



Bin Shabib & Associates (BSA) LLP

Sukuks

I. **Legal and Regulatory Issues:**

a. **Introduction**

– **Overview of the Sukuk Market**

In a growing Islamic Finance market, it is essential to continually strengthen the legal framework for the Islamic financial services industry, given the powerful forces of change constantly transforming the functioning of the global economy and the international financial system. A legal framework which is aligned with market developments leads certainly to financial transactions and innovative products and at the same time gains public confidence.

The legal and regulatory framework is a vital pillar in the sustainable development of Islamic finance. It provides the legislative framework that defines the conduct of Islamic financial institutions. It also provides due protection to the consumers of Islamic finance, ensures the enforceability of Islamic financial contracts and provides an effective mechanism for legal redress.

The legal framework for Islamic finance also needs to address any specific elements that could result in a comparative disadvantage to the industry. More specifically, in a world which finance has long been defined by conventional practices and laws, the features that are

unique to the requirements of Islamic finance need to be taken into account to ensure neutrality of treatment.

Equally important to the development of Islamic finance is not only the financial intermediaries but also the Islamic financial markets. The demand for Islamic financial products and instruments is expanding at increasingly significant rates in predominantly Islamic countries in the Middle East and Asia as well as in the non-Muslim economies in the West. The rapid growth of the Islamic financial markets has seen the development of a wide range of products including money, debt and capital market instruments. Such markets are important for the effective management of investment portfolios and for the diversification of risks.

However, till this day, this rapid growth is still faced by the slow evolution of the laws and regulations governing the subject.

– **Different schools of thought**

Many of you here know that in Islam, there are a number of different schools of jurisprudence. These are the Hanafi, Shafi'i, Maliki and Hanbali schools of thought; which are generally based on geographical regions.

The Hanafi School is based on the verdicts and legal analysis of Imam abu Hanifa, Abu Yusuf and prophet Mohammed. It is perhaps the most liberal interpretation of the Quran and, consequently, the most flexible and easiest to accept. The Hanafi school of thought does cater for diverse cultures and this is precisely why it has been adopted primarily by non-Arabs in regions such as Iran, Turkey and the sub-continent.

By contrast, the Hanbali school adopts a much more literal approach, taking almost every text by its words only. A substantial number of people in Saudi Arabia follow this school of thought in the present day.

The Maliki approach to jurisprudence is to follow the practice of the people of Madinah. Most Imam Malik's students traveled to North Africa and Spain and hence almost all of North Africa (with the exception of Egypt) Spain and Sudan follow the Maliki school of thought.

The last of the Sunni schools, followed in countries like Egypt, Malaysia, Indonesia and Iraq, is the Shafi'i school. This school adopts a systematic methodology for developing legal principles, in an attempt to minimize analogy and speculation. The Shafi'i school is considered one of the more conservative of the four Sunni schools of Islamic jurisprudence.

No Standard

By virtue of the differences between the schools, the undertaking of Islamic finance transactions is not a standard process throughout the Islamic world. When seeking to carry out transactions under Islamic law, the practice, as we know, is to have the transaction approved by a recognized Islamic scholar who, after reviewing the proposed transaction documents, will issue an opinion confirming whether or not the transaction complies with Islamic law.

The scholar might be a follower of a different school of jurisprudence from the jurisdiction at which the proposed transaction is aimed. This, in turn, means that a transaction that one scholar deems perfectly acceptable could be rejected by another because of its perceived non-compliance with the tenets of Shari'a. It is not uncommon to have a lot of negotiations with the scholar to make sure that the transaction complies with the Shari'a requirements as they have been identified and interpreted in the relevant jurisdiction.

b. **Islamic securities based on Ijarah**

– **What is Ijarah?**

In Islamic jurisprudence, the term Ijarah is used for two different situations. In the first place, it means to employ the services of a person (ajir) on wages (ujra) given to him in consideration for his services. The employer is the musta'jir.

