CLIFFORD CHANCE

Briefing note | Spring 2013

Shari'a Compliant Investment Funds

Introduction and general overview

The recent economic crisis has thrown the spotlight on *Shari'a* compliant investment funds as an alternative form of investment management. These prohibit speculation and instead promote taking an interest in a company or asset for a medium to long term period in order to generate returns for investors. The growth of wealth within the Middle East has encouraged fund managers to consider establishing *Shari'a* compliant funds as either completely stand alone products or as part of a wider investment strategy to complement existing investments and investors.

A *Shari'a* compliant investment fund is structured and governed in accordance with *Shari'a* principles. In many respects, the characteristics of a *Shari'a* compliant investment fund will not differ from those of a conventional investment fund, such as tax or regulation.

The main difference from conventional funds is the investment process: a *Shari'a* compliant investment fund will typically have a *Shari'a* board to oversee compliance with *Shari'a* principles or the fund will be established on the basis of accepted *Shari'a* screening criteria and the fund must comply with those principles both on making the initial investment and throughout the investment period. Constraints will be placed on the fund in terms of the activities of the investee companies or the types of asset that the fund may invest into, for example: leverage (e.g. limits, financial ratios, use of swaps and derivatives, prohibition on interest and requirement to purify *haram* (forbidden) income), closing adjustments and subsequent investors, default (late payment amounts and forfeiture), carry and use of inter-company debt.

A *Shari'a* compliant investment fund may take the form of a fully *Shari'a* compliant investment vehicle, parallel *Shari'a* compliant and conventional investment vehicles, a *Shari'a* compliant feeder fund or a conventional investment vehicle with explicit investor provisions for *Shari'a* compliant investors in that fund. The form that the fund will take will be dictated by the investments which have been identified for the fund, the target investors, the fund investment policy, use of *Shari'a* screening criteria and the availability or otherwise of *Shari'a* compliant debt if leverage is required.

Shari'a compliant funds can be established to invest in a wide range of asset classes including real estate, shipping, aviation, private equity and commodities. Funds have also been established to specialise in *Shari'a* compliant mezzanine financing, Islamic index tracking and Islamic equities. *Shari'a* compliant real estate investment trusts which are in compliance with the regulations of certain jurisdictions to obtain tax incentives for investment have also been seen in the market.

Recent deals

Clifford Chance is proud to be at the forefront of the *Shari'a* compliant investment fund market. The team has won numerous awards for its achievements in the Islamic funds industry. Some of the recent *Shari'a* compliant investment fund transactions on which Clifford Chance has advised include:

- **CITIC Capital China Real Estate Investment Fund III –** advising on the addition of a *Shari'a* compliant vehicle to invest in parallel with the main fund
- **European Islamic Investment Bank –** advising on the EUR500 million ELLB Pan-European Islamic Real Estate Fund
- **i-cap Partners Limited –** advising i-cap Partners Limited on the conversion of their Ireland based fund, i-cap private equity fund PLC (an ongoing representation) to a *Shari'a* compliant fund

Key issues

- **Noor Financial Investment Co** – advising the sponsor on the establishment of a *Shari'a* compliant feeder fund for India Infrastructure Development Islamic Fund Ltd
- **Islamic Development Bank Infrastructure fund** – advising on the IDB Infrastructure Fund LP, a Bahraini LP sponsored by the Islamic Development Bank with a target size of US$1.5 billion, with an equity capability of US$1 billion and a financing facility of US$0.5 billion
- **United Development Company real estate development fund** – advising on the establishment of a *Shari'a* compliant real estate development fund and debt raising for United Development Company in Qatar, for the Qanat Quartier development on The Pearl, Qatar. The firm acted for the Sponsor in establishing the US$300 million fund, and the legal structuring for the debt raising, using a US$300 million revolving musharaka
- **NAVIS Capital** – advising NAVIS on the development of a *Shari'a* compliant Malaysia-based private equity fund which was marketed in parallel to a conventional fund. Malaysia-based *Shari'a* advisers approved a structure whereby Islamic investors invest in a separate asset class

Shari'a compliant investments

The investment policy of a *Shari'a* compliant fund must be designed to ensure that investments made by the fund do not contravene *Shari'a* principles. Certain investments are prohibited as *haram* (forbidden) products. These investments include:

- companies or assets involved in:
  - the production, sale, distillation or distribution of alcoholic beverages or related products;
  - gambling, casinos, lotteries and related games;
  - the production, sale, distribution or slaughter of pork and pork-related products;
- non-Islamic banks, financial institutions and insurance companies; and
- companies engaged in pornography and obscenity of any form.

