely Islamic and conventional.

In structuring Islamic investment products, promoters and issuers must satisfy the demands of individual and institutional investors in the jurisdiction where they intend to offer such products. It follows that promoters of Islamic funds and issuers of Islamic instruments, including conventional



banking institutions, should develop both a generalised understanding of Islamic law and a working knowledge of the regulatory system in force in the jurisdiction where the investment vehicle will be structured. In addition, a knowledge of the regulatory system of the jurisdiction in which the product is to be offered, if different, is also required. The financial advisers should work with the legal and *Shari'a* advisers to fine-tune their product ideas and vehicle structures in order to ensure full legal and *Shari'a* compliance.

## Role of legal and *Shari'a* advisers

The decision by a financial institution to structure an Islamic product requires the early engagement of legal counsel and *Shari'a* advisers.

Despite the recent growth in Islamic banking, there are few legal advisers in major financial centres who have developed the know-how and experience that would permit them to actively participate in the process of structuring and documenting 'quality' cross-border Islamic financial products. To be effective, such legal advisers require both a thorough understanding of *Shari'a* and familiarity with Western financial market practices.

The decision to domicile an investment vehicle in a particular jurisdiction will necessarily require legal advice with respect to the regulatory and tax regimes in such jurisdiction based on the proposed Islamic structure. For example, an Islamic structure that involves multiple asset transfers is likely to prove to be expensive in a jurisdiction that imposes taxation on each asset transfer. By the same token, legal advisers must possess a good understanding of Islamic law to be able to advise on methods by which legal issues can be addressed in compliance with the requirements of *Shari'a*, and in so doing must be able to communicate in a positive and constructive manner with *Shari'a* advisers.

Such specialised legal advice is also necessary in view of a number of recent troublesome rulings issued by English courts and by judicial bodies in various Gulf Cooperation Council (GCC) jurisdictions, adding another layer of analysis that practitioners and fund promoters must not neglect. For example, in a recent ruling by the English High Court on a case related to a *murabaha* transaction, the court decided that despite a choice of law provision in the relevant *murabaha* agreement, which provided that the governing law of the contract should be English law 'subject to the principles of glorious *Shari'a*', English law would take precedence.

Non-Islamic financial institutions often rely on recommendations made by their legal counsels or experienced counterparties in selecting *Shari'a* advisers on a product-by-product basis. Islamic financial institutions, however, have their own *Shari'a* supervisory boards that advise on and provide *Shari'a* auditing with respect to all investment products offered by such institutions. Most jurisdictions require that financial institutions licensed to provide Islamic banking have their own *Shari'a* supervisory boards.

*Shari'a* advisers represent differing schools of Islamic jurisprudence, although many of them are knowledgeable in the teachings of the key schools. Care should be exercised in selecting a *Shari'a* adviser, as only a small number of them combine an in-depth knowledge of Islamic law with a good understanding of and familiarity with conventional financial and economic concepts. Another factor to be taken into account in selecting a *Shari'a* adviser is the ability to communicate in English.

The mandate given by promoters of Islamic investment instruments to *Shari'a* advisers includes assisting in the development of a suitable structure for the proposed investment product, reviewing documentation, issuing a *Shari'a* compliance certificate and providing ongoing supervision – also known as a *Shari'a* audit – to ensure that the implementation of such structure is *Shari'a*-compliant.

## Choosing a jurisdiction

Whether a financial institution is structuring a conventional or Islamic investment fund, the local legal environment must be capable of accommodating the proposed structure as well as offering a favourable tax treatment. Some jurisdictions have proved to be extremely flexible in adapting to both conventional and Islamic structures, particularly Bahrain and Malaysia. In addition, the Channel Islands and the Cayman Islands continue to attract a growing number of Islamic funds and instruments.

A primary reason for the trend towards setting up Islamic funds in tax-friendly common law jurisdictions stems from their advanced trust systems, which offer protection for the investors' beneficiary ownership over the assets of the fund. This is important in the context of an issue of Islamic bonds (*sukuk*), for example, where a special-purpose vehicle is created to purchase certain assets, and issues *sukuk* that are backed up by such assets.

