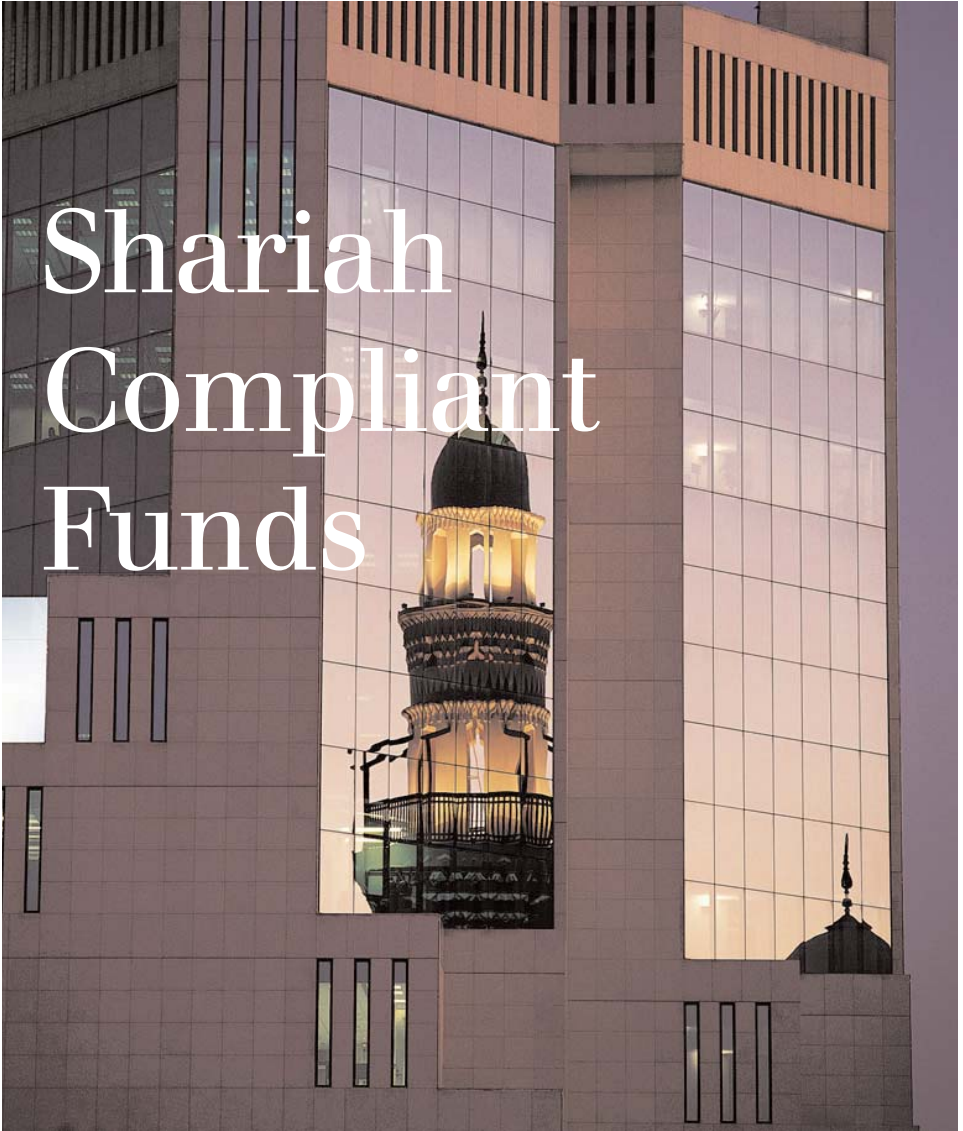


Lovells



Alicante Amsterdam Beijing Berlin Brussels Chicago Dusseldorf Frankfurt Hamburg Ho Chi Minh City Hong Kong
London Madrid Milan Moscow Munich New York Paris Prague Rome Shanghai Singapore Tokyo Warsaw
Associated offices: Budapest Vienna Zagreb

Contents

	Page
Introduction	1
Shariah compliant investment funds - a brief overview	3
Islamic finance contacts	11

Introduction

This brochure provides a brief outline of our Islamic finance practice, and provides some introductory information on Shariah compliant investment funds.