The second type of Ijarah and which is of interest to us today, relates to the usufructs of assets and properties. Ijarah in this sense means to transfer the usufruct of a particular property to another person in exchange for a rent claimed from him. In this case, the term Ijarah is analogous to the English term "Leasing". Here the lessor is called mu'ajir, the lessee is called musta'jir and the rent payable is called ujarah.

– **Sale or lease**

The rules of Ijarah, in the sense of leasing, are very much analogous to the rules of sale. This is because in both cases, something is transferred from one person to another for a valuable consideration. The only difference between Ijarah and sale is that in the latter case the corpus of the property is transferred to the purchaser. Whereas, in the case of Ijarah, the property remains in the ownership of the transferor and only the usufruct (i.e. the right of use), is transferred to the lessee.

c. **Ijarah – the most commonly used**

Ijarah Sukuk are sukuk that represent ownership of equal shares in a rented real estate or the usufruct of the real estate. These sukuk give their owners the right to own the real estate, receive the rent and dispose of their sukuk in a manner that does not affect the right of the lessee, i.e. they are tradable. The holders of such sukuk bear all cost of maintenance of and damage to the real estate.

Ijarah sukuk are securities representing ownership of well defined existing and known assets tied up to a lease contract, whereby the rent represents the return payable to sukuk holders. Payment of Ijarah rentals can be unrelated to the period of taking usufruct by the lessee. It can be made before beginning of the lease period, during the period or after the period as the parties may mutually decide. This flexibility can be used to evolve different forms of contract and sukuk that may serve different purposes of issuers and the holders.

There are two forms for the Ijarah Sukuk:

a) **Sukuk of ownership in leased assets**

These are certificates issued either by the owner of a leased asset or a tangible asset to be leased by promise, or they are issued by a financial intermediary acting on behalf of the owner with the aim of selling the asset and recovering its value through subscription so that the holders of the Sukuk become owners of the assets.

The certificate holders jointly own the assets through an undivided ownership sharing the profits and losses on the basis of the partnership that exists between them. Such

Sukuk are tradable and redeemable at the market price or at a rate agreed upon between the certificate holder and the issuer.

b) Sukuk of ownership of usufructs of assets

These are Sukuk issued by the owner of an existing asset (or owner of the usufruct of an existing asset (lessee)) with the aim of leasing the asset (or subleasing the usufruct) and receiving the rental from the revenue of subscription so that the usufruct of the assets passes into the ownership of the holders of the Sukuk.

Features of Ijarah sukuk

1. It is necessary for an ijarah contract that the assets being leased and the amount of rent both are clearly known to the parties at the time of the contract and if both of these are known, ijarah can be contracted on an asset or a building that is yet to be constructed, as long as it is fully described in the contract provided that the lessor should normally be able to acquire, construct or buy the asset being leased by the time set for its delivery to the lessee. The lessor can sell the leased asset provided it does not prevent the lessee from taking benefit of the asset. The new owner would be entitled to receive the rentals.
2. Rental in ijarah must be stipulated in clear terms for the first term of lease, and for future renewable terms, it could be constant, increasing or decreasing by benchmarking or relating it to any well-known variable.
3. As per shariah rules, expenses related to the corpus or basic characteristics of the assets are the responsibility of the owner, while maintenance expenses related to its operation are to be borne by the lessee.
4. As regards procedure for issuance of ijarah sukuk, an SPV is created to purchase the asset(s) that issues sukuk to the investor, enabling it to make payment for purchasing the asset. The asset is then leased to third party for its use. The lessee makes periodic rental payments which the SPV will in turn distribute to the sukuk holders.

5. Ijara sukuk are completely negotiable and can be traded in the secondary markets.
6. Ijara sukuk offer a high degree of flexibility from the point of view of their issuance management and marketability. The central government, municipalities, awqaf or any other asset users, private or public can issue these Sukuk. Additionally, they can be issued by financial intermediaries or directly by users of the leased assets.

