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SHARIA COMPLIANT FUNDS IN IRELAND

Introduction

The last number of years has witnessed an increased interest in both Sharia Funds and in Islamic financial products worldwide. Sharia Funds are funds which are deemed to be compliant with an Islamic branch of law based on the teachings of the *Koran* and *Sunna*.

According to the London-based Institution for Islamic Banking and Insurance, there are now approximately 100 Sharia equity funds managing US\$ 5 billion in assets, a figure that is growing by 12-15% a year. On a broader scale, there is estimated to be approximately US\$250billion invested in Islamic products worldwide, key markets for Sharia funds being the Middle East and North Africa (MENA) region with growth also evident in more traditional markets within the European Union.

This article sets out to explore the features of Sharia Funds in the context of the Irish legal and regulatory environment given recent Irish approvals for such funds.

The key features of a Sharia Fund are:

- the appointment of a Sharia Board,
- investment in Sharia compliant (Halal) products, and
- the purification of income.

These features are explained in detail below.

The Appointment of a Sharia Board

Similar in structure to other Irish funds, Sharia Funds will be set up as an investment company (or other legal vehicle) with a board of directors and an investment manager or advisor who manages the investments of the Fund and advises the board.

However, a distinguishing feature of Sharia Funds is the requirement to appoint a Sharia Board which provides guidance to the directors of the Fund and to the investment manager

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on matters of Sharia law and in particular whether the proposed investments of the fund are Sharia compliant.

The Sharia Board will consist of Sharia scholars, experts on matters of Islamic law and practice and who are usually members or advisers to Islamic banks. The Board will be heavily involved in the early stages of drafting the fund documentation and will review the constitutional documents and material agreements and will issue a *Fatwa* which is a religious ruling issued after an examination of fund rules and investments made by a Fund which in effect certifies that the fund is "Sharia compliant". The *Fatwa* is an important precondition in order for a Fund to be marketed to prospective investors as Sharia observant.

The role of the Sharia Board is therefore twofold: (1) to initially advise on the fund set-up and on the core documents; and (2) to provide ongoing advice on the monitoring of the Sharia element of the fund investments.

Sharia Compliant Investments

A fundamental principle of a Sharia Fund is that it must ensure that the underlying business in which it holds securities is Sharia or *Halal* compliant.

The Fund's offering document will spell out the Islamic-based investment restrictions on its investment universe and in particular will normally set out that the Fund may not invest in businesses which among other things:-

- manufacture, sell or offer alcohol or pork;
- invest in gambling establishments;
- provide interest based financial services;
- invest in nightclubs or are involved in pornography or adult orientated material.

In addition a Sharia Fund may not invest in interest—bearing instruments, may not sell short and may not engage in speculative transactions. These restrictions have in the past been deemed to rule out Sharia compliant hedge funds or even funds which invest in derivatives. However, there have been recent developments to broaden the range of permissible investments for Sharia funds, as dealt with further below.



"Purification" software involving a stock screening process is used to detect and reject noncompliant investments and the Fund's investment manager will act to liquidate the noncompliant securities when necessary.

Income Purification

A third key feature of Sharia Funds is "income purification". As it is often unavoidable that some of the income generated by the underlying companies in which a Sharia Fund invests will include some form of interest, it will be necessary to purify that income which process can be addressed in a number of different ways.

For example, a certain proportion of income could be deducted prior to distribution of dividends. Alternatively investors may be informed of the amount that should be deducted from their dividends in order to achieve a Sharia compliant return. In other funds, income purification is achieved by simply calculating that an amount equivalent to 5% of all cash dividends received on interest income in the fund will be donated to a charity recommended by the Sharia Board.

Irish Legal and Regulatory Considerations

Sharia Funds are a welcome development for Irish funds industry. Whilst the Irish Financial Regulator does not treat them differently from any other type of investment funds, the Irish legal and regulatory framework provides a favourable environment for such funds and the Financial Regulator has recently authorised Sharia equity funds. The Financial Regulator has recognised the significant development of Sharia Funds and the activities of MENA based fund promoters and investment managers and in 2008, it established a dedicated team specialising in the authorisation of Sharia complaint funds.

