

Regulating *Sukuk* in the UK: the new framework

HM Treasury (the "**Treasury**") has laid before Parliament the Financial Services and Markets Act 2000 (Regulated Activities) (Amendment) Order 2010 (the "**Order**"), the purpose of which is broadly to ensure that alternative finance investment bonds ("**AFIBs**") (such as *sukuk*) are treated in a similar manner to conventional debt securities for UK regulatory purposes. The Order is scheduled to come into force on 24 February 2010. This follows the recent consultation by the Treasury and the UK Financial Services Authority (the "**FSA**") on the legislative framework for the regulation of *sukuk* and the publication of draft statutory instruments in December 2008 and October 2009.

Sukuk: the regulatory difficulty

The breadth of the definition of "collective investment scheme" ("**CIS**") in section 235 of the Financial Services and Markets Act 2000 ("**FSMA**") makes it a potential trap for those involved in various *Shari'a* based structures, particularly in light of: (a) the principle of mutual co-operation, one of the general principles of Islamic business ethics and norms; (b) the need for an asset capable of generating profits; and (c) the pooling of resources, management of assets and sharing of risk and profits which underpins arrangements such as *Ijara*, *Mudaraba* and *Musharaka*, which in turn underpin *sukuk* - *Shari'a* based certificates representing an undivided interest in an underlying asset or transaction, sometimes referred to as "Islamic bonds".

The classification of any arrangement as a CIS means that anyone wanting to market the arrangement is limited as to whom it may market the arrangement because it amounts to an "unregulated CIS". An unregulated CIS is, essentially any scheme, such as an authorised unit trust, which the FSA does not individually approve. If classified as units in an unregulated CIS, *sukuk* would be treated like units in a hedge fund and could only be marketed in the UK to professional or similar investors, thereby prohibiting access to the retail market. Moreover, where the asset underpinning *sukuk* is located in the UK and the FSA were to treat those *sukuk* as units in a CIS, the holder or manager of the asset would find itself branded, like the trustee of a unit trust, as a CIS "operator" in need of FSA authorisation to avoid sanction for breach of FSMA's General Prohibition on operating a CIS.

It does not necessarily follow that *sukuk* are units in a CIS – the actual structure of *sukuk* may be, and often is, such that they do not fall within the CIS definition. However, the lack of legislative clarity with the consequential need to undertake analysis and often approach the FSA for guidance, which the issuers of conventional bonds no longer battle with as a result of express legislative exclusions, used to place the issuers of *sukuk* at a competitive disadvantage. It is the recognition of this disadvantage which has helped drive the Treasury and FSA's proposed solution for regulating *sukuk*.

The solution: a new type of specified investment

In the consultation on the legislative framework for the regulation of alternative finance investment bonds published on 10 December 2008 (the "**Consultation**"), the Treasury and FSA suggested four policy options for regulating *sukuk* or AFIBs. The first of these options was to: (a) create a new specified investment under the FSMA (Regulated Activities) Order ("**RAO**") with

Key Issues

The Treasury has laid before Parliament an order designed to address the regulatory classification of *sukuk*. The order is scheduled to come into force on 24 February 2010.

Sukuk will be classified as alternative finance investment bonds ("**AFIB**"), a new type of specified investment, and excluded from the definition of Collective Investment Scheme.

The requirement for *sukuk* to be listed in order to benefit from the AFIB exclusion remains.

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a unique regulatory definition of AFIBs for this purpose; and (b) amend the FSMA (CIS) Order ("**CIS Order**") to exclude AFIBs from CIS regulation in light of the new specified investment. As indicated in the summary of responses published jointly by the Treasury and the FSA in October 2009 (the "**Response**"), this was the option chosen. The goal is to regulate AFIBs in an equivalent manner to conventional bonds with the benefit, in the words of the Treasury and FSA, of "[providing] clarity about the regulatory treatment and [reducing] compliance and legal costs for these instruments and thus [facilitating] their issuance in the UK." The Order implements the relevant changes.