Steps involved in the structure

- The obligor sells certain assets to the SPV at an agreed pre-determined purchase price.
- The SPV raises financing by issuing sukuk certificates in an amount equal to the purchase price.
- This is passed on to the obligator (as seller).
- A lease agreement is signed between SPV and the obligator for a fixed period of time, where the obligator leases back the assets as lessee;
- SPV receives periodic rentals from the obligator;
- These are then distributed among the investors i.e. the sukuk holders;
- At maturity, or on a dissolution event, the SPV sells the assets back to the seller at a predetermined value. This value should be equal to any amounts still owed under the terms of the Ijara sukuk.

Chart: (Dotted Lines indicate the flow of funds)

1. The company seeks advice from the Investment Bank regarding the issue of securities; an SPV is created for this purpose
2. SPV issues securities to investors;
3. In return, SPV collects funds from investors;
4. SPV pays to Vendor for the purchase of asset;
5. The company as agent of the SPV takes delivery of Assets;

6. Company takes assets from the SPV on Ijarah and makes payment of ijara rentals to SPV;
7. SPV passes them on to investors after deducting mudarib share or wakala fee for itself.

d. **Mudarabah or Muqaradah bonds**

Sukuk-Al-Mudaraba

Sukuk al-mudaraba, commonly referred to as muqarada bonds are the most basic instruments for raising equity capital. Such securities are to be known as muqarada bonds unless the use of the funds is known before hand, such as, in murabaha, ijara, salam or istisna operations, in which case the sukuk are known by the nature of investment. When the funds are invested in any project with a fixed rate of profit, the return on muqarada bonds become fixed. And when the funds are invested in any project with a variable rate of profit, the return on muqarada bonds becomes variable.

As we said, the Muqarada bond is a financial instrument for raising equity capital. To the capital provider, the Muqarada bond is one form of investment. Unit price is determined by dividing the Muqarada capital by the number of units issued. It registers under bondholder name (recorded bonds) all of which represent the common asset in Muqarada capital. This financial instrument is called the Muqarada Sukuk Bonds (MSB.) A Muqarada Bond has the following main elements:

Muqarada Sukuk Bonds represent a common ownership and entitle their holders shares in the specific project which the bonds have been issued for financing purposes. Duration of this ownership will be limited to the duration of the specific project or business on which the Muqarada was based. On the ownership of the Muqarada bonds, a bondholder is entitled to all rights specified by Shari'ah in matter of sale, gift, mortgage and succession.

The contract (aqd) in Muqarada sukuk is based on the official notice of bonds sale, namely the Prospectus. Subscriptions in these bonds (sukuk) are considered as offer from the investors. Approval of the issuer is then regarded as acceptance to the contract. Official

notice of sale must contain all the conditions which are required by Shari'ah in the Muqarada (mudaraba) aqd and the clear information concerning acknowledge of the capital, the proportion and the distribution of profits which are in conformity with Shari'ah rules.

Muqarada sukuk (bonds) on the expiry of the specified time period of the subscription the bondholder is given the right to transfer the ownership by sale or trade, the bonds in the securities market at his discretion, considering that this right has been agreed by the mudarib while the investor entering into the contract of Muqarada bonds.

The disposal or sale of the bonds must observe the following rules:

- i. If, after the subscription period is over and before the operation of the specific project, the Muqarada capital is still in the form of money, therefore, the trading of bonds would be based on the exchange of money for money and it must satisfy the rules of sarf.
- ii. If such capital is still in the form of debt, it must be based on the principle of Islamic debt trading or exchange: debt for debt.
- iii. If such capital is in the form of money, debt, assets and benefits, trade must be based on the market price evolved by mutual consent.

In the distribution of profits, the following rules must be observed:

- i. The mudarib is the person who has received the fund and also been charged with the duty to run the affairs of the specific project or business.
- ii. Profits realized from investment in Muqarada bonds will be distributed between the mudarib and the investor according to the agreement.
- iii. The Mudarib shares with the investor the ownership of the assets in accordance with his participation to the total value of the company/project assets.
- iv. It is not permissible to guarantee a fixed lump sum amount of profits.
- v. The issuer has the right to purchase bonds offered for sale by others according to the prices declared from time to time by the issuer.

