

# **Global Islamic Finance Forum**

**Kuala Lumpur 26 – 29 March 2007**

**Investors & Issuers**

**Session 4 – Facilitating Cross Border Activities**

Neil D Miller

Partner, Norton Rose

## **Disclaimer**

Please note that the materials in this pack contain information confidential to Norton Rose. Copyright in the materials is owned and retained by Norton Rose and the materials should not be copied or disclosed to any other person without the express authorisation of Norton Rose.

These materials have been prepared for training purposes only and not to give legal advice and, accordingly, they should not be relied upon. They are intended only to provide a general outline of the material covered. They should not be regarded as a comprehensive statement of the law and practice relating to this area. Readers should take specific legal advice on any particular matter which concerns them. If you require any advice or information, please speak to your usual contact at Norton Rose.

## Your Speaker



**Neil D Miller** is a partner in the banking department of Norton Rose. Now based in London, he spent 5 years running the firm's office in Bahrain where he first started undertaking Islamic finance transactions. On returning to London in 2000 he established the firm's Islamic Finance Group which now co-ordinates the firm's activities globally in this sector.

His practice focuses on all types of Islamic financial products and covers a wide range of asset classes, investment and industrial sectors. In the past three or four years a large part of his work has related to a wide variety of different financial products that have been developed for use in financing the acquisition, development and investment in real estate on a Shari'ah compliant basis.

He acts for clients such as HSBC, BNP Paribas, Citigroup, ABN AMRO, Deutsche Bank and the Islamic Bank of Britain as well as a wide range of Middle East based institutions including Dubai Islamic Bank, Kuwait Finance House and Arab Banking Corporation.

His most recent innovative work involves advising Citigroup on their range of profit rate and currency swap products, UBS on their commodity linked instrument and Calyon on a variety of investment products.

Earlier this year, the readers of IFN Weekly in an independent poll nominated Norton Rose as "*Best Legal Advisor in Islamic Finance*".



The award-winning Islamic finance team at Norton Rose, with over 20 years of experience and more than 30 lawyers in an international network of offices in Europe, the Middle East and the Far East, is at the forefront of the evolution and development of Islamic financial practices.

Norton Rose advised the banks in deals which were awarded the Islamic Finance News Deals of the Year 2006 Award in the following categories:

- Equity Deal of the Year
- Murabahah Deal of the Year
- Initial Public Offering of the Year
- Project Finance Deal of the Year
- Bahrain Deal of the Year
- Kuwait Deal of the Year
- Turkey Deal of the Year


# Contents

- IFSB, Beirut – May 2006
- Legal & Regulatory Challenges
- Some tricky jobs
  - Contract standardisation – necessary?
  - Taxation – the UK illustrating changes
  - Property ownership – an ongoing problem
  - Insolvency law – underdeveloped or non-existent
  - Governing law – a contractual dilemma
  - Shariah observance – the Fatwa problem
  - Dispute resolution – to arbitrate or to litigate?
  - Securitisation and trusts

# Progress since Beirut – May 2006

- AAOIFI – in July 2006 published the Shariah Standard (Banking Services in Islamic Banks”; Governance and Ethics for Fatwa” plus an exposure draft on Tawarruq
- IFSB – published in December 2006
  - Guiding Principles on Corporate Governance for IIFS
  - Exposure Draft No 4 Disclosures to Promote Transparency and Market Discipline for IIFS
  - Exposure Draft No 5 Guidance on Key Elements in the Supervisory Review of IIFS
  - August saw a paper on *Takaful* regulatory issues
- IIFM - ISDA initiative with ISDA re master agreements and looking at commodity *Murabaha* for liquidity purposes
- UK Treasury – Last week’s announcement of a *Sukuk* framework for UK issuers


## Some of the legal challenges

- Legal difficulties faced by those seeking to:
    - Deliver Islamic financial products;
    - Regulate the delivery of such products
  - “No grand plan to create a legal system”
  - Two aspects of the legal challenge:
    - general legal framework in which these contracts have to operate; and
    - Regulatory law framework needed to ensure probity and effective supervision
  - Several interested parties: bankers & scholars, government & regulators and customers
- 

