

## CHAPTER 11

# Product Positioning in the Global Capital Markets

### 11.1. Introduction

Due to the fast paced growth of the Islamic capital market products and the increasing demand for listing such products on credible exchanges and trading platforms, the industry has realised that it needs to market its products and broaden their appeal, to achieve a higher degree of global credibility. This requires the industry to be nurtured not only by its practitioners, but also the legislative and judicial environment within which such products are being developed and marketed. In addition, practitioners should be cognisant of the fluid state of the global capital markets as a result of the economic crisis and its ramifications. The global capital markets can no longer be viewed as a static object within which Islamic products are required to carve a niche.

The Islamic financial industry is now presented with a tangible opportunity to be more proactive in reaching a much wider audience through a renewed focus (reinvigorated by its new spotlight in the current global financial climate) on developing and subsequently marketing products that function within the ambit of Shari'a guidelines, and compete efficiently in the conventional market. That said, within the parameters of an existing legal and regulatory environment, a number of considerations must be addressed and eventually tackled if we are to contribute to the creation of a credible Islamic capital markets industry and a global sense of product reliability.

### 11.2. Capital markets considerations applicable to Islamic capital markets products

Islamic bankers and lawyers often face the task of creating a checklist of capital markets' specific considerations that apply in the context of offering public or private Shari'a-compliant securities. Many of these considerations also apply to conventional products too. It is this convergence that makes many Islamic products suitable for listing both on exchanges and platforms that are not inherently Shari'a-compliant and for marketing to non-Islamic investors. Obviously, the differences between conventional and Islamic investment products are substantial, but the wrapper used for listing and trading purposes is comparable. For example, Cayman Islands' exempt limited liability companies with trust arrangements for the purpose of holding the assets are utilized for issuing sukuk and bonds. In addition, both conventional and Islamic banks in Kuwait, for example, have complained that the listing rules of the Kuwait Stock Exchange are not robust enough to accommodate conventional instruments such as short sale, and Shari'a-compliant instruments such as bai al-arbun (a form of option). Keeping these considerations in mind, some of the key legal and regulatory considerations that are applicable to the listing and trading of Islamic investment products will be examined below.

### 11.3. Legal form of investment vehicles

Selecting the most appropriate legal form for an Islamic investment vehicle involves assessing the advantages

and disadvantages of each form available in a particular jurisdiction and the level of compliance of such legal form with Shari'a. Issues relevant to that assessment will include the time, difficulty and cost required to establish an entity; capital requirements; how the entity is to be controlled or managed; the liability of the members or shareholders; and the periodic or annual reporting requirements. Analysis of the availability of attractive ownership structures whether through direct ownership (in the absence of foreign ownership restrictions) or through trust, nominee or agency arrangements should also be undertaken. In common law jurisdictions, assets can be held in a trust, allowing investors to beneficially own the assets of the underlying fund. In jurisdictions where trust instruments are not available, such as Saudi Arabia or Kuwait for example, Islamic and conventional bankers must resort to agency declarations or nominee structures to bridge the ownership gap. SPV are increasingly being established in tax-friendly common law jurisdictions to take advantage of agency-based ownership structures which have become common sukuk issuances. In short, Islamic capital markets products have, in a number of cases, already successfully adapted to offering structures that have historically been applied by the broader capital markets industry.

## 11.4. Regulation of Islamic products and investor suitability requirements

Regulatory requirements, including know-your-customer and other compliance requirements, also differ from jurisdiction to jurisdiction. In recent years, promoters of investment funds and products have been attracted to jurisdictions such as Bahrain and Malaysia, which offer comprehensive regulations applicable to the establishment of collective investment schemes. They are tax-friendly environments for both conventional and Islamic products, and they both offer increasingly acceptable compliance policies. As developed capital markets endorse stricter know-your-customer (KYC) requirements, Islamic bankers seeking to market their products via such capital markets are recognising the need to meet these benchmarks.