- vi. The mudarib is considered as the depositary of the common fund and the project assets entrusted to him. If he is negligent or has committed dishonesty leading to losses, he shall be liable for the losses.

In matters concerning the Guarantee of Muqarada bonds, the following points must be observed:

- i. It is permissible for a third party to promise to compensate any losses sustained in the specific project. However, this guarantee should be concluded in a separate contract and not included in the main contract of the Muqarada bond between the issuer and the investor.
- ii. It is not permissible for the issuer to guarantee the capital of the Mudaraba (the investor would not bear any loss in the value of the bonds) or to guarantee the investor a fixed amount paid as profit.
- iii. It is permissible for the Mudarib and the investor to agree to put aside a specific or certain portion of the profit as reserves to provide for protection or to meet any losses arising during the implementation of the project.”

e. **Musharakah/ Musharakah Mutanakisah bonds**

A. **Musharaka Sukuk**

– **Definition**

Musharaka Sukuk are certificates of equal value issued with the aim of using the mobilized funds for establishing a new project, developing an existing project or financing a business activity on the basis of a partnership contract so that the certificate holders become owners of the project or the assets of the activity as per their respective shares, with the Musharaka certificates being managed on the basis of participation or Mudaraba or an investment agency.

– **Features of Musharak**

As we mentioned previously, Musharakah are investment sukuk that represent ownership of Musharaka equity. It does not differ from the Mudaraba sukuk except

in the organization of the relationship between the party issuing such sukuk and holders of these sukuk, whereby the party issuing sukuk forms a committee from the holders of the sukuk who can be referred to in investment decisions (AAOIFI).

Musharaka Sukuk are used for mobilizing the funds for establishing a new project or developing an existing one or financing a business activity on the basis of partnership contracts. The certificate holders become the owners of the project or the assets of the activity as per their respective shares. These Musharaka certificates can be treated as negotiable instruments and can be bought and sold in the secondary market.

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– **Steps involved in the structure:**

1. A Corporate entity and the Special Purpose Vehicle (SPV) enter into a Musharaka Arrangement for a fixed period and an agreed profit-sharing ratio. In addition, the corporate entity undertakes to buy Musharaka shares of the SPV on a periodic basis.
2. The corporate entity (as Musharik) contributes land or other physical assets to the Musharaka;
3. The SPV (as Musharik) contributes cash i.e. the issue Proceeds received from the investors to the Musharaka;
4. The Musharaka appoints the Corporate entity as an agent to develop the land (or other physical assets) with the cash injected into the Musharaka and sell/lease the developed assets on behalf of the Musharaka;
5. In return, the agent (i.e. the Corporate entity) will get a fixed agency fee plus a variable incentive fee.

6. The profits are distributed to the sukuk holders.
7. The Corporate entity irrevocably undertakes to buy at a pre-agreed price the Musharaka shares of the SPV on say semi-annual basis and at the end of the fixed period the SPV would no longer have any shares in the Musharaka.

B. Musharaka Mutanakisah

– Definition

Another form of Musharakah, developed in the near past, is 'Diminishing Musharakah'. According to this concept, a financier and his client participate either in the joint ownership of a property or an equipment, or in a joint commercial enterprise. The share of the financier is further divided into a number of units and it is understood that the client will purchase the units of the share of the financier one by one periodically, thus increasing his own share till all the units of the financier are purchased by him so as to make him the sole owner of the property, or the commercial enterprise, as the case may be. For transactions which apply the diminishing partnership concept, i.e. Musharakah Mutanaqisah, the Sukuk holders' interest in the venture will reduce over time with payment of Sukuk to the Sukuk holders (by the obligor). Some believe that the Sukuk holders' interests are compromised as its interest reduces over time. However, agreement by the Musharakah party whose interest increases over time to waive his rights to profit payments until all profits and capital payments are made to Sukuk holders is deemed a necessity so as to ensure Sukuk holders' interests are protected throughout the tenure of the transaction.

f. Islamic Asset Backed Securities

– Interpretation

Asset-backed securities or mean private debt securities or Islamic securities that are issued pursuant to a securitization transaction. Such securities shall exclude all debt securities or Islamic securities that are capable of being converted into equity howsoever and whether redeemable or otherwise.