Additionally, jurisdictions vary on their know-your-customer and other compliance requirements. A number of offshore jurisdictions have enacted and implemented the strictest compliance policies, such as Luxembourg and Dublin. As discussed in the 'Legal frameworks for the offering of Islamic funds' section later in this chapter, the marketability of, for example, a Luxembourg-based *Shari'a*-compliant investment fund in EU member states would require that the investment fund comply with EU regulations. Compliance issues are therefore crucial when fund promoters wish to give Muslims in EU member states access to *Shari'a*-compliant investment vehicles. If Islamic fund promoters and investors wish to continue to expand the availability of *Shari'a*-compliant investment products in these markets, the relevant compliance issues will need to be addressed.

From a technical point of view, Islamic funds are subject to the same requirements as conventional funds in these markets. Some Islamic fund promoters, particularly those with head offices in GCC states, argue that the level of disclosure to which such institutions are made subject exceeds that which applies to conventional institutions licensed in non-Arab or non-Muslim jurisdictions. Islamic financial institutions are facing new challenges as a result of the enactment and implementation on a worldwide basis of rigorous know-your-customer and other compliance policies.



In recent years, promoters of investment funds and products have turned their attention to jurisdictions such as Bahrain and Malaysia, which offer regulations applying to the set-up of collective investment schemes, both conventional and Islamic, tax-friendly environments and increasingly strict compliance policies. Other jurisdictions are in the process of enacting regulations that apply to the set-up of collective investment schemes and other investment structures. For example, Saudi Arabia, which recently enacted strict compliance regulations and a Capital Markets Law, is also in the process of enacting the Investment Business Regulations (IBR), which will govern the set-up and offering in Saudi Arabia of securities, including investment funds.

In many instances, *Shari'a* itself provides alternatives to non-regulated mechanisms. For example, in the context of a private equity or venture capital fund, fund promoters often face the dilemma of 'sweat capital' not being recognised under the regulations for commercial companies in Saudi Arabia, but often resort to *Shari'a*, being the basic law of Saudi Arabia, which provides the *mudaraba* alternative. By the same token, *Shari'a* investment techniques such as commodity trading *murabahas* may prove problematic in Saudi Arabia where financial institutions must act in compliance with the Banking Control Law which prohibits banks from engaging in trading activities.

Additionally, lawyers and bankers alike should establish investors' acceptability criteria through the method of defining terms such as 'sophisticated', 'professional', 'high net worth' and 'institutional' investors. For instance, the term 'professional investors' is defined in a Bahrain Monetary Agency (BMA) circular governing collective investment schemes, but this is not the case in other regional jurisdictions.

Notwithstanding the foregoing, and both as a matter of *Shari'a* requirements and legal prudence, risk factors and investment guidelines should be clearly and sufficiently described in the offering memorandum of the fund. Risk factors often include investment, liquidity of shares, forfeiture, country-specific factors, corporate disclosure standards, political climate, currency, foreign investment considerations and, in the context of *Shari'a*-compliant investment funds, *Shari'a* compliance risks. The latter risks relate to cases when the returns of an investment fund are adversely affected by the immediate liquidation of a position taken by the relevant investment fund when such position no longer complies with *Shari'a*.

In summary, the structuring of a *Shari'a*-compliant investment fund requires that concerns pertaining to both substance and form be addressed. That process involves much more than the mere cloaking of a conventional fund with a *Shari'a* compliance stamp. Additionally, *Shari'a*-compliant investment funds are subject to the same, or arguably a higher, degree of compliance, risk and suitability analysis and scrutiny than conventional investment funds given the emphasis of *Shari'a* on full and accurate disclosure.

## Examples of *Shari'a*-compliant investment structures

Many financial industry professionals are today involved in the development of *Shari'a*-compliant alternatives to most of the conventional investment vehicles and products available in Western markets.

Working together with experienced legal counsel and established *Shari'a* advisers, they have created *Shari'a* equivalents to a number of investment vehicles, including the Islamic investment funds described below. Simply put, an Islamic investment fund is one in which investors pool money to be invested in *Shari'a*-compliant investments in order to earn legitimate profit (*halal*).

## Long-only equity funds

In an Islamic long-only equity fund, amounts raised from investors are invested in shares of listed companies, provided that such companies have been declared to be *Shari'a*-compliant. The companies in whose shares investment is permitted may be identified as *Shari'a*-compliant by reference to their inclusion in Islamic indexes such as the Dow Jones Islamic Market Index or the TII-FTSE Islamic Index. The companies included in such indexes will have been declared *Shari'a*-compliant by the indexes' respective *Shari'a* advisers. Otherwise, the compliance of a company with *Shari'a*, and thus the permissibility of its shares as an investment for the fund, will be verified by the respective fund's *Shari'a* supervisory board. In either case, regular *Shari'a* auditing is usually conducted by specialised *Shari'a* advisers to ensure the fund's continued compliance with the requirements of *Shari'a*.

