FUND STRUCTURING: SHARIAH COMPLIANT FUNDS IN GUERNSEY

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Guernsey has traditionally been a favoured domicile for Shariah compliant structures. In an article for IFC Review, Carey Olsen Counsel Andrew Tually and IQ-EQ Chief Commercial Office Jacques Vermeulen discuss the principles underpinning Shariah-compliant investments and some particular fund structuring techniques for Shariah investors.

We are seeing renewed interest in these types of structures – particularly from managers who have not previously targeted Shariah investors - as sovereign wealth funds, pension funds and HNW individuals from the Middle East and South East Asia diversify into alternative assets like private equity, and traditional or "western" managers look to expand into the Shariah market by establishing bespoke feeder or parallel funds in Guernsey which offer a Shariah compliant route into their conventional funds. With the introduction of new fast-track regimes to attract overseas managers/funds to Guernsey, we hope to see more promoters enter this space in future.

Shariah law v traditional or 'western' investment models

Shariah law is Islam's legal system. It is derived from both the Qur'an, Islam's central text, and fatwas - the rulings of Islamic scholars. The three main tenets of Shariah law that are relevant in this article are the prohibition of riba, meaning interest; the prohibition of gharar, meaning unacceptable levels of risk or uncertainty; and the prohibition of investments in sectors prohibited by Shariah law, like gambling, tobacco and alcohol.

Such restrictions are typically incompatible with traditional/western models of investment which involve a fixed return component or riba, or otherwise require Shariah investors to be excused from investments on the basis they are not halal. In private equity funds, interest-bearing debt at the portfolio company level and with any Guernsey holding companies can be of concern to Shariah investors. In addition, fund documents must be tailored to remove instances of riba which would typically apply - for example, when a fund charges interest on late contributions or when the investment policy permits the fund to invest surplus cash in interest-bearing temporary investments.

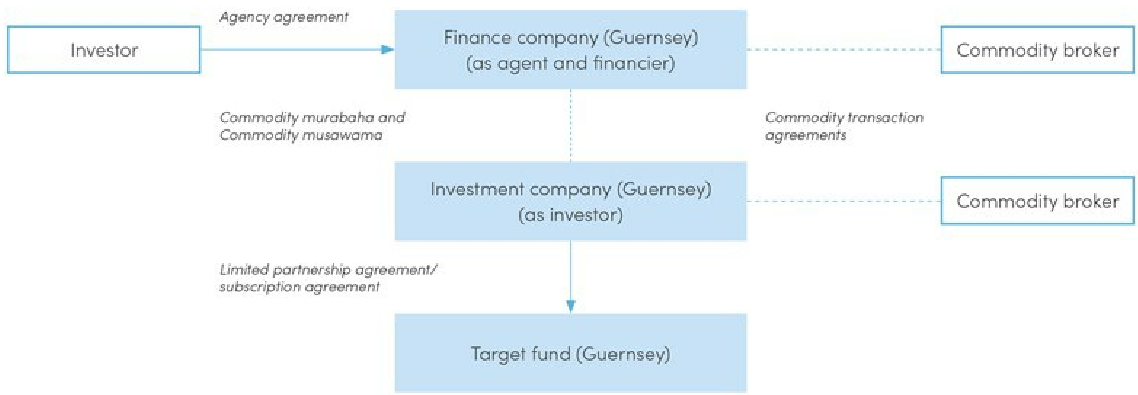
For all of these reasons it is normal to establish separate feeder or parallel fund vehicles for Shariah investors so that investment terms can be tailored for them and/or to permit them to be excused from investments which are not halal. These vehicles can be structured as limited partnerships issuing partnership interests, trusts issuing units, trust interests or certificates, and protected cell companies.

Alternatively, a manager with a predominantly Middle Eastern client base may choose to launch a Shariah compliant 'stand-alone' fund. As with the Shariah compliant feeder or parallel vehicles, such a fund would usually be signed off as Shariah compliant by an Islamic scholar so that it can be marketed to investors seeking Shariah compliant investments.

Naturally, any manager would weigh the cost/time implications and inherent complexity in managing multiple vehicles against the significance of the financial contribution to be made by the Shariah investors.

Structuring techniques

There are numerous techniques to achieve Shariah compliant investments, all of which have at their core an interest-free component. Ultimately, the goal is to allow Shariah investors to indirectly invest into a traditional/western target fund (e.g. real estate or a Private Equity fund) in a manner that complies with Shariah principles whilst also treating the investor, from an economic perspective, as if they were a direct investor in the target fund. A common approach is use one or more Guernsey holding companies in a Shariah compliant financing (typically, a commodity murabaha, which is a financing technique involving the purchase and sale of underlying assets at pre-determined prices). The proceeds of the Shariah compliant financing are then applied towards an investment in the underlying target fund. There is no Guernsey tax leakage as the Guernsey holding companies are tax neutral in Guernsey. There are no capital gains taxes and no withholding taxes in Guernsey in this context.



Other considerations

Because Shariah compliant structuring often involves interposing various holding companies between the investor and the target fund, there is a lack of direct contractual nexus between the investor and the target fund. It is therefore usual to prepare a Wa'd, which acts as a guarantee that in the event of a default or insolvency event within the holding structure then the ultimate Shariah investor repay the financing in full.

From an administration perspective, the administrator, such as IQ-EQ, works closely with advisers to ensure that repayment dates under a murabaha contract are aligned with the distribution cycle of a fund to guarantee that cash is passed up a structure efficiently.

Why Guernsey?

Guernsey is a preferred destination for such structures because of its political and economic stability, its trusted legal system and tax neutrality; its pragmatic and proportionate regulation, meaning some or all parts of the structure can be unregulated (if desired); and world-class legal, accounting and administration service providers who regularly deal with Shariah compliant structures.

Guernsey has also traditionally had strong ties with the Middle East and South East Asia and we have developed close relationships with clients and advisers in those regions including the Shariah committees or board of advisors that review the structures and issue opinions as to their compliance with Shariah principles.

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