– Requirements

The assets that are the subject matter of a securitization transaction must fulfill all of the following criteria:

1. The assets must generate cash flow;
2. The Originator has a valid and enforceable interest in the assets and in the cash flows of the assets prior to any securitization transaction;
3. There are no impediments (contractual or otherwise) that prevent the effective transfer of the assets or the rights in relation to such assets from an originator to an SPV. For example-
 - a. that the necessary regulatory or contractual consents have been obtained in order to effect the transfer of such assets from an Originator to an SPV;
 - b. that the originator has not done or omitted to do any act which enables a debtor of the Originator to exercise the right of set-off in relation to such assets;
4. The assets are transferred at a fair value;
5. No trust or third party's interest appears to exist in competition with an originator's interest over the assets; and

Where the issue, offer or invitation of Asset Backed Securities is Islamic in nature, the assets that are the subject matter of the securitization transaction must be acceptable in accordance with Shariah principles. In the event of doubt, clarification should be sought from the Shariah Board.

g. **Hybrid Sukuk Issues**

Considering the fact that Sukuk issuance and trading are important means of investment and taking into account the various demands of investors, a more diversified Sukuk - hybrid or mixed asset Sukuk- emerged in the market. In a hybrid Sukuk, the underlying pool of assets can comprise of Istisna, Murabaha receivables as well as Ijara. Having a portfolio of assets comprising of different classes allows for a greater mobilization of funds. However, as Murabaha and Istisna contracts cannot be traded on secondary markets as securitised instruments, at least 51 percent of the pool in a hybrid Sukuk must comprise of Sukuk

tradable in the market such as an Ijara Sukuk. Due to the fact that Murabaha and Istisna receivables are part of the pool, the return on these certificates can only be a pre-determined fixed rate of return.

Steps involved in the structure:

- Islamic finance originator transfers tangible assets as well as Murabaha deals to the SPV.
- SPV issues certificates of participation to the Sukuk holders and receive funds. The funds are used by the Islamic finance originator.
- Islamic finance originator purchases these assets from the SPV over an agreed period of time.
- Investors receive fixed payment of return on the assets.

Conclusion:

In order to accommodate for all these

- Lack of regulatory support from key Islamic markets
- Lack of initiative in developing a separate legal framework for sukuk vis-à-vis conventional instruments
- Lack of harmonization in existing Islamic securitization products and difference of opinions among various Shari'a scholars
- Substantially more documentation and legal due diligence requirement for an Islamic issue
- Limited number of qualified personnel well versed in capital market issues both from Shari'a and commercial perspective
- Small number of Islamic investment banks lacking capability in structuring, originating or arranging capital market transactions.

In the wake of the current wave of oil revenues and increasing demand for Shari'a-compliant products, Islamic capital markets are emerging at a quickening pace and stakeholders are starting to realize the potential. Development of institutional infrastructure in the international for a, such as the establishment of accounting standards and regulatory bodies, are all steps in the right direction. However, for the market to grow further, it also needs

strong leadership and constructive policy actions of host governments, to enable the market participants to originate Islamic finance transactions.

Well-developed Islamic capital markets will not only be beneficial for borrowers and institutional investors, they can also further enhance the stability of Islamic financial institutions, providing them with improved portfolio, liquidity and risk management tools. Ultimately, all these developments will contribute to integrating Islamic financial markets, as well as the people who form these markets, into the framework of the broader conventional international financial system.