Islamic finance is a key developing international practice area for Lovells. This has led to the development of an experienced and highly specialised team of lawyers throughout our extensive network of international offices. We work on some of the most significant deals in the market.

We have been advising clients since the early days of the Islamic finance market. Our global presence means we are well placed to provide a fully integrated and efficient service irrespective of the jurisdictions involved. This enables our clients to exploit more global opportunities and the more complex Islamic financing solutions which are coming to the market.

With 27 offices in 18 countries throughout the world, Lovells delivers the breadth of experience and depth of expertise you expect from a successful, international law firm.

All our lawyers - more than 1,600 and counting - have an incisive awareness of commercial priorities, ensuring we give you practical solutions that make business sense.

Our particularly strong commitment to collaboration - both internally and with our clients - underpins our ability

to work with you in finding the ways forward that best suit your circumstances and objectives.

In addition to London, we provide full service Islamic finance advice from our offices in Frankfurt, New York, Moscow, Singapore and Tokyo. We are able to provide expertise across the Middle East and North African (MENA) region through close ties with leading regional law firms.

Shariah compliant investment funds - a brief overview

1. INTRODUCTION

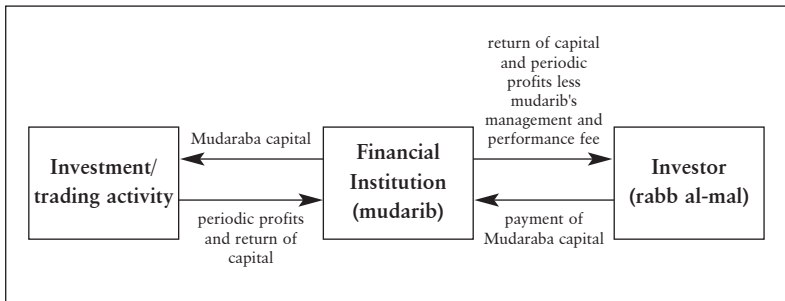
There has been a recent surge in demand for Shariah compliant investment instruments including institutional funds. According to a recent survey there is growing demand from investors domiciled in the Gulf Co-operative Council region for investment portfolios to include Shariah compliant instruments. This outlook has spurred the growth of the Shariah compliant investment funds that invest in a wide range of sectors - real estate, private equity, infrastructure (most notably power projects) and equities. Some of these funds have been admitted to trading on the more established stock exchanges, such as Dublin as well as the emerging stock exchanges of Dubai and Bahrain. It is estimated that there are currently more than 100 Shariah compliant investment funds with over US\$5billion under their management¹.

2. STRUCTURE OF A SHARIAH COMPLIANT INVESTMENT FUND

An investment fund can be structured based on the Mudaraba contract under which an investor (rabb al-mal) provides capital to another person/body (akin to a fund manager - mudarib), who uses their expertise to devise a suitable investment strategy. Any profits generated by the joint enterprise are divided between the mudarib and the rabb al-mal in accordance with a predetermined formula

¹ Source: www.falaika.com

(management and performance fees are permitted under the Mudaraba contract). If any financial losses occur, these will be borne by the investor to a maximum of his capital investment. Conversely, the mudarib's losses are limited to that of his time and efforts if the venture is not profitable. Certificates evidencing the rabb al-mal's investment, such as shares in the company constituting the investment fund, can be issued in negotiable form akin to conventional fund practices.



Many of the basic collective investment characteristics applying to conventional investment funds also apply to Shariah compliant funds, including, the technical structure of the fund, the role of the fund's service providers and the appointment of a board of directors or trustee to take overall responsibility for the fund.

The Mudaraba contract provides sufficient flexibility to structure a fund with broad investment criteria. However, there are certain overreaching principles of Shariah which need to be factored into a fund's investment strategy:

A. Riba

Shariah prohibits usury (*Riba*), which may be defined as exploitation by the owner of a product which another requires. The payment or receipt of interest is usury

and therefore investment in entities involved in lending (or borrowing) are prohibited. This will preclude investment in certain key sectors, such as conventional banking, even though the activity of banking is not, in itself, contrary to Shariah.