In addition, investors in Islamic products should satisfy additional suitability requirements pertaining to the appreciation of risks involved in Shari'a-compliant investments, particularly in as far as profit and loss participation is involved. One way to satisfy all suitability requirements would be to embed any such requirement within the existing investor suitability criteria. For example, in the United States there are no specific disclosure requirements for private placements when the only investors are so-called 'accredited investors' (i.e. banks, insurance companies, investment companies, employee benefit plans, trusts, the issuer's directors, executives or partners, corporations over a certain size and certain individuals with high incomes or net worth), but Regulation D requires that information, largely akin to that required in a registered transaction, be supplied to all non-accredited purchasers. These requirements apply to conventional and Islamic products alike. Having said that, financial advisors should address an additional layer of transparency as disclosure documents

may satisfy regulatory requirements yet fail to reflect the true nature of the marketed or listed Islamic product accurately because the nature of an Islamic product may differ from what an outsider may view as a comparable conventional product. Even if the listing requirements of jurisdictions make distinctions between Islamic and conventional products, financial institutions entrusted with the task of placing such products should ensure that investors actually appreciate the risks associated with their investments and, rather importantly, the substantial differences between conventional and Islamic products. For example, investors should be aware that sukuk are not the Islamic alter ego for bonds and that IPE funds may need to utilize funding arrangements that may be uncommon in the context of conventional buy-out funds.

## 11.5. Exchange suitability

The decision to list an Islamic financial product on an exchange is often less a factor of the Shari'a-compliance of such an exchange than of its credibility among the targeted investor base. This is mainly because a successful placement or marketing campaign is one that can most efficiently reach its target audience. In fact, only a minority of security exchanges are truly Shari'a-compliant, in that they provide an exclusive platform for the trading of Shari'a-compliant products and companies. The decision by the Dubai Financial Market (DFM), for example, to partly convert to an Islamic exchange was well received by Islamic investors, particularly as it applied a pragmatic approach that did not prescribe immediate conversion requirements for firms already listed that were not compliant. Notably the conversion of the DFM has been cemented through a global marketing campaign that included international road shows and cooperation arrangements with regional and international exchanges including the Bahrain Stock Exchange.

In many Islamic jurisdictions, including most of the Arab world, the development of healthy and internationally recognized capital markets is in itself an almost insurmountable task that is yet to be successfully tackled. Until such capital markets reach some level of maturity, it may be unwise to separate conventional and Islamic exchanges at this stage. Arguably, the same argument does not necessarily apply to Malaysia, whose relatively healthy capital markets industry and tried and tested Islamic banking infrastructure may justify the adoption of parallel Islamic and conventional regulatory frameworks. Elsewhere, however, regional and international exchanges that are keen to attract business from Islamic investors should themselves seek to invest in creating a suitable platform. This includes adding rules that can accommodate Shari'a-compliant investment products while respecting their special nature. The Bahrain Monetary Agency (the predecessor to the Central Bank of Bahrain) issued the Guidelines for the Issuing, Offering and Listing of Debt Securities in 2004. These rules appear to treat sukuk as debt products, and include Islamic products and sukuk within the definition of "Debt Securities" adding extra requirements for Islamic Debt Securities such as appointment of the Shari'a advisor.

## 11.6. Shari'a-compliance certificates (fatwa)

Moving from the financial environment to the assets themselves, more factors must be subjected to an in depth analysis. One of those factors is that the assets must be Shari'a-compliant. Whether a regulator should be involved in assessing the credibility of fatwa or apply a softer-touch approach that shifts the burden to the underwriters and eventually investors can be questioned. It is no secret that investors in Islamic products, particularly sukuk, investment funds and structured notes, conduct their due diligence not just on the product itself, but also on the content of the relevant fatwa and, rather notably, the composition of the Shari'a supervisory board that has approved it. This is a market driven process that has proven effective in the past though it has given rise to something akin to fatwa shopping, where the credibility of scholars approving a product has a strong correlation to whether they are acceptable to the target investor base. Another option would be for the regulators to license Shari'a scholars or advisory firms much the same way as they license financial and professional services firms, and for such regulators to have their own Shari'a advisory board that would advise on Islamic banking and takaful businesses, which, for example, is the role assumed by the Shari'a Advisory Council of Bank Negara Malaysia.