A number of investments fall into a "grey area", and whilst not explicitly declared to be *haram*, are generally discouraged for *Shari'a* compliance purposes. These investments include:

- assets relating to tobacco and tobacco-related products;
- companies or assets involved in the entertainment business (film, video, theatre, cinema);
- companies using leverage provided on a non *Shari'a* compliant basis (although exceptions to this principle have been developed); and
- companies or assets involved in the production of weapons.

Forms of *Shari'a* compliant investment vehicles

Fully *Shari'a* compliant fund

In principle, a *Shari'a* compliant fund must only invest in *Shari'a* compliant assets and be financed solely through *Shari'a* compliant debt. However, where this becomes overly restrictive for the needs of the fund, the *Shari'a* committee may permit exclusion provisions to be included in the fund documentation (although these will not be widely drafted). For example, where there is a pressing need to obtain non *Shari'a* compliant financing for a project, such financing may be accepted provided that it does not exceed a pre-agreed threshold (usually around 33%) of the acquisition cost of the project.

Shari'a compliant parallel partnership

Under this structure, the *Shari'a* compliant partnership is completely distinct from the other partnerships comprising the fund and will co-invest alongside the other fund partnerships in any investment opportunities taken up by the fund, provided that these are *Shari'a* compliant. There would be no obligation on the *Shari'a* vehicle to make (and it would be prohibited from making) investments that were not *Shari'a* compliant. The advantages of this option are that it allows the main fund to benefit from a wider investment policy and the ability to invest free from *Shari'a* compliance issues.

Shari'a compliant feeder fund

A *Shari'a* compliant feeder fund will usually involve the establishment of an investment vehicle which will have solely *Shari'a* compliant investors and which will then enter into a *murabaha* agreement with the main conventional fund pursuant to which the feeder fund will generate a return comparable with that received by the conventional investors. The use of the *murabaha* removes the *Shari'a* compliant feeder fund from involvement with any *haram* activity of the conventional fund. The *Shari'a* compliant feeder fund will usually have a "wrapper" of the main conventional fund prospectus for potential investors.

Conventional investment vehicle with explicit investor provisions for Shari'a compliant investors in that fund

This approach involves exceptions for *Shari'a* investors, allowing them to opt-out of investing in a potential transaction identified by the fund manager which is not *Shari'a* compliant.

Types of *Shari'a* compliant investment funds

Islamic equity funds

An Islamic equity fund is prohibited from holding, buying or dealing in shares of companies involved in *haram* activities. Islamic equity funds tend to employ *Shari'a* screening when choosing equity investments and these screening techniques concentrate on both the business activity of the company in question as well as the company's financial ratios. Typically, at least 95% of gross revenues must be generated from *Shari'a* compliant business activity, interest-based debt must be less than 33% of the company's equity or total assets and interest income must not be more than 5% of total income. Islamic equity funds generate profits through both the capital gains of buying and selling equities and any distributions received through holding equities in portfolio companies. A characteristic of Islamic equity funds is that a portion of a distribution representing profit earned from non *Shari'a* sources must be purified i.e. must be donated to charity. A hedge fund can be replicated on a *Shari'a* compliant basis through the use of *arbun* (deposit) contracts.

Islamic index funds

Islamic index funds tend to passively track *Shari'a* compliant versions of the main indexes and sub-indexes. Investing in accordance with an index spreads risk across a range of securities and reduces the impact that fluctuations in a single security can have on the overall return of a fund.

***Shari'a* compliant exchange-traded funds**

An exchange-traded fund is an open-ended investment fund which tracks an underlying index and its shares are traded on one or multiple stock exchanges. Exchange-traded funds provide a relatively low cost, simple and tax efficient way of accessing liquidity pools for a wide range of stock markets. The majority of exchange-traded funds created are designed to track an underlying index, which allows an investor to gain exposure to a particular sector or hedge their position in a basket of securities without having to purchase the underlying assets. Investors trade units or securities in an exchange-traded fund on stock exchanges in much the same way as they trade securities in companies. With the development of *Shari'a* compliant versions of the main indexes and sub-indexes, exchange-traded fund providers are targeting Islamic markets and exchange-traded funds have been launched tracking both *Shari'a* compliant equity and *sukuk* indices.