Debt is frowned upon in the same way as the payment or receipt of interest. As a result highly geared companies will not constitute acceptable investments. It was once thought that an absolute ban on companies relying on debt finance was a Shariah compliant investment fund's only way of ensuring compliance with this tenet of Shariah. Clearly, such a hard-line approach dramatically reduces a fund's investment pool. Shariah has evolved and such a blanket prohibition no longer applies. Modern Islamic jurisprudence accepts a debt to equity ratio of 1:3².

A fund offering a fixed or guaranteed return on capital will be prohibited. Rather a fund must link profit to actual earnings generated from the underlying assets. This should be made clear to potential investors at the outset in any marketing material.

Notwithstanding the prohibition against Riba, investment funds can be structured which may make leveraged investments in underlying assets. Such investments may be made within the confines of Shariah by utilising the diminishing Musharaka contract (see Lovells publication - Shariah, Sukuk and Securitisation, for more information).

B. Haram

It is well-known that companies involved in certain products and industries will, as a rule, constitute forbidden investments. These are, principally, alcohol

2 Source: the *Financial Times*, 4 August 2004

and the gambling industry, as well as entities engaged in illicit, immoral or dubious trade. Companies engaged in these or related activities (e.g. a restaurant where alcohol is sold and which makes up a large proportion of its revenue) may not form part of a Shariah compliant fund's investments strategy.

C. Maisir

Shariah imposes an absolute prohibition on gambling. This may extend to futures and options in certain circumstances. However, this area is currently being revisited by Shariah scholars to determine whether the traditional prohibition on futures and options is still justified.

3. SHARIAH COMPLIANT FUNDS

There are several types of Shariah compliant fund which manage to operate within the confines of Shariah. The most common forms of Shariah compliant funds and the techniques they utilise in their investment strategy are outlined below.

A. Commodity funds

A commodity fund derives income from the purchase and resale of commodities. However, it is strictly prohibited by Shariah to sell a commodity before it is actually owned. Therefore, short sales (as commonly entered into by traditional hedge funds) are not permissible. A product must be held physically, or at least constructively, before it may be sold. Therefore, forward sales are also forbidden in most cases.

Nevertheless, the following contracts may legitimately be used by a fund of this type (or indeed any Islamic investment fund) to generate profits:

- (i) *Istisna'a* is a contract of exchange that allows the deferred delivery of goods at a specified date. The contract relates to the production of made-to-order items and allows a manufacturer to fund the production process by receiving the sale price of the produce up front. A detailed specification of the item to be produced must be agreed between the buyer and seller prior to the commencement of the production process. Once production has commenced, the contract may not be unilaterally cancelled. The consideration must be paid in full on the date the contract is entered into, otherwise the contract may be classified as a future and consequently prohibited.

- (ii) *Bay al-salam* is a sale contract in which the buyer pays immediately against the deferred delivery of a specified amount of fungible (not uniquely identifiable) goods of a given quality at a given date in the future. The contract is most like a forward contract, but is different in two material respects. In a forward contract, exchange of the underlying goods and cash are deferred to the maturity date. The seller in a *bay al-salam* contract has full use of the cash from the time the *bay al-salam* contract is agreed. Hence the credit risk is on the buyer, whose exposure relates to whether the seller will fulfil its obligations - the reverse of a conventional forward contract. The other difference relates to pricing. In a forward contract prices are derived by considering, for example, what the benefits are to the buyer/seller of the assets by deferring payment and delivery rather than a contemporaneous deal in the cash market. However, the delivery price in a *bay al-salam* contract is the spot price minus a discount. The rationale being that the

buyer must be compensated for credit risk exposure as well as some performance flexibility.

B. Equity Funds

Profits in equity funds are generally derived from capital gains and dividends paid by investee companies. It is evident that on a strict interpretation of Shariah there are a limited number of companies in which Shariah compliant fund may legitimately invest. Most companies partake in interest-based debt finance and invest surplus cash in interest bearing bank accounts and other investments.

