

islamic investment funds

CORPORATE FINANCE • **FINANCIAL INSTITUTIONS** • ENERGY AND INFRASTRUCTURE • TRANSPORT • TECHNOLOGY

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“The firm most dedicated to Islamic finance”, offering “the market’s largest team consisting of lawyers whose work is focused entirely on Islamic finance matters”.
Chambers and Partners 2008

We are the only legal practice ranked in the top tier in *The Legal 500 2007* for Islamic finance which also describes us as “the clear market leader”.
The Legal 500 2007

Islamic Business and Finance award 2007 for “Best Islamic Finance Law Firm

The range and variety of recently launched Islamic investment funds evidences a dynamic and rapid assimilation of Islamic financing techniques to market opportunities. As a consequence, funds have been structured in sectors as diverse as real estate, high-tech industries, private equity, the aviation and shipping sectors and major infrastructure focusing on power, water and transportation projects in countries within the Organisation of Islamic Conferences.

At its core, Islamic finance is concerned with the deployment of capital in genuine commercial activities that will benefit the community as a whole. The system seeks a rational distribution of wealth based on the taking of prudent commercial risk. In this scenario, entrepreneurial capital providers are entitled to make a profit. Exactly how that profit is extracted by a capital provider will depend upon where any particular financial transaction sits on the debt through to equity spectrum. As a starting point, Islamic transactions seek to avoid interest and money cannot be lent simply to make money. Consequently, much Islamic financial activity requires a close connection to real assets and genuine business activities with returns linked to actual investment outcome.

Investment funds appeal to Islamic investors because they often provide a convenient method of acquiring a position in a new class of assets. Investors are keen to diversify away from conventional markets

and Islamic funds offer ways to do this. Any new product, in addition to offering competitive returns, needs to be well thought out, carefully structured and observant of Islamic strictures to ensure Shariah credibility.

Our Islamic finance group, working closely with our asset management group, has been involved in helping clients establish a variety of different Islamic investment funds. The process requires a clear appreciation of the fundamental Islamic principles and the ability to devise solutions the investor will find acceptable. This has been achieved through experience through 15 years of advising Islamic banks and financial institutions, a clear understanding of the concerns and issues faced by Islamic financiers and investors, and the development of strong working relationships with Shariah scholars and advisers.

Some basic Islamic principles

Justice, equity, fairness and morality are values which underpin the Islamic way of life, of which commerce is only a part. These relationships are governed by the body of Islamic jurisprudence generally referred to as Shariah. In particular, the following concepts should be noted:

- *Riba* – Shariah strictly prohibits “interest” or “usury” but *riba* is a wider concept than this. Effectively, it covers any “unlawful” gain derived from the quantitative inequality of the values in any transaction. Put more simply, it is a prohibition on exploitation by one party which owns a product which another party wishes to acquire or use.
- *Gharar* – this is, broadly, the concept of “full disclosure” or the removal of uncertainty, risk or speculation. Generally speaking, a transaction which is tainted with *gharar* will not be permitted. Transactions involving conventional insurance or assurance, life annuities and any type of transaction where the subject-matter, the price, or both are not determined and fixed in advance will fall outside Shariah requirements.
- Hoarding money is improper; money is merely a means of exchange and cannot be treated as a commodity
- Profit cannot be assured and there can be no guarantee of a fixed return. Taking security is permitted, however, to guard against negligence, wilful wrongdoing or breach of contract by partners.

Structuring an Islamic investment fund

If an investment fund is to meet the needs of Islamic investors, it must be structured in a way which accords with the principles of Shariah. The concept of an investment fund is understood and well-recognised from an Islamic perspective. For example, the Islamic concept of *mudarabah* envisages a “limited partnership” between a financial institution, such as an asset manager, and investors whereby the financial institution will exercise control over and invest a pool of funds on behalf of such investors. Certificates evidencing the investment, such as shares in the company constituting the investment fund, can be issued in negotiable form (as either registered or bearer instruments). The division of profits between the investors has to be on a proportionate basis and cannot involve a lump sum or a guaranteed return (though examples exist of structures where capital protection can be achieved). Adopting this method, management fees charged as a percentage of assets and performance fees are acceptable. The *rab al maal* (the investor) is not liable for losses beyond the amount of the capital initially subscribed and, conversely, the *mudarib* (the asset manager), who need not invest his own money, would not bear any share of any losses other than his own time and effort.