The investment manager to an Islamic long-only equity fund can act as a *mudarib* (sweat partner) under a *mudaraba* arrangement, a *wakil* (agent) under a *wakala* arrangement or an investment manager pursuant to an investment management agreement. The investment managers, *wakils* or *mudaribs*, as the case may be, usually adhere to pre-defined investment guidelines that set out the industries in which the fund may invest and the financial ratios it must maintain. The ongoing *Shari'a* compliance of the fund should be subject to a regular (annual or semi-annual) audit by the *Shari'a* supervisory board, although external accounting firms also can be appointed to audit the fund's compliance with its investment guidelines.

## Capital-protected funds

*Shari'a* prohibits the generation of income by way of interest. This is primarily due to the fact that *Shari'a* requires that any return on funds invested by an investor, or lent by a lender, be the outcome of a commercial transaction in which the investor or the lender risks its capital. Thus, capital-guaranteed funds and investments are not *Shari'a*-compliant. The alternative is a fund or an instrument that offers capital protection without guaranteeing the capital.

Most *Shari'a*-compliant capital-protected funds use two investment mechanisms to achieve the required investment objective: (1) a *murabaha* instrument, which involves the investment of the bulk of the monies raised from investors in a fixed-term commodity trade transaction or a series of such transactions; and (2) a *bai' al-urboun* (a *Shari'a* alternative to call options) transaction based on which the fund invests a small percentage (for example 10 per cent) of the monies raised from investors to purchase an option over a basket or portfolio of *Shari'a*-compliant shares or commodities. *Murabaha*

transactions, which are customarily viewed as low investment risk transactions, are structured to generate the required capital protection, while *bai' al-urboun* transactions are intended to increase returns. If the basket of shares subject to the *bai' al-urboun* depreciates, the fund manager will not exercise the option and the payment price for the option will have been lost. *Murabaha* transactions, however, are structured to compensate for the lost option payment, hence protecting, but not guaranteeing, the capital.

## Venture capital funds

With *Shari'a* encouraging risk-taking and prohibiting interest, unleveraged venture capital funds are ideal tools for making investments in an Islamically compliant manner. A sponsor of the venture capital fund can act as a *mudarib* under a *mudaraba* arrangement, a *wakil* under a *wakala* (agency) arrangement or an investment manager pursuant to an investment management agreement.

A number of conventional venture capital funds have passed *Shari'a* compliance tests with only minor adjustments being made to the offering document and ancillary agreements. In each case, a *Shari'a* supervisory board was appointed and detailed *Shari'a* compliance criteria were introduced and implemented.

## Private equity funds

The discussion becomes more complex in the context of private equity funds, particularly those that utilise leverage to purchase a controlling stake in a target company or that invest in leveraged target companies.

An Islamic private equity fund must finance the acquisition of a target company by using *Shari'a*-approved mechanisms. In addition, the leverage of the target itself is often relevant. Different schools of Islamic jurisprudence have different views on the subject. Some *Shari'a* advisers are of the opinion that if an Islamic private equity fund were to purchase a controlling stake in a leveraged company, then such a fund would be given a fixed period of time (perhaps three years) to pay off the target company's debt or convert it into Islamically acceptable debt. Another view prohibits the acquisition of target companies if their debt exceeds one-third of the total capital of the target company. In such cases, debt should be reduced to one-third of the total capital of the target company prior to the acquisition being approved. In each case, the activities of the target company should be *Shari'a* approved. Therefore, investing in companies that are involved in industries such as gambling, conventional banking and insurance, arms manufacturing and alcohol is strictly prohibited. In addition, issues such as the nature of the debt (Islamic or non-Islamic) and the manner in which the total capital of the target company is calculated can be challenging.

