SHARIAH COMPLIANT FUNDS AND MIDDLE EAST MONEY: TOP FIVE POINTERS (GUEST ANALYSIS)

By Wael Jabsheh, Akin Gump Strauss Hauer & Feld LLP
November 2, 2010

A large number of global financial institutions and fund managers are intrigued by the possibility of raising a Shariah compliant fund targeting Middle Eastern investors. Despite this initial interest, however, many are dissuaded from doing so because they simply don't know where to begin. Below are five basic pointers for any institution or fund manager who might be inclined to develop a Shariah compliant fund and conduct fundraising efforts in the Middle East.

1. Understand Your Structural Options

Shariah prescribes certain requirements which heavily influence a fund's structural options. While the economic arrangements commonly found in conventional funds are usually adaptable to Shariah, the structural arrangements are often quite different. For example, Shariah prohibits the issuance of preferred shares, which limits one's ability to use a corporation for the fund vehicle when establishing a hedge fund (since most hedge funds need to issue different classes of shares in order to reflect the interests of management and special deals entered into with particular investors). Shariah also prohibits the payment of interest, which means that fund managers must give additional thought to the structuring of carried interest and performance fees. Under the rules of Shariah, it is permissible for fund managers to earn a modified form of carried interest which is referred to as a "mudaraba". A mudaraba is an arrangement whereby a silent partner provides capital to the partnership while the other partner provides know-how and manages the capital in consideration for a percentage of generated profit; under such a structure those payments must not be tied to capital invested by the fund manager (a common method employed for tax purposes in the U.S. and other jurisdictions).

These examples highlight the types of structural issues which fund managers should consider. Financial institutions or fund managers seeking to establish a Shariah compliant product should speak to an experienced Shariah funds legal practitioner to consider whether their overall idea for the fund works. The various operational and structural requirements of Shariah may lead to the establishment of a Shariah-compliant fund as a parallel investment vehicle to a conventional fund. Such a parallel track investment structure may enable fund managers to take advantage of the flexibility offered by a conventional fund, while simultaneously providing an alternative investment opportunity for Shariah-minded investors.

2. Understand the Impact on Your Investment Strategy

Shariah places certain financial limitations upon a fund, including prohibiting the following activities: (a) providing or obtaining conventional loans, including for purposes of leveraging / gearing a fund's portfolio investments; (b) investing in overly-leveraged portfolio companies; (c) investing in interest-bearing financial instruments, including convertible securities; (d) investing cash in short-term financial instruments or derivative transactions that are based on underlying assets or obligations that are not Shariah compliant; and (e) engaging in naked short-selling and other derivative transactions where the fund does not have title to the asset being sold. If your fund intends to use any of these financial strategies, your fund is not likely to be compatible with Shariah.

If you intend to use leverage as part of your investment strategy, you should also consider whether Shariah compliant financing will be easy to obtain, given the nature and geographic location of the fund's target investments. While Shariah compliant financing is widely available in the Middle East and certain parts of Asia, this isn't yet the case in many other parts of the world. Although the Islamic finance industry has made significant gains, in countries where Shariah compliant financing is not widely available, it will likely cost more than conventional financing.

3. Understand Your Investment Limitations

The proposed investments of your fund must be “halal” (meaning permissible) in order for them to meet the requirements of Shariah. Your fund will be prohibited from investing in certain industries, including: (a) the production or distribution of alcoholic beverages; (b) the production of pork products; (c) the production or distribution of certain types of entertainment, including pornography; (d) any business that earns income from gambling (including online); and (e) the production or sale of military equipment and weaponry.

Shariah does allow flexibility to invest in companies which derive a small portion of their income from prohibited sources (generally agreed not to exceed five percent). This flexibility recognizes that strict adherence is sometimes not possible; including for example where an investee company derives income from a prohibited source after your fund has made its investment. In such cases, your fund may “purify” these earnings by separating them from the fund’s Shariah-compliant assets, and disposing of them in a manner approved by its Shariah board or scholar (for example, by donating them to a charity).

4. Know Your Market

The Middle East is a large and culturally diverse region. Many institutions and fund managers assume that the only investment products which are acceptable to Middle Eastern investors are Shariah compliant products. This is not the case. Many investors in the Middle East, including many of the major sovereign wealth funds, actively seek and invest in conventional investment products. Before you decide to develop a Shariah compliant product for the Middle East, study your market carefully and understand its needs. The preference for Shariah compliant products is more prevalent in certain parts of the Middle East than others and, in my personal experience, is generally more prevalent among retail investors than institutional investors.

5. Get Shariah Advice Early

If you decide that offering a Shariah product is desirable, you should seek Shariah advice at the earliest stages. A qualified Shariah advisor will need to review your proposed fund structure, the fund’s proposed investments, and its business operations to determine whether they will be Shariah compliant. Discovering that an essential element of your fund is not compatible with Shariah is best done early. Once your fund is established, be prepared to either appoint a Shariah board composed of Islamic scholars or a single Shariah scholar to provide ongoing advice and direction on the operations of the fund. Different scholars may have different views on what is and isn’t permissible; it therefore makes sense for a fund manager to appoint the same scholar who advised on the structuring to also advise on the ongoing operations. In all cases, ensure that the scholar you are appointing is experienced, has the credibility required in the market, and has a good understanding of your fund’s sector focus.

About the Author

Wael Jabsheh *(mwjabsheh@akingump.com) is corporate counsel in the Abu Dhabi office of Akin Gump Strauss Hauer & Feld LLP. With more than 800 lawyers in 14 offices, Akin Gump Strauss Hauer & Feld LLP is one of the world’s largest law firms. Read his full biography.*

Related Resources from Westlaw BUSINESS

Standards and Guidance
Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) Shari'a Standard No. (13) - Mudaraba
Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) Shari'a Standard No. (27) - Indices
Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) Shari'a Standard No. (31) - Gharar Stipulations in Financial Transactions (*Arabic Only*)
Islamic Financial Services Board (IFSB) 6 - Guiding Principles on Governance for Islamic Collective Investment Schemes
Islamic Financial Services Board (IFSB) 10 - Guiding Principles On Shari'ah Governance System

Related Westlaw Business Currents Coverage
Westlaw Business Talks: Challenges and Opportunities for Private Equity in Saudi Arabia
Westlaw Business Talks: In the Infant Islamic Finance Delivery Room with Michael McMillen
Westlaw Business Talks: One Expert, Two Islamic Finance Perspectives

Related Reuters Coverage
Islamic Fund Management Sector to See Global Players
Reliance Capital Plans Islamic Funds
Private Equity Boom Seen for Islamic Finance