There are currently two schools of thought regarding investments made in companies which, although predominantly Shariah compliant, may incidentally breach Shariah (for example, the prohibition against Riba) from time to time as the company carries on its principal activities. The traditional school of thought was that every investor in a fund is a partner and impliedly consents to, and is responsible for, every transaction. Unless a company was engaged exclusively in halal practices, the concern was that each and every investor could be implicated by the dealings of the fund manager, whether or not the investors actually consented to these (or were even aware of them in any detail).

The more contemporary school of thought adopts the view that investors are not partners in a fund but are merely investors. Since no one investor has the power of veto, it would be wrong to ascribe responsibility to an individual for any particular transaction. This may allow some leeway to invest in entities which have merely incidental non-halal features, since investors will not be deemed under Shariah necessarily to have authorised the investment. Nevertheless, there is still a belief among Shariah scholars that investors should raise any concerns

they have as to the running of the fund generally, or over specific transactions, especially if the fund is thought to be straying away from Shariah principles. Clearly, this raises a practical issue given that most funds will be involved in many different trades on an ongoing basis and it will be impracticable for investors to be kept informed of each and every one.

It is widely believed that if a company is engaged predominantly in *halal* business, but earns interest on account, an equivalent proportion of any dividend paid to a Shariah compliant fund must be given to charity (purification), be it at the fund or the investor level. Some scholars believe the same concept of purification also applies to capital gains, to the extent that the market price of the stock incorporates any discernible element of interest.

It is also important that the company invested in owns at least some non-liquid assets, otherwise its securities will be classified as non-negotiable by Shariah. Opinion is divided as to the appropriate ratio of non-liquid assets to liquid assets. It appears safe to say, however, that a company with at least 51% of non-liquid assets will be suitable for these purposes.

C. Murabaha Funds

Murabaha is a type of 'cost-plus' financing. Typically the fund in question will acquire goods and will resell them to a third party at their cost plus a fixed profit. As such the fund will not own tangible assets but will instead consist of obligations owed to it by third parties. The costs and profit margin must be agreed in advance. However, a Murabaha fund should always be closed-ended, since the fund will not actually own any tangible assets as such, and cash/debts are not classified as negotiable instruments by Shariah.

D. Ijara Funds

An Ijara fund will usually be established for the purpose of purchasing assets (property, machinery etc) and then leasing those assets to third parties in return for rental income. Wide use of this structure is made by real estate funds. Legal ownership of the assets remains with the fund as does responsibility for the management of such assets. A management fee will normally be paid to the manager. It is important to bear in mind that with an Ijara fund, the assets that are leased out must be used in a halal manner. Furthermore, the leasing arrangement put in place between the fund and the lessees must comply with Shariah.

September 2004

Islamic finance contacts

Lovells international presence means that we can deliver experienced Islamic finance capability across our substantial network of offices. Some of our key personnel are:

LONDON

Shibeer Ahmed

Direct telephone: +44 (0)20 7296 5455

email: shibeer.ahmed@lovells.com

Mohammed Asaria

Direct telephone: +44 (0)20 7296 5408

email: mohammed.asaria@lovells.com

Tamara Box

Direct telephone: +44 (0)20 7296 2045

email: tamara.box@lovells.com

David Hudd

Direct telephone: +44 (0)20 7296 2792

email: david.hudd@lovells.com

Simon Atiyah

Direct telephone: +44 (0)20 7296 2239

email: simon.atiyah@lovells.com

FRANKFURT

Oliver Kessler

Direct telephone: +49 69 96 23 60

email: oliver.kessler@lovells.com

MOSCOW

Chris Owen

Direct telephone: +7 095 9333002

email: chris.owen@lovells.com

NEW YORK

Robert Ripin

Direct telephone: +1 212 909 0600

email: robert.ripin@lovells.com

SINGAPORE

Andrew Taylor

Direct telephone: +65 6 557 4 507

email: andrew.taylor@lovells.com

TOKYO

Tim Lester

Direct telephone: +81 3 3221 8511

email: tim.lester@lovells.com

For further information about Lovells visit our website.