## Ijarah funds

*Ijarah* funds are often described as lease finance vehicles, but there are some substantive differences between a lease in the conventional sense and an *ijarah*. In an Islamic *ijarah* fund, the fund purchases

the assets (normally equipment, real estate and, in some instance, fixtures such as power generators) and on-leases them to the lessee. The agreed rent paid by the lessee to the fund, as lessor, is calculated such that an agreed profit element is built into the rent payment. An *ijarah* differs from a conventional lease in that Islamic law does not permit that a binding future sale or option be incorporated into the lease contract for the disposal of the residual value of the leased assets at the end of the lease term. Additionally, developing a floating-rate lease under Islamic law is more problematic than a conventional lease. This is mainly due to the fact that *Shari'a* requires that a single rent must apply throughout the life of the lease.

The *Shari'a* equivalent of lease-to-own transactions are *ijarah wa iqtina* arrangements, in which lease payments are payable to a special account and are then used to make the final payment for the leased asset, hence transferring ownership over such leased asset to the lessee on the expiration of the lease term and satisfaction of the terms of the lease agreement.

## Legal frameworks for the offering of Islamic funds

This section discusses certain of the legal issues associated with the marketing of Islamic investment products in a number of jurisdictions, comprising Bahrain, Saudi Arabia, the EU and the United States.

### Bahrain

The Kingdom of Bahrain has been, and continues to be, an active participant in developing the Islamic banking industry. Bahrain attracts fund promoters who are encouraged by its open economy, its laws and regulations, which are favourable to foreign investors, and its efficient regulatory body in the form of the Bahrain Monetary Agency (BMA), which controls all financial activities within Bahrain. Regulations and circulars are issued by the BMA from time to time in respect of financial services rendered in Bahrain, some of which are mandatory in character while others are issued merely as guidelines. BMA circular No. OF/121/99 states as follows:

The BMA will consider applications for authorisation and approval to establish schemes in Bahrain, and/or to market schemes in/from Bahrain from banks and other financial institutions or other institutions which are not operating in/from Bahrain (and, therefore, not licensed by the [BMA]), but which are institutions of high standing and good reputation. Such institutions must appoint a local representative who will be either a licensed financial institution, or a law or accountancy firm.

The BMA, in its drive to attract reputable foreign (including Islamic) fund promoters, implements a robust interpretation of the above regulations. For example, a prospectus must be provided to potential investors in connection with the offering in Bahrain of collective investment schemes. There are no BMA circulars with respect to subjects that should be covered in a prospectus. The BMA is, however,



developing a draft circular that will address such documentary requirements. For the time being, the BMA requests that offering memoranda include those subject areas that are customary in comparable offering memoranda approved by regulators in other reputable financial centres. Such areas include, among others, notices to investors, investment guidelines, investment restrictions, fees, management, investment risks, conflicts of interest, know-your-customer and other compliance procedures, and subscription details. The above applies both with respect to investment funds established in Bahrain, and to those established abroad and marketed in Bahrain, often to regional financial institutions that invest in such instruments as part of their proprietary investment or that on-sell them to investors.

While the BMA has issued a separate set of circulars that apply to Islamic banks, it continues to treat Islamic investment funds as being subject to the same requirements as conventional or non-Islamic investment funds, particularly in respect of compliance, investment guidelines, investors' notices, risk factors and net asset value calculations. Thus, the offering document of an Islamic fund must state the investment criteria that the fund will implement, as well as the *Shari'a* compliance and supervision implemented by the funds' promoters.

## Saudi Arabia

The Saudi Arabian Monetary Agency (SAMA), Saudi Arabia's central bank, has circulated draft Investment Business Regulations (IBR) purporting to apply to local and international brokerage and advisory services, distribution activities, offering of investment funds, offering of custodial services, and advertising in relation to the offering of investments and securities. Bankers in Saudi Arabia have advised that, despite the absence of a formal issuance of the IBR, affected persons should comply with its terms.

As a general rule, financial institutions wishing to undertake the marketing of securities in Saudi Arabia require SAMA authorisation. Although there are exemptions, none appear to be relevant to the offering of securities by a foreign financial institution. Based upon the IBR, a foreign financial institution is required to associate with a Saudi Arabian bank, and the placement must be made through a local licensed bank and must not contravene the provisions of the IBR. Offers to sell, and formal subscriptions to purchase, a foreign-issued security and any subsequent acceptances can only be legally made in Saudi Arabia through licensed institutions.

In the context of a private placement, 80 or less offerees resident in Saudi Arabia may be approached. Those investors approached must be sophisticated in terms of wealth and ability to bear risks, and should also have an appropriate level of understanding in assessing investments. In addition to the general exemption (grantable by SAMA) under Section 1-13(1) of the IBR, the Regulations provide for the relaxation of certain restrictions for private placements.