Nevertheless, the endorsement of special licensing requirements for Shari'a advisors or firms may well be premature in most markets, even those with a sizeable Islamic banking industry. For now what is really required is an active dialogue among regulators, practitioners and scholars, in which the aim is to arrive at a development plan that would focus on educating a new generation of Islamic bankers and lawyers. In addition, scholars should be encouraged to institutionalize their practices through the formation of professional service firms which operate in key Islamic finance jurisdictions.

## 11.7 Nature and location of the assets

Islamic investment products are by definition products that involve an investment in Shari'a-compliant assets. While the Islamic banking industry has built a fairly well-established track record in commodity and equity-based products, new challenges arise in the context of structured products and those involving the structuring and marketing of investment in assets located in non-Islamic jurisdictions.

The Shari'a compliancy of structured notes, particularly those placed with high-net-worth individuals is the subject of a growing degree of scrutiny within the industry. While on the face of it, such uncertainty may hinder the development of Shari'a-compliant capital markets products, it may well provide a heightened sense of compliance for, and hence facilitate the marketing of, non-controversial capital markets products (e.g. bai al-arbun notes backed by a basket of Shari'a-compliant equities or commodities). In other words, the need to widen the spectrum of capital markets instruments available to Islamic investors should not weaken the credibility of the overall industry. On the other hand, the industry should

not punish attempts for creativity so a balance has to be struck. Islamic financial institutions should be encouraged to invest in research and development and, in so doing, mobilize Shari'a, financial and legal resources to achieve that end. While the ultimate product may prove to be unacceptable to some Islamic investors, the disapproval in itself should not preclude innovation so long as the process of that innovation is carried out in good faith. In fact, debates almost certainly from widespread innovation are what the industry badly needs.

Additionally, despite the historical focus on mura-haba trades, real estate and equity, a recent trend has emerged in which some Islamic banks, namely PE houses and sukuk arrangers, have targeted new sectors, e.g. the East Cameron Partners (ECP) sukuk transaction in the United States which closed in the summer of 2006 and was backed by oil and gas rights in the Gulf of Mexico, often in non-Islamic jurisdictions. A few such sectors are energy, transport and consumer goods among others. In as far as the oil and gas sector is concerned, this trend has less to do with the abundance of the relevant energy resources in such jurisdictions (at least as compared to the Middle East) and more to do with the fact that such jurisdictions offer a legal and regulatory environment that is more amenable to private-sector investment, as evidenced by a proven track record of successful conventional offerings of securities that are backed by energy rights. For example, the offer and sale of sukuk in the United States must generally be registered under the United States Securities Act of 1933 (the Securities Act) or structured to take advantage of an exemption from United States securities registration. The principle exemptions from registration are provided by Section 4(2), Rule 144A and Regulation S. This is an area which requires active involvement by United States capital markets lawyers although such lawyers will require direct support from their Islamic finance colleagues as well as the investment banking teams of the financial arrangers. Financial arrangers and fund managers who have historically used one or two law firms on structuring and documenting transactions, have opted in the past to engage an additional law firm with specific Shari'a expertise to support their normal deal counsel. By the same token, Islamic bankers and lawyers should be aware that broadening the appeal of Islamic products, partly through listings on developed exchanges, will also require active involvement from industry specialists (be it is real estate, energy, transport or otherwise).

## 11.8. Enforcement and bankruptcy considerations

In as far as enforcement and bankruptcy is concerned, another key consideration is the degree of certainty provided by an Islamic product's underlying documentation.