Another traditional Islamic fund structure is the *musharakah*. This is based on a general partnership model whereby losses are shared between investors in proportion to the capital invested but profits are shared between the parties at pre-agreed levels.

These structures therefore involve a combination of business activity and commercial risk taken by the investors. Business risk is perfectly permissible, from an Islamic perspective, but risk arising from a lack of knowledge which materially obscures any of the constituent elements of a transaction is not permissible. Thus, it is not the business outcome of a transaction which needs to be certain; it is the basis upon which the transaction is put together.

As noted earlier, Islamic investment funds can be structured to suit a number of different asset classes. It is also possible to leverage the investment, and many Islamic funds now achieve this through Shariah compliant investment methods. This has been achieved most readily in the real estate and aviation sectors. Techniques developed in a recent transaction are gradually being extended into other asset classes. Although the structures required to leverage an Islamic fund in a compliant manner are relatively complex and may involve a higher management burden, the issues are becoming better understood and so administration should become easier. This means that, at an early stage of the structuring process, consideration must be given to tax implications, accounting treatment, listing requirements (if any) as well as the Shariah issues, the latter being only one element of the overall fund package.

When structuring these transactions, it is now becoming increasingly important that the documentation used to establish the investment fund achieves a level of

sophistication and transparency that would be expected in any conventional global investment fund. The recent launches of several high profile sovereign Islamic debt securities (or Sukuk) demonstrate this further. We have also witnessed a shift away from the more traditional mudarabah and musharakah structures and new structures are being adopted to balance the investor's need for protection and the mitigation of risk.

Although an investor in an Islamic fund (whether Muslim or not) can now expect the fund documents to look like any conventional investment offering, he can be certain that care will have been taken to ensure that the offer document and constitution will prohibit the investment fund from charging interest or practising usury in any form. Similarly, the investment fund will be forbidden to invest in equities or other assets which are interest-bearing (subject to any parameters agreed for the purification of the asset class which might be relevant, for example, in the case of a fund tracking any of the Dow Jones Islamic Indices or those of other index providers). Other restrictions will include certain industries (eg, gambling and the manufacturing of armaments), certain products (eg, alcohol and pork) and certain investment strategies (eg, speculative). The promoters of the fund, their lawyers and Shariah advisers will carefully review the documentation and the investment objectives to ensure that the above requirements and a number of other sensitivities are recognised.

“a strong professional outfit, with the resources and back-up [to handle all aspects of fund work]”
Chambers 2008

Equity team of the year
2007 *Financial News*

[shortlisted for] Legal team of the year Funds Europe Awards 2008

Shariah Guidance

The constitutional documents of most Islamic investment funds will also provide for the election of a religious supervisory board (the Shariah Board) whose role is to ensure compliance with Shariah whilst at the same time assisting those in charge of the day-to-day running of the fund with finding Islamically acceptable solutions to issues as they arise including dealing with purification of any income tainted by non-permissible investment strategies. Responsibility (both initially and on a continuing basis) for ensuring that the investment guidelines set by the Shariah Board are complied with is delegated to a Shariah Advisor. For corporate governance reasons, these two roles are often performed by two different entities.

Our experience

Our asset management group is a leading team within the sector working closely with our Islamic finance group which has unsurpassed experience in Shariah compliant finance and investments. In our capacity as legal advisers we have represented many financial institutions (both Islamic and conventional) actively involved in the structuring of investment funds and Islamic financial transactions. Norton Rose Group is experienced in developing such transactions to comply with the principles and policies approved by Shariah Boards. In addition, through our extensive network of overseas offices, particularly in the Middle East, the Far East and Eastern Europe, we are able to draw upon particular local and regional expertise.

Shariah compliant funds experience

Al-Safi Fund

Advising Barclays Capital in their role as structured product developer of the Al-Safi trust, a Cayman-based multi-asset trust which seeks to provide an innovative, Shariah compliant structure to enable investors to access a broader range of exposure profiles for Shariah compliant equities by utilizing the Arbun contract. A Shariah board has been appointed with a remit to oversee the business, activities and investments of the sub-trusts an expert Shariah advisor has been appointed to provide day-to-day monitoring of the investments of the fund.