The Saudi Arabian legal system is based on the precepts of *Shari'a* and, as such, there is no formal distinction between Islamic and non-Islamic banking activities even in the context of investment funds.

However, SAMA does require the offering document of an Islamic fund to provide detailed *Shari'a* investment guidelines.

## European Union

The EU allows promoters of Islamic funds the opportunity to access a growing and relatively wealthy European Muslim community. A promoter of an Islamic fund planning to market its fund in one or more of the EU member states must first obtain a certificate (also commonly referred to as a 'European Passport') in compliance with Council Directive of 20 December 1985 on the Coordination of Laws, Regulations and Administrative Provisions relating to Undertakings for Collective Investment in Transferable Securities (the UCITS Directive). Member states must apply the UCITS Directive to undertakings for collective investment in transferable securities (UCITS) within their territories. Accordingly, no unit trust can carry on activities as such unless it has been authorised by the competent authorities of the member state in which it is situated. Such authorisation would then be valid for all member states. Since 14 February 2004 all EU member states have been required to enforce the UCITS Directive.

A unit trust can be authorised only if the competent authorities have approved the management company, the fund rules and choice of depository. The UCITS Directive provides for detailed conditions that apply to taking up business, relations with third parties and operations. The same applies to the choice of a depository in connection with a UCITS.

With respect to obligations concerning the investment policies of UCITS, the investments of a unit trust must consist solely of transferable securities and money market instruments admitted to, or traded on, a regulated market of a member state. Additionally, a unit trust can invest in transferable securities and money market instruments admitted to official listing on a stock exchange in a non-member state, or traded on another regulated market in a non-member state that operates regularly and is recognised and open to the public, provided that the choice of stock exchange or market has been approved by the competent authorities, or is provided for in law or in the fund rules, or in the investment company's instruments of incorporation. The UCITS Directive provides additional conditions that must be met in connection with a fund's investment policies. As such, it does not appear that the enforcement of such provisions would necessarily result in ruling out *Shari'a*-compliant securities, as the bulk of the investment criteria set out in the UCITS Directive pertain to market admissibility and allocation of investments.

Article 1(6) of the UCITS Directive provides that a member state may apply to a unit trust situated within its territory requirements that are stricter than, or additional to, those laid down in the UCITS Directive, provided they are of general application.

Promoters of Islamic funds may additionally pursue two alternatives that would permit them access, though limited, to the EU markets; namely, internal funds and Islamic certificates. Internal funds arise in the context of a European insurance company promoting *takaful* (the Islamic equivalent of insurance)



products. That company can offer Islamic investors the option to invest in *Shari'a*-compliant investment plans – even if such plans are not registered in the EU – by developing investment schemes in the form of internal funds of the *takaful* company. In such cases, the investment fund can be embedded in the respective *takaful* products offered by the *takaful* company.

The other alternative involves the issuance of Islamic equity certificates, which can be listed on a major European stock exchange and which mirror the performance of an underlying portfolio, thereby allowing the Islamic investor to participate in the gains or losses of the relevant portfolio. The first of these were 'Islamic equity builder certificates', which were developed and promoted jointly between The National Commercial Bank and Deutsche Bank, and listed on the Frankfurt Stock Exchange.

## United States

Generally speaking, entities undertaking investment banking activities in the United States are required to comply with the requirements of the US Investment Company Act of 1940, as amended. That Act governs the registration and activities of investment companies. To avoid the application of the Investment Company Act, entities undertaking investment banking activities in the United States should monitor their activities to ensure that either the Act does not apply or that specific exemptions are available.

Separately, the offer and sale of units of an investment fund, or other securities, in the United States must be registered under the US Securities Act of 1933. To avoid this requirement, transactions can be structured to take advantage of the safe harbours from registration provided by Rule 144A and Regulation S.

Rule 144A affords safe harbour treatment for reoffers or resales to qualified institutional buyers (QIBs) of securities of domestic and foreign issuers that are not listed on the US securities exchange or quoted on a US automated inter-dealer quotation system. In general, a QIB is any entity included within one of the categories of 'accredited investor' defined in Rule 501 of Regulation D of the Securities Act, acting for its own account or the accounts of other QIBs, that in the aggregate owns and invests on a discretionary basis at least US\$100 million in securities of issuers not affiliated with the entity (US\$10 million for a broker-dealer). There are four conditions to relying on Rule 144A, which are outside the scope of this article. One of those conditions requires that the reseller take reasonable steps to ensure that the buyer is aware that the reseller may rely on Rule 144A in connection with the resale. This is typically done by way of a legend on the security, a statement in the private placement memorandum or other offering document, and a restricted Committee on Uniform Securities Identification Procedures (CUSIP) number.