(i) Sharia Board

One area that the Financial Regulator will look at is the role of the Sharia Board and the capacity in which it acts and will require confirmation that the Sharia Board is acting in an advisory capacity only with no discretionary powers over the assets of the Fund. If acting in an advisory capacity only, the Financial Regulator will not seek to regulate or approve the Sharia Board.



The contract appointing the Sharia Board will usually constitute a material agreement which should be disclosed in the Prospectus and filed with the Financial Regulator. In addition if the fees of the Sharia Board are being paid directly out of the assets of the Fund, details of these fees must be disclosed either in the Fund's Prospectus or in the relevant advisory agreement.

(ii) Sharia Investment Restrictions

Another relevant area to consider is whether the Financial Regulator imposes any conditions on requirements on the Sharia element of the fund.

In our experience, the Financial Regulator will not seek to impose any oversight of the Sharia element as that is really an embodiment of a set of guiding principles, investment philosophy or investment guidelines. From a regulatory prospective, the Sharia element is viewed very much as an overlay, comparable to a fund established with a "socially responsible" investment ethos. What the Financial Regulator will be concerned with is to seek to ensure is that the statements of policy and principle are transparent and clear and that the offering document is drafted in such a way that investors are able to clearly understand the basis on which they are investing. Typically, the Irish regulatory authority will be focusing on issues such as the suitability and expertise of the entity carrying out the asset management.

(iii) Monitoring of Compliance

Another issue to consider in the context of a Sharia Fund is the monitoring of compliance with Sharia principles and how and by whom the monitoring functions will be carried out. To a large part, this will depend on how the legal documents are drafted. For example, in most cases, the Sharia element would be stated as guiding principles and investment guidelines rather than as hard core investment restrictions.

However if, for example, there was a statement in the Prospectus that no more than 10% of the net assets of the Fund may be invested in banking stocks, this might well fall within the ambit of an "investment restriction" and would need to monitored in the same way as any other investment restriction would be. The monitoring role for compliance with Sharia would usually be provided by the Sharia Board and/or the investment manager, although specific advice would need to be sought depending on the construction of the legal documents.



Tax Considerations

Recent changes to Irish tax laws proposed in the Irish Finance Bill 2010, will have the effect of extending the tax treatment applicable to conventional finance transactions to Sharia compliant or Islamic financial products. The relevant transactions covered by the legislation are credit transactions, deposit transactions and tax considerations. Essentially, the new legislation treats the returns arising from these transactions as equivalent to interest for tax purposes. For example, in respect of *Sukuk*, the investment return on the *Sukuk* certificate will be treated as interest for the purposes of Irish tax legislation and the *Sukuk* issuer will be entitled to deduction in respect of the coupon paid.

The Bill also introduces amendments to Irish stamp duty legislation to ensure that no stamp duty will arise on the issue, transfer or redemption of a Sukuk certificate. Amendments have also been proposed to the VAT legislation to treat Islamic finance transactions corresponding to financial services as VAT exempt.

The net effect of these changes is to extend to Islamic financing the tax relief provisions which currently apply to conventional financing.

Recent Developments

Despite the restrictions faced by Islamic funds on short selling, interest and speculative investments, investment managers have recently been working on developing classic alternative strategies and hedge funds to suit Sharia principles.

For example, through the use of *Salaam* contracts and *Murabaha*. Salaam is a short term contract to make full prepayment for an asset prior to delivery. *Murabaha* contracts are a transaction where the bank buys an asset on behalf of the end user who then repurchases it over time. Total payment in such contracts would be more than the cost of the asset providing the bank with its profit margin and also avoiding the concept of borrowing and interest. In addition, other fund promoters are looking at designing wrapper type products i.e. packaging existing investment products into Sharia compliant equivalents.

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In the case of such alternative investment products, the role of the Sharia Board will be critical both in designing and advising on the products and in negotiation of the fund documentation and material contracts, particularly if there is a prime broker involved.

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