## Legal challenges

- Global phenomena of Islamic finance
- Shariah – Qur'an many provisions of a legal nature but not a comprehensive code
- The common law system – case law precedent
- Codified systems
- Difficulty of interaction between systems; harmonisation
- The European Union as an example:
  - Primacy of national systems
  - European Court of Justice
  - No European contract law; limited advance on the insolvency front

## Regulatory considerations

- The regulatory purpose; the FSA's statutory objectives:
    - Maintaining market confidence
    - Protecting consumers
    - Increasing public awareness of financial products
    - Reducing financial crime
  - The regulatory task:
    - Establish framework in which practitioner's can operate
    - Identify key characteristics of products subject to regulation
    - Create regime to monitor compliance & approve products
  - Need to balance commercial need for creative approach against regulatory certainty
- 

## Comprehensive or parallel regulation (1)

- Different approaches in different countries
- Comprehensive – a “one size fits all” model
  - Ensures equal treatment
  - May not be sufficiently flexible to cope with Shariah principles
- Parallel – regulation of Islamic finance sits alongside conventional
  - Risks unequal treatment if not same regulatory body

## Comprehensive or parallel regulation (2)

- IFSB Exposure Draft No 3 recognises:
  - “No single model” can work in every country
  - “Any hasty and rigid rule based approach to strengthen the corporate governance of IIFS may riskily hinder the potentials and healthy growth of IIFS”
- IDB Ten Year Master Plan
  - “This goal [i.e. improving the legal framework for Islamic finance] is to be met over the medium term, by helping national authorities to develop...Legal infrastructures underpinning laws, contract, property rights, insolvency and creditor regimes, and financial safety nets”

[NB: emphasis added]

## Legal challenges

- Global phenomena of Islamic finance
- Shariah – Qur'an many provisions of a legal nature but not a comprehensive code
- The common law system – case law precedent
- Codified systems
- Difficulty of interaction between systems; harmonisation
- The European Union as an example:
  - Primacy of national systems
  - European Court of Justice
  - No European contract law; limited advance on the insolvency front

# Contract standardisation – necessary?

- The desire to standardise
  - is it necessary? Consumer protection may be a ground for intervention?
  - who should do it? Practitioners or regulators?
  - the Deutsche Bank experience – positive or negative?
- ISDA and LMA – from the practitioner side - [NB: serious reservations about the role of LMA in any standardisation exercise]
- The Malaysian approach and some comments on the role of the Syariah Advisory Council:
  - “...to guide the financial institutions to adhere strictly to Islamic principles”
  - “The confidence of the public as well as the shareholder depends very much on the credibility of the particular SCC, and to that end, it has never been assigned the duty of product innovation”

# Taxation

- Why is this relevant?
- Contrast the UK with Pakistan
  - The double taxation of *Murabaha*
  - Tax on the marked up price
- Bank of England Working Party
- UK Treasury activity:
  - Finance Act 2003 – SDLT reliefs – *Murabaha / Ijara* for individuals; Finance Act 2005 – extended to diminishing *Musharaka*; established the “level paying field” principle for profit treatment ; Finance Act 2006 – extending SDLT relief to corporate bodies; future changes by Regulation
  - 2007 Budget announcement – a framework for *Sukuk* has been created in the UK - equivalent tax treatment and hurdles removed

# Property ownership

- The critical role of ownership in Islamic finance
  - Common law concepts - legal and beneficial
  - identifying a *usufruct* – we need more clarity in this area
  - The harm of contrivance – undermines legal certainty
- The problem
  - Lack of foreign ownership rights
  - Uncertain legal basis of ownership rights
  - Inability to create and perfect local law security interests against third party claims
- Need for major politico-economic assessment re impact of changes – use of zoning increasing in Middle East