Two general conditions apply to the safe harbours provided by Regulation S: first, the offer and sale must be an 'offshore transaction', which generally means the buyer is not someone in (or a resident of) the United States; and secondly there are to be no 'directed selling efforts', which generally means that

there should be no conditioning the market for the securities in the United States. In connection with the prohibition on 'directed selling efforts', promoters of investment funds and products must refrain from publishing information or statements, or conducting publicity efforts that refer to the offering of units (a) in publications with a general circulation in the United States; (b) in the speeches, seminars or presentations (live or taped) to groups of investors inside the United States or specifically targeted to US citizens residing abroad; (c) in advertisements on radio or television stations broadcasting into the United States; or (d) in brochures or other printed materials mailed to investors inside the United States or specifically targeted to US citizens resident abroad.

In the offering circulars of Islamic and conventional investment funds and products, where the promoters wish to avoid the requirements of the US securities laws, detailed declarations and notices are incorporated into the offering documents and subscription agreements to ensure that investors represent and warrant that they are not US Persons, and that they are not subject to the US Securities Act in any manner.

US securities laws do not distinguish between conventional and Islamic products. The focus of Islamic institutions to date, as well as institutions active in the development, offering and marketing of Islamic products, has been non-US investors, despite the growing demands of the Muslim community in the United States. The hurdles posed by the US Securities Act, as well as the compliance criteria promulgated in the Patriot Act of 2001, should not prevent the development of suitable *Shari'a*-compliant investment products to be offered to Muslims in the United States. To that end, regulatory bodies in the United States have been supportive of the development of an Islamic financial industry, and, most recently, the US Congress has hosted round-table discussions on various modes of Islamic financing, such as asset leasing.

## Conclusion

The integration of the Islamic banking industry, including *Shari'a*-compliant investment funds and products, into the global banking community will inevitably result in greater exposure to legal systems and compliance requirements at various levels of development and complexity. Some of the world's most sophisticated commercial legal jurisdictions are increasingly addressing the needs of *Shari'a*-compliant investment funds in order to attract the significant, and growing, investment pool available to those funds.

Regulatory agencies in the United States are becoming increasingly familiar with *Shari'a*-compliant investment structures. Reportedly, state tax authorities and banking regulators issued rulings that secure tax benefits important to certain Islamic finance and investment structures, and others have declared that certain Islamic structures are permissible under state banking laws.

Moreover, in a seminar on Islamic banking held in London in September 2002, Howard Davies, chairman of the Financial Services Authority (FSA), emphasised the importance with which the FSA views



Islamic banking and offered to work closely with the industry to ensure that the United Kingdom attracts financial institutions that specialise in Islamic banking, and which cater for the needs of the Muslim community in the United Kingdom. Mr. Davies concluded with the following policy statement:

[The FSA] see[s] no objection of principle to the establishment of an Islamic bank in the UK. Indeed, [the FSA] would welcome a soundly financed and prudently managed Islamic financial institution in [the United Kingdom], which would be good for Muslim consumers, good for innovation and diversity in our markets, and good for London as an international financial centre. But [the FSA has] to treat applications from Islamic institutions in the way it does those from other, conventional firms, to ensure that they can compete effectively, and in the long term, on a level playing field with conventional finance providers.

It is important for the Islamic banking industry to keep working with regulators in the United States and Europe to make *Shari'a*-compliant products more available in the West, but much of the demand for these products will continue to come from the Muslim world. The Islamic banking industry can evolve into being more sophisticated and modern only if promoters of *Shari'a*-compliant investment products and their professional advisers work together to meet the regulatory, legal and judicial challenges resulting from operating in jurisdictions which implement differing legal systems and compliance policies. A number of initiatives, such as those included in the Dubai International Financial Centre and the Bahrain Financial Harbour efforts, are specifically intended to address these challenges. To meet the worldwide demand for advanced and sophisticated Islamic products, the industry and its advisers will need to continue to work closely with many different regulators to create legal structures within which to operate in a secure and *Shari'a*-compliant manner.

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