The Family Shariah Fund Limited

Advising the Family Shariah Fund Limited on its admission to trading on AIM and associated placing of \$31.55 million. The fund will be managed by The Family Office Company B.S.C. (Closed) ("The Family Office"), a multi-family office based in Bahrain, with the objective of generating stable long-term capital appreciation across a market cycle through a diversified pool of investments, in accordance with Shariah principles. The Family Office has a track record of managing and advising on a number of investments and specific mandates from GCC-based high net worth families and individuals.

Islamic Shipping Fund

Advising DVB Bank AG and a syndicate of banks in respect of a loan of US\$60 million to assist in financing the acquisition of mv Mars Glory by Mars Shipholding Limited. The equity portion of the purchase price for the vessel was provided by an Islamic equity fund. Following the purchase, the owner leased the vessel to an SPC which is a subsidiary of the Islamic equity fund under a Shariah compliant Ijara wa iqtina.

US\$5 billion family of sector specific funds

Advising Millenium Financial Advisory/Dubai Islamic Bank and Dubai World in relation to the first TMT Private Equity Fund part of the first of its kind US\$5 billion family of private equity funds to participate in strategic transactions on a global basis.

Al Khaleej Development Company

Advising Al Khaleej Development Company on the establishment and marketing of two Shariah compliant property investment funds.

Hexagon Project, Dubai

Advising Nexus Capital SA on the corporate finance aspects and capital raising for "The Hexagon", a \$260 million, high quality mixed use real estate complex in Central Dubai. The joint venture project with the Dubai International Financial Centre is aimed specifically at attracting foreign direct investment into the new Dubai International Financial Centre. This project was structured to comply with the requirements of Shariah.

Hotels fund

Advising a private equity company on the establishment of a fund which will focus on Shariah compliant hospitality investments in the MENASA Region.

GCC property fund

Advising on the creation of an investment fund structured to be able to invest into GCC property and which complies with the requirements of Shariah.

Health, science and technology fund

Advising on a multi-million dollar Shariah compliant fund investing in the health, science and technology sectors in the MENA region.

Millennium Aircraft Leasing Company (“MALC”)

Advising MALC in relation to a US\$200 million private placement of its equity and related US\$800 million aircraft lease financing which constituted the first Shariah compliant aircraft investment fund.

UCITS III

Advising Deutsche Bank on the establishment of what was believed to be the first UCITS III Shariah compliant equity investment fund. Five sub funds were launched under the DWS family of products.

Scottish Widows Investment Partners

Advising on the first Shariah compliant equity investment fund established by Scottish Widows Investment Partners.

Pan-European Islamic real estate fund

Advising on €75 million Framework Agreement and related Loan Agreement in connection with a private pan-European Islamic real estate investment fund. This was the first time that an Islamic equity fund has been supported by conventional debt on a cross-collateralised basis.

Albait UK Real Estate Fund Limited

Advising ABC IB Islamic Asset Management Limited and Credit Suisse Asset Management on a £40 million property fund which enables Islamic equity to be combined with conventional loan financing to achieve a tax efficient investment for offshore investors in UK real estate. We also subsequently advised on the disposal of this portfolio and unwinding of the financing arrangements to provide shareholders with an exit.

Dubai Islamic Bank

Advising Dubai Islamic Bank on its UK property fund.

WestLB Islamic forfaiting fund

Acting for WestLB on the first ever Islamic forfaiting fund aimed at institutional investors seeking to diversify their investments into new classes of asset such as discounted letters of credit. The fund enables investors to directly invest in such assets but at the same time ensuring that the investment takes place on a Shariah compliant basis.

Masefield Islamic energy fund

Advising Masefield Limited on the structuring of a US\$100 million Islamic investment fund investing in energy projects globally.

Private offering of Balexco House

Advising Gulf Finance House in connection with the private offering of Balexco House, which complies with the requirements of Shariah.

The first Iran fund

Advising the Iran Foreign Investment Company (a wholly owned subsidiary of the Government of the Islamic Republic of Iran) on the establishment of the first investment fund ever to invest into Iran. The Fund was structured to adhere to the principles of Islamic Banking as practised in Iran and as embodied in the 1983 Law on Usury Free Banking. Norton Rose (Middle East) LLP also advised on the listing of the Fund on the Bahrain Stock Exchange.

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Norton Rose Group

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