In order for *sukuk* or other similar instruments to fall within the definition of an AFIB under the new article 77A of the RAO and, therefore, the amended paragraph 5 of the CIS Order which includes instruments falling within the article 77A definition, they will need to have the following characteristics:

1. **Payment of capital** - the AFIB-holder's payment of an amount of money (the "**Capital**") to the AFIB-issuer;
2. **Identification of assets** - the identification of assets, or a class of assets, which the AFIB-issuer will acquire for the purpose of generating income or gains directly or indirectly ("**AFIB Assets**") (an interpretative provision specifies that this may be assets of any kind, including rights in relation to property owned by someone other than the AFIB-holder, and may be acquired before or after the arrangements take effect);
3. **Fixed term** - the specification of a period at the end of which it ceases to have effect (the "**AFIB Term**");
4. **Structure of payments** - the AFIB issuer's undertaking to: (a) repay the Capital (the "**Redemption Payment**") to the AFIB-holder during or at the end of the AFIB Term (whether or not in instalments); and (b) to pay to the AFIB-holder other payments on one or more occasions during or at the end of the AFIB Term (the "**Additional Payments**");
5. **Amount of payments** - the amount of the Additional Payments must not exceed an amount which would, at the time at which the AFIB is issued, be a "reasonable commercial return on a loan of capital"; and
6. **Listed or traded** - the admission of the AFIB to: (a) an official list within the meaning of the Prospectus Directive; or (b) trading on a regulated market within the meaning of the Markets in Financial Instruments Directive.

The definition is similar to that contained in the draft order which was circulated with the Response. The Treasury and FSA have also added language to make it clear that AFIBs do not fall within the RAO definition of "instruments creating or acknowledging indebtedness", thereby maintaining a distinction between AFIBs and conventional bonds.

In addition to adding an AFIB as a new RAO specified investment, the Treasury and FSA have added it as a new controlled investment for the purpose of the FSMA (Financial Promotion) Order. This will ensure that the financial promotion regime is properly aligned with the RAO and removes the promotion of AFIBs from the FSMA (Promotion of CIS) Order.

Exchanges and Listing

Perhaps the most significant extension, compared to the regime suggested in the Consultation, is the broadening of the category of exchanges and/or lists to which AFIBs can be admitted to fall within the definition. The former proposed definition would have restricted the category of exchanges and/or lists to recognised investment exchanges within the meaning of FSMA, *i.e.* an exchange in respect of which the FSA has made a recognition order. The definition now adopted extends this to include any regulated exchange located in the EEA.

The category of exchanges is, however, more narrow than the HM Revenue & Customs list of recognised exchanges for the purposes of the AFIB definition under the Finance Act 2007. So, whereas *sukuk* listed on, for example, the NASDAQ Dubai would receive the same tax treatment as *sukuk* listed on the LSE, *sukuk* with characteristics 1 to 5 above listed on the NASDAQ Dubai could not be offered to retail investors in the UK, whereas *sukuk* having the same characteristics and listed on the LSE could be.

Moreover, the requirement for an AFIB to be listed places it at a disadvantage as against a conventional bond in respect of which there is no listing requirement in order to qualify for inclusion within the RAO definition of "instruments creating or acknowledging indebtedness" and, therefore, exclusion from the definition of a CIS in the CIS Order. However, the Treasury and FSA have sought to justify their position by reference to the risk of regulatory arbitrage, *i.e.* "*the risk that the exclusion from being classified as a CIS is exploited by instruments not intended to be excluded*". They also point to the fact that the tax regime for AFIBs also requires a listing.

Analysis

Legal certainty is necessary for doing business and in this regard the express recognition of *sukuk* is most positive. Some may argue that the solution is not perfect and that the Treasury and FSA have not completely achieved their

stated desire to create a "level playing field" between *sukuk* and conventional bonds. Moreover, the new framework does not cover all types of *sukuk* (some of which are more akin to equity or equity-linked instruments). However, few regulatory solutions are ever perfect. Moreover, regulatory certainty does not equate to *Shari'a* certainty – *sukuk* which comply with the requirements for an AFIB, thereby avoiding classification as units in a CIS, are not necessarily also *Shari'a* compliant. The question of *Shari'a* compliance will remain one for the *Shari'a* Supervisory Board charged with approving the *sukuk* and the investors who choose to purchase the *sukuk*. As the FSA has indicated, it is a secular and not a religious regulator, and the Order should be seen for what it is: a regulatory solution to the unforeseen consequence of a broad definition in a financial services sector on the rise.

Link to Order: http://www.opsi.gov.uk/si/si2010/pdf/uksi_20100086_en.pdf

Link to Consultation: <http://www.fsa.gov.uk/pubs/cp/sukuk.pdf>

Link to Response: http://www.fsa.gov.uk/pubs/cp/afibs_sukuk.pdf

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