

# 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 collective investment scheme, which the FSA (or an equivalent European regulator) 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 treats those *sukuk* as units in a CIS, the holder or manager of the asset would find itself treated, 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 is not necessarily the case 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 (something the issuers of conventional bonds no longer have to do, 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

## **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.

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

*Sukuk* will be required to be listed or traded on a regulated market in order to qualify as AFIBs and benefit from the CIS exclusion remains.

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regulating *sukuk* or AFIBs. The first of these options was to: (a) create a new category of investment under the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 ("**RAO**") with a unique regulatory definition of AFIBs for this purpose; and (b) amend the Financial Services and Markets Act 2000 (Collective Investment Schemes) Order 2001 ("**CIS Order**") to exclude from CIS regulation this new category of 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, for them to benefit from the new exclusion contained in the amended paragraph 5 of the CIS Order, which refers to instruments falling within the article 77A definition, they will need to have the following characteristics:

1. **Payment of capital** - the payment by the AFIB-holder 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**"); these 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** – an undertaking by the AFIB-issuer: (a) to 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 the 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 making an AFIB a new category of investment under the RAO, the Treasury and FSA have added it as a new controlled investment for the purpose of the Financial Services and Markets Act 2000 (Financial Promotion) Order 2005. This will ensure that the financial promotion regime for AFIBs is properly aligned with that for conventional bonds.

### Listing and Trading

Perhaps the most significant extension, compared to the regime suggested in the Consultation, is the broadening of the category of lists or markets to which *sukuk* can be admitted and still fall within the definition of AFIB. The Consultation restricted the category of exchanges and/or markets 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 adopted extends this to include any regulated exchange or regulated market located in the EEA.

The category of exchanges is, however, narrower than the HM Revenue & Customs list of recognised exchanges for the purposes of the Finance Act 2007. So, whereas *sukuk* listed on, for example, the NASDAQ Dubai would receive the same withholding tax treatment as *sukuk* listed on the London Stock Exchange, *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 London Stock Exchange could be.

Moreover, the requirement for an AFIB to be listed or traded on a regulated market places it at a disadvantage as against a conventional bond in respect of which there is no equivalent requirement in order to qualify for 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 UK tax regime also requires a listing in order to qualify for a withholding tax exemption.

## Analysis

Legal certainty is important 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.

**Link to Order:** [http://www.opsi.gov.uk/si/si2010/pdf/uksi\\_20100086\\_en.pdf](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](http://www.fsa.gov.uk/pubs/cp/afibs_sukuk.pdf)

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