# Insolvency and corporate recovery

- Impact of insolvency and corporate recovery regimes on development of Islamic finance – a much wider question
- General practitioner consensus – regional regimes generally underdeveloped
- Two reasons for improvement:
  - Investor and consumer protection
    - Scope of liquidators powers
    - Permit work out solutions / orderly disposal of business assets
  - Development of derivatives products – will be hindered if the insolvency issues are not addressed in relevant jurisdictions

## Development of derivative products

- Hedging and risk protection solutions have been developed - several PRS transactions closed
- Increasing body of writings supporting [perhaps contemplating is more accurate!] derivative-like activity to support legitimate business enterprise as opposed to purely speculative behaviour where *maslaha* can be demonstrated
- ISDA - there are no netting opinions for the Gulf States and few for other OIC member states (cf. Indonesia, Malaysia & Turkey)
- ISDA / IIFM initiative – advancing progress in this area but its ability to address local legal issues limited
- Lawyers in most Islamic states cannot give clear guidance on insolvency matters and concepts such as netting, set-off, mark-to-market all of which are crucial to developments in this area


# Governing law – a dilemma

- Over the last 12 years this matter seemed to improve
- UK and Malaysian Courts of Appeal have both issued sensible judgements in this area
  - UK- Shamil v Beximco – gives the SSB a Shariah compliance role
  - Malaysia - Emcee Corporation – “law applicable no different”
- But we are seeing evidence of retrograde steps are taking place
  - Banks are still using split governing law clauses
  - There is need for more guidance on best practice
- Shamil v Beximco – whilst a strong case for certainty - not properly understood
- Balance needed – between (a) legal certainty and (b) Shariah observance

# Shariah observance - the Fatwa problem

- What is the role of the Fatwa in society?
- Should ad hoc decision making determine the shape of the Islamic finance industry?
  - “Are scholars equipped or required to take into account public policy concerns or the needs of different societal groups?”
  - A general application of piecemeal Fatwas ... will eventually result in a system riddled with anomalies, exceptions and uncertainty” [Hegazy, 2004]
- Inherent potential for conflict in the roles of scholars
  - The advisory / approval function
  - The audit function
- Recent developments
  - AAOIFI – July 2006 ED “Governance and Ethics for Fatwa”
  - IFSB – Guiding Principles and ED No 4, Section 6
- Starting to offer guidance but will the industry adopt?

## Dispute resolution - to arbitrate or litigate?

- Greater clarity is needed here
  - Arbitration is [arguably] the solution favoured by the Qur'an
  - Litigation probably favoured for most cross border deals for reasons of certainty
  - Few arrangements in place for the reciprocal enforcement of judgements
  - New York Convention of the enforcement of arbitration awards has a wider take up
  - Need for bespoke split clauses giving arbitration and litigation options
- 

## Some nice to have's

- Securitisation laws
  - Developing capital markets need a framework for new products
  - Few jurisdictions have laws in this area
  - Can Lebanon's Law No 705 of December 2005 be rolled out elsewhere?
- Trust laws
  - A creature of the common law but consistent in many respects with the concept of *Amanah*
  - Technically difficult to introduce in civil code based jurisdictions
  - May be crucial for the development of Musharakah-based tools

## Concluding remarks

- Regulators should regulate – focus on identifying Guiding Principles – whilst working towards harmonisation
- Islamic financial contracts – practitioner's should:
  - innovate but with respect for the Guiding Principles
  - Determine standardisation for themselves
- Avoid prescriptive rule based approach to both processes
- Maintain pressure for legislative action in the right direction
- In practice cross-border deals are getting done but care has to be taken in selecting what deals will or will not work
- Greater pre MoU legal and tax due diligence is probably needed

# Contact information

## Neil D Miller

Tel: +44 (0)20 7444 3353

Mobile: +44 07767 646 638

E-mail: [neil.d.miller@nortonrose.com](mailto:neil.d.miller@nortonrose.com)

The logo features a stylized, upward-pointing chevron shape in a light brown color, positioned above the letter 'N' of the word 'NORTON'.

**NORTON ROSE**