***Shari'a* compliant private equity funds**

Shari'a compliant private equity funds operate in much the same way as conventional private equity funds; this is because the private equity model reflects one of the basic principles of Islamic finance: risk sharing. The purpose of *Shari'a* compliant private equity funds is to invest in companies and/or projects which fit within specific *Shari'a* guidelines with a view to exit at a later time for a higher price than originally paid. When exiting an investment, a *Shari'a* compliant private equity fund must determine which proportion of the profit is attributable to non *Shari'a* sources and undertake purification of that proportion of the profit.

Mezzanine financing funds

Mezzanine financing funds enter into *murahaba* transactions to fill the funding gap where companies require financing for major acquisitions. The *murabaha* financing is established to provide an equity type return for the fund and may be supplemented by a *wa'ad* (undertaking) to provide the fund with the option to convert certain of the financing into equity in the company in certain circumstances. As the financier in a *murahaba* transaction may only hold title to the asset for a brief period of time, *murahaba* funds do not hold assets. As a result mezzanine financing funds are typically close-ended funds and are not traded on a secondary market.

***Shari'a* compliant real estate funds**

Some of the largest open ended *Shari'a* compliant funds have invested into real estate in many jurisdictions including many emerging markets. One of the biggest challenges for a *Shari'a* compliant real estate fund is the use of structures which will allow for the use of conventional leverage where there is no Islamic financing available within certain markets. It is usual for a fund to utilise a birfurcated structure, subject to local tax issues, whereby an orphan company will be incorporated to enter into the conventional financing with an *ijara-wa-iqtina* (lease with right to purchase) entered into with the fund.

Further issues are encountered in jurisdictions where there are prohibitions in entering into a lease over existing leases with underlying tenants. Other considerations, such as *Shari'a* compliant insurance solutions, *i.e. takaful*, of real-estate, are also key concerns.

Islamic real estate investment trusts ("Islamic REITs")

An Islamic REIT is a collective investment scheme in real estate, in which the tenants operate permissible activities according to *Shari'a*. Considerations in respect of Islamic REITs are (i) which activities are permissible and (ii) what is the position where tenants conduct mixed *Shari'a* and non *Shari'a* compliant activities. Malaysia is the principal jurisdiction where Islamic REITs have been established. In Malaysia, guidance provides that where tenants conduct mixed activities, the fund manager must ascertain and then aggregate the total amount of non *Shari'a* compliant activity of its tenants. Where non *Shari'a* compliant rental income exceeds 20% of total turnover, this will not be considered a *Shari'a* compliant investment for an Islamic REIT. Furthermore, an Islamic REIT cannot hold an investment where all of the tenants conduct non-*Shari'a* activities, notwithstanding that the total amount of non *Shari'a* compliant activity is less than 20%.

Islamic commodity funds

Islamic commodity funds purchase commodities (other than those considered *haram*, for example pork or wine, or those considered currencies, for example gold and silver) with the purpose of resale at a later date to generate a profit return. The commodity in question must be actually or constructively owned by the fund (*i.e.* the risk of the commodity must have passed to the fund) prior to resale and short-selling of commodities is not allowed. Future contracts relating to commodities are usually entered into on the basis of *salam* and *istisna'a* contracts.

Shari'a screening

Under *Shari'a* principles, the ownership of shares in a company is considered a proportionate share of that company's business and assets with the result that Muslim investors cannot own a company that is involved in any *haram* activity. It has therefore become standard practice for investors to seek the guidance of a *Shari'a* committee, on the permissibility of an investment or business venture.

As the conventional interest-based banking system prevails, it is virtually impossible for any company to conduct its financial affairs without breaching *Shari'a* principles regarding the prohibition of interest or *riba*. As a result these companies would not qualify as *Shari'a* compliant investments and Muslim investors would be prohibited from investing in such companies.

In order to increase access to the financial markets for Muslim investors, a group of leading *Shari'a* scholars developed a series of screening criteria which aim to identify the non-*Shari'a* compliant elements of a company and provide a means of avoiding or dealing with them in a manner consistent with *Shari'a* principles. *Shari'a* compliant investors can invest in companies which fulfil these screening criteria.