Legal Documentation in Sukuk issuance:

a. Legal framework for Islamic capital markets

Regulators in the Muslim world have undoubtedly welcomed the debut of the sukuk market because of the abilities of the product in creating more efficient deployment of domestic liquidity. The product also assists in the process of capital formation by channeling private savings into a range of investment opportunities leading to a process of financial deepening.

However, to invest confidently in the product, the investing public first needs to be assured that the regulatory framework will protect their investments. Secondly, the public needs to be confident that the institutions taking their funds have the technical capability to keep records and ensure the safe custody of assets. The development of the market will undoubtedly continue to witness the creation of new financing structures and also new market participants such as financial intermediaries, dealers, brokers and so on.

Such developments call for the establishment of appropriate regulatory and legal frameworks which will also provide a level playing field for all participants in the market. Malaysia has certainly achieved much in this regard. However, as for the GCC and other Muslim countries of the Middle East, regulators apparently had to make the choice between an immediate full-blown financial infrastructure for the market or a framework within which a gradual evolution of the market could take place as the number, diversity and size of the issues grow. Taking a gradual approach seems to be the case for the moment, although regulators would want to implement international best practice in line with the fast development of events in the market.

b. **Key Documentation of the most common Sukuk Structures**

- Sukuk al Ijarah
Purchase Agreement, lease agreement, servicing agreement, purchase undertaking
- Sukuk al Musharakah
Musharakah Agreement, management agreement, purchase undertaking
- Sukuk al Mudarabah
Mudarabah agreement, purchase undertaking

Ijarah Agreement:

Most of the sukuk issuances to date have been sukuk al ijarah. The Ijarah agreement should be executed independent of the initial asset purchase agreement and the two should not be conditioned one upon the other. Any such conditionality of entering into the purchase of the assets so as to lease them to the seller is not acceptable to the majority of Islamic jurists, who view it as repulsive from a Sharia perspective. In their view, this equates to two agreements in one. However, what appears acceptable in organizing the transaction is the possibility of entering into a general non contractual memorandum of understanding which may be signed prior to the agreements.

The validity of the contract rests in appreciating the fact that the leased assets are the responsibility of the issuer as lessor throughout the duration of the Ijarah. The leased assets in the possession of the lessee are held be the lessee in fiduciary capacity on behalf of the lessor. The lessee is not to be held liable for any damage or destruction of the leased assets unless such damage or destruction is a result of misconduct or negligence on the part of the lessee.

Accordingly, all major maintenance and repairs relating to the assets shall be the responsibility of the lessor, while the lessee will be responsible for ordinary maintenance and repair. Of course, the nature of the works to be undertaken by each party will need to be clearly defined in the contract to avoid any dispute at a later stage. The issuer may, however, delegate to the lessee as agent to undertake on his behalf all maintenance activities that are the responsibility of the issuer, but on condition that this is done at the cost of the issuer. The costs of the arrangement are taken into account in fixing the lease rentals. Often, minor repairs are left to the discretion and expense of the lessee.

Purchase and sale undertakings:

In the case of sukuk al ijarah, transfer of the ownership in the leased asset cannot be made be executing, along with the ijarah agreement, a contract of sale that will be signed in advance and that will become effective at a future date. The sale/purchase contract, in the case of a sale lease-back deal, can only be executed at the time of transferring back the assets to the original owner. However, given the nature of the transaction, the initial

commitments become necessary for the ultimate sell-back of the assets by the lessor to the lessee and for the lessee to buy back the same from the lessor. This may be achievable in line with the Sharia requirements by an initial purchase undertaking entered into by the lessee to ultimately buy the assets from the lessor and a similar initial sale undertaking made by the lessor from the ultimate sale of the assets to the lessee.

However, it should be realized that an undertaking is not a contract and is only binding on the undertaking party while the other party must have the option not to proceed. This is to avoid bilateral undertakings between the two parties that are contradictory from a Sharia perspective, as this would amount to an advance sale/purchase contract combined with the contract of lease. Nevertheless, it is essential that the undertakings are signed/exchanged after completing the initial sale agreement relating to the assets. It should also be noted that the undertakings are separate from the Ijarah agreement and should not be referred to as forming integral parts.