With enforcement, one should be able to predict the outcome of disputes that involve Islamic contracts governed by, say, English law, though this is not the case in the GCC for example. In fact, even in the context of a ruling issued by an English court in connection with assets in, say, Saudi Arabia or the UAE, there are a number of challenges pertaining to the enforcement of the for-

eign judgment. This is a consideration that impacts doing business in the Middle East and, generally, most Islamic jurisdictions, and is one that almost applies equally to conventional and Islamic documents and agreements. Moreover, an additional complication in the enforcement or restructuring of a transaction stems from the fact that some Middle Eastern jurisdictions have a hybrid legal system, in which Shari'a is a source of law but not the sole one. Although constitutionally, a number of these jurisdictions including Saudi Arabia and, arguably, Kuwait, consider Shari'a to be the primary source of law, question marks still arise in assessing whether an agreement that, on the face of it, satisfies the requirements of the civil or commercial code, is enforceable even if, arguably, it is not fully compliant with Shari'a. In such cases, will Shari'a experts be called to assess the level of compliance of the relevant agreement, or would the courts take a short cut and determine that the civil or commercial code cannot possibly be unconstitutional and consequently, that an instrument created in compliance with such code should prima facie be in compliance with Shari'a. A similar type of debate is currently taking place with respect to whether sukuk should be treated as a debt or equity instruments. These debates will be greatly influenced by local laws, and are far from settled.

A similar, and possibly even more complex, consideration can be derived from the lack of a developed bankruptcy regime in most Islamic jurisdictions. Where such regimes exist, there is an evident lack of precedent and, in some instances guidance, in as far as the process itself is concerned. In addition, where Islamic investment banks or companies are involved, central banks are given broad powers to control the bankruptcy, liquidation or administration process, but in many cases they do not seem to have adopted a unified approach to such process. A number of sukuk transactions, and, more broadly, Islamic investment companies and institutions, are currently being restructured, which should strengthen the foundations of this industry.

Specialised legal advice is also required to identify other issues that may be relevant in deciding which jurisdiction a sukuk issuer should be domiciled. This includes conducting a bankruptcy analysis and testing the degree to which the local legal environment would accommodate certain Shari'a investment paradigms.

## 11.9. Tax

Tax issues are particularly important in deciding where to domicile any investment vehicle, Shari'a-compliant or otherwise. At the establishment stage, the promoters of a structure that will initially execute multiple asset transfers will require tax advice to determine the taxation treatment of such transfers. Tax advice is also necessary in order to confirm the favourable tax treatment of a particular jurisdiction to all aspects of the business and operation of the investment vehicle. For example, in the ECP sukuk, the structure utilised a funding arrangement that was heavily driven by United States tax considerations. Legislation in some jurisdictions require, in connection with the transfer of title in real estate or property transactions (which would be required in the context of a sale-lease-back structure), that the sale contract and the resulting title transfer be recorded in a real estate register and that a transfer of title fee or tax be paid.

## 11.10. Looking ahead

The success of the Islamic capital markets should not be measured solely by the number of regulations endorsed to govern it. Important factors to consider include the relevance of the regulations, the quality and sophistication of the products themselves, the degrees of compliance with the principles of Islamic banking and the market's ability to reach a broad Islamic and non-Islamic investor base.

What does this entail for Islamic capital markets? This may be the time for new thinking and a new approach: one that genuinely recognizes that the current economic turmoil may well provide Islamic finance, generally, and Islamic capital markets products, more specifically, with an opportunity to offer an alternative investment model that focuses on a combination of ethical and financial soundness criteria; one that is flexible enough to adapt to the requirements of the various global securities exchanges while still maintaining its special nature; and finally, one that is led by practitioners who in conducting their securities' placement activities highlight to all investors, Islamic and conventional, such principles as fairness, transparency, participation in profit and loss and a focus on what is purely ethical. After a period of global market decay this is a great opportunity for the principles of Shari'a to shine through.