There are three general conditions to the use of the screening criteria:

- Where a company fulfils the criteria, this does not constitute an endorsement of its non *Shari'a* compliant practices. Investors should still encourage the company to adhere fully to *Shari'a* principles.
- The criteria only apply to companies that are majority owned by non *Shari'a* compliant shareholders. Companies that are majority owned by Muslim investors must be fully *Shari'a* compliant.
- The criteria are not applicable to private equity investments due to the extent of shareholders' influence and involvement. The criteria are only used for investments in listed companies where shareholders do not have a direct say in the management of the company's affairs. Private equity investors must ensure that the company is fully *Shari'a* compliant.

The screening criteria are applied at the time of the investment decision and during the subsequent monitoring process by the *Shari'a* Board to ensure that the company remains *Shari'a* compliant during the investment period.

There has been significant debate as to the interpretation and application of the screening criteria which will often vary on a case-by-case basis. More recently, independent screening methodologies have been developed by the Securities Commission of Malaysia and the Accounting and Auditing Organisation of Islamic Financial Institutions ("**AAOIFI**").

Islamic indices

In conjunction with the growth of the Islamic investment funds industry, several index providers have launched *Shari'a* compliant versions of their main indexes and several sub-indexes. An Islamic equity index works by filtering companies included in the conventional index using the *Shari'a* screening criteria.

The Islamic equity indexes currently available include:

- Bursa Malaysia *Shari'a* Index;
- FTSE Global Islamic Indexes;
- Dow Jones Islamic Market Indexes;
- Standard & Poor's *Shari'a* Indexes;
- Global GCC Islamic Index; and
- MSCI Islamic Index Series.

Shari'a supervisory board

Islamic funds are required to either establish a *Shari'a* supervisory board with the purpose of overseeing the funds compliance with the principles of *Shari'a* or to make investments on the basis of recognised *Shari'a* compliant investment criteria. The members of the *Shari'a* supervisory board are required to have the necessary competence to conduct their functions and the fund manager is required to document (i) how appointments, dismissals or changes will be made to the *Shari'a* supervisory board, (ii) the process through which the suitability of a *Shari'a* supervisory board members is considered, and (iii) the remuneration of *Shari'a* supervisory board members. The fund manager and the fund also have certain obligations with respect to the *Shari'a* supervisory board, including providing them with all necessary assistance and the right of access to all documents and records. Furthermore, the fund manager and the fund must not interfere with the work of the *Shari'a* supervisory board and must not provide false or misleading information.

The scholars would typically be appointed to:

1. review the structure paper and investment criteria of the fund at the outset and give an "in principle" approval of the same, subject to review of the final documentation;
2. review the fund documentation to ensure that it complies with the principles of *Shari'a* (for example, ensuring that there are no default interest provisions, the arrangements are sufficiently certain as to their fundamental terms etc) and issue a *fatwa* confirming that the structure of the fund, the investment criteria and the associated documentation is *Shari'a* compliant; and
3. on an on-going consultancy basis, to conduct periodic audits to ensure that the investment criteria is being complied with and that the investments that are made during the life of the fund are *Shari'a* compliant.

This should be seen as part of the overall corporate governance of the Fund and given associated priority/charged as a fee to the Fund accordingly.

Additional disclosures in the prospectus

Islamic funds are also required to provide additional information with regards the *Shari'a* compliant nature of their activities in the fund prospectus. Specifically, information in the prospectus should set out the basis upon which the fund has been approved and certified as *Shari'a* compliant by its *Shari'a* supervisory board and set out the rationale for determining why each of the key features of the fund is considered *Shari'a* compliant. Where a fund has appointed a *Shari'a* supervisory board or a single *Shari'a* advisor, details of such appointments must also be included within the prospectus, including all relevant qualification and experience of each of the members. Should the fund be relying on accepted *Shari'a* screening processes, then details of the screening methodologies must be included instead.

If you would like to know more about the subjects covered in this publication or our services, please contact:

Authors

Qudeer Latif
Partner

T: +971 4 362 0675
E: qudeer.latif
@cliffordchance.com

Robin Balmer
Senior Associate

T: +971 4 362 0708
E: robin.balmer
@cliffordchance.com

Mark Shipman
Partner

T: +852 2 825 8992
E: mark.shipman
@cliffordchance.com

Matthias Feldmann
Partner

T: +852 2 825 8859
E: matthias.feldmann
@cliffordchance.com

Nigel Hatfield
Partner

T: +44 207 006 1834
E: nigel.hatfield
@cliffordchance.com

Joëlle Hauser
Partner

T: +352 48 505 0203
E: joëlle.hauser
@cliffordchance.com