According to shariah scholars, it is preferable to draft these contracts in a shariah compliant manner rather than converting conventional contracts into shariah compliant ones.

c. **Principles of drafting legal documentation**

– **Conventional Requirements vs Sharia Requirements**

Usually, conventional contracts are drafted in a manner to protect the interests of the bank or financial institution. They insert for example several clauses releasing them from any responsibility in case of total loss of the underlying asset. Of course, in a conventional financing transaction, the loss of the asset does not release the borrower from paying the debt. However, according to Shariah, the total loss of the asset leads to

Shariah principles consider that the structure of the contracts should be balanced for both parties and there should be no room for ambiguity that will lead to Gharar.

– **Sequence of execution**

It is very important from a Sharia perspective to sign the contracts in a given transaction in the proper sequence. We can not sign, for example the lease agreement before signing the purchase agreement. Shariah scholars are very keen on this issue.

- **No Ambiguity:**

e. **Types of clauses in documentation**

What not to include:

- Penalty Clause: Usually, in cases of default an amount is paid to charity.
- Illegality Clause: This is usually found in conventional financing agreements which protects the interests of the bank should it become impossible, due to any directive of any central bank central bank or other fiscal directifor it to make available
- Cross references: Shariah scholars would like to see that each contract is independent from the other. Conventional contracts usually, in the definition of terms, give reference to these definitions as mentioned in another contract.
- Increase costs: Nothing in the contract should give any party the right to claim any amounts due to increased costs or other unpredictable payments. Everything should be predetermined otherwise it would lead to Usury (Gharar).
- Taxation: In a Mudaraba agreement, Mudarib is not responsible for taxation. In the event taxes should be paid, these should be born by the Rab UI Mal.

What to include:

- In case of total loss of the asset, the lease should be terminated;
- The underlying asset and the use of it should be clearly described;
- Calculation mechanism of returns should be well defined leaving no room for Gharar; and

f. **Cross border transaction and jurisdiction**

– **Choice of law**

The governing law of the transaction documents and the laws of the jurisdiction in which sukuk assets are located may require significant legal input in order to protect the rights of the sukuk holders, as well as to prevent any impairment to the integrity of the sukuk structure. This is not an elementary process and has significant fall-out in terms of an issuer's prospective cross-listing of sukuk on different exchanges, the choice of asset vehicle and even accounting treatment.

Often sukuk and underlying assets will be documented with a law choice that reflects UK or US law. This may be done to drive enforcement to such courts that investors or financiers deem to be friendlier. The risks in such decision arise when for example UK courts decline to make Shari'a interpretations. In such cases, the underlying transaction may not be Shari'a-compliant or its Shari'a features may be deemed to be unenforceable as they are not documented or are not consistent with local statute.

h. **Conclusion**

– **Challenges**

While legal issues within a domestic financial system can be resolved by the home regulators and Shariah authorities, the integration of Islamic finance with the international financial system brings with it many challenges. There is a need for mutual recognition of financial standards and products across jurisdictions. The progressive harmonization of Shariah, in this respect, needs to be viewed as a driver towards greater international financial integration.

Such a convergence and harmonization can only happen with greater engagement among the regulators, practitioners and scholars in Islamic finance in the international community. The Annual International Shariah Scholars' Dialogue that has been taking place since 2005 is aimed at achieving this objective. This Dialogue has served to promote interactions between Shariah scholars from around the world contributing towards greater understanding and international convergence.

– **Recommendations**

While the legal framework and rules are constantly being reviewed to ensure that they remain relevant for the new areas of financial activity, it should not only be undertaken for the domestic Islamic financial system but also in the context of the international financial system.

Having said that, there is a need for establishing more standards in order to further simplify putting together the necessary documents for a specific sukuk issue. Governments, regulators, shariah scholars as well as investors must play a bigger role in trying to achieve this goal.



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