THE CITY OF LONDON LAW SOCIETY

4 College Hill
London EC4R 2RB

Telephone 020 7329 2173
Facsimile 020 7329 2190
DX 98936 – Cheapside 2
mail@citysolicitors.org.uk
www.citysolicitors.org.uk

BY E-MAIL

Ms Aviva Rosen
Room 3/W2
Financial Services Strategy
HM Treasury 1 Horse Guards Road
London SW1A 2HQ

Email address: Islamic.finance@hm-treasury.x.gsi.gov.uk

16 November 2009

Dear Ms Rosen

Comments on the legislative framework for the regulation of alternative finance investment bonds (sukuk)

The City of London Law Society ("**CLLS**") represents approximately 13,000 City lawyers through individual and corporate membership including some of the largest international law firms in the world. The members of the Committee have particular experience in relation to the establishment and regulation of all types of domestic, EU and third country funds and represent firms with international fund establishment practices. Our comments are not therefore made solely from a UK perspective.

These are comments of the Regulatory Law Committee of the City of London Law Society (**CLLS**) to the "Summary of responses" document published in October 2009 by HM Treasury and the Financial Services Authority (**FSA**) in respect of the (sukuk).

A number of firms whose partners are members of the Regulatory Law Committee have been active in advising on *sukuk* issues and have had to address the issues which were raised in the joint consultation paper of HM Treasury and the FSA on the legislative framework for the regulation of alternative finance investment bonds, published in December 2008 (the **Initial CP**).

In this letter we refer to alternative finance investment bonds as "**AFIBs**", and to the Summary of responses document as the "**Feedback Statement**".

Executive Summary

We welcome the decision to implement Option 1 of the four policy options set out in the Initial CP, which is the option we favoured in our response last March.

The Annex to this letter contains our full comments on the draft Statutory Instrument which is annexed to the Feedback Statement. These are summarised below:

- We have some significant concerns about the "reasonable commercial rate of return clause" which we consider inappropriate in determining the regulatory perimeter, particularly given the criminal law consequences of breach of the perimeter – we believe this approach is unprecedented;

- We consider that the definition could be improved in several other respects which are consistent with the policies stated in the Feedback Statement; and

- We mention some corrections to, and other points on, the Consequential Amendments set out in the Schedule to the draft Statutory Instrument annexed to the Feedback Statement.

Please let us know if you would like us to clarify any of our comments.

Yours sincerely

Margaret Chamberlain
Chair, CLLS Regulatory Law Committee

Members of the CLLS:

Chris Bates, Clifford Chance
David Berman, Macfarlanes
Peter Bevan, Linklaters
Patrick Buckingham, Herbert Smith
John Crosthwait, Slaughter and May
Richard Everett, Lawrence Graham,
Robert Finney, Denton Wilde Sapte
Ruth Fox, Slaughter and May
Jonathan Herbst, Norton Rose
Mark Kalderon, Freshfields Bruckhaus Deringer
Nicholas Kynoch, Mayer Brown International
Tamasin Little, S J Berwin
Simon Morris, CMS Cameron McKenna
Rob Moulton, Nabbaros
Bob Penn, Allen & Overy
James Perry, Ashurst
Richard Stones, Lovells

ANNEX

City of London Law Society Regulatory Committee

Comments on the Draft Statutory Instrument annexed to the Summary of Responses to the HM Treasury/FSA Consultation on the legislative framework for the regulation of alternative finance investment bonds (*sukuk*)

This response is in three parts:

- Concerns about the "reasonable commercial rate of return clause";
- Other improvements to the definition; and
- Points (including corrections) on the Consequential Amendments set out in the Schedule to the draft Statutory Instrument.

1. Concerns about the "reasonable commercial rate of return clause"

The concerns we expressed in our March response were acknowledged in the Feedback Statement. However, a crucial point seems to have been ignored, namely that in the context of financial regulatory perimeter, a misjudgement about the reasonableness of a rate of return can lead to commission of a criminal offence whereas in a tax context it merely affects the tax treatment (and therefore the economics) of a transaction. Whilst the latter is likely to be of great significance to the parties (including investors), it is of a different nature to the liabilities imposed for breach of the perimeter under the Financial Services and Markets Act 2000 (**FSMA**).

We believe that it is unusual and perhaps unprecedented to define a product or service in financial regulation by reference to financial numbers and this type of assessment, rather than by reference to structure, purpose and legal terms. We consider that this is not only inappropriate, but will create substantial uncertainty, and undermine the very clarity and cost benefits of reform which were extolled by the Initial CP (e.g. at paragraph 3.3).

Whilst the draft perimeter guidance proposed by the FSA is helpful so far as it goes, its comfort is limited because the judgment about the reasonableness of a rate of return depends on the particular facts (as the FSA indicates in draft paragraph PERG 2.6.11H G (5)), and in any event the FSA's views are not binding on a court. We expect that the FSA would be unwilling to give individual guidance in a particular case that a proposed return is reasonable.

However, one possible means of reduce uncertainty would be to provide that a certification by an EEA listing authority, in accordance with rules and arrangements approved by HM Treasury for this purpose, would be conclusive evidence that the bond satisfies Article 77A(2)(e).

2. Other improvements to the definition

Consideration

We would urge you to amend the definition to allow for consideration in kind. Without this, AFIBs will not be available in situations where conventional debt securities are commonly used, for example as part (or alternative) consideration in a corporate acquisitions and (importantly in the current climate) in restructurings. Indeed, restructurings where an existing sukuk is substituted for a new sukuk would be

impossible. Indirectly, this also place Islamic equity investors at a disadvantage when considering a takeover offer, since they cannot be offered AFIBs in part or full consideration of their shares. Even if the AFIBs were not Qualifying Corporate Bonds for tax purposes[1], there could nevertheless be capital gains tax reasons for issuing them in these circumstances.[2]

Curiously, although draft Article 77A(2)(h) would allow AFIBs to be redeemed through an issue of securities, (2)(a) means that those securities could not themselves be AFIBs.

Redemption payment

The Feedback Statement seems to suggest that the term "repayment" in draft Article 77A(2)(d)(i) could be replaced by reference to redemption, but the annexed draft does not do so.

Although the Feedback Statement acknowledges (at paragraph 2.13) concerns about this term, and at paragraph 2.14 suggests that an alternative term will be used, no change has been made to 77A(2)(d)(i) from last December's Initial CP. We suggest that one of the following as an alternative:

- '(i) to make a payment of capital ("the redemption payment") to..'
- '(i) to make a redemption payment in respect of capital ("the redemption payment") to...'
- '(i) to pay back the capital (such payment being "the redemption payment") to...'

Mandatory Listing

We believe that the views expressed by HM Treasury and the FSA on this matter, in paragraphs 2.31to 2.33 of the Feedback Statement do not recognise the key distinction between, on the one hand, the purposes and effects of the regulatory perimeter and the FSA's consequent definition of categories of permissions, and the tax provisions on the other. That the UK tax regime requires a listing for treatment of sukuk as Qualifying Corporate Bonds does not mean that non-listed sukuk should be collective investment schemes (**CIS**) for the purposes of the regulatory perimeter and the permissions of FSA-authorised firms.

We would therefore encourage HM Treasury to follow the making of the Statutory Instrument with further work on conditions under which non-listed sukuk (or sukuk listed/traded outside the scope of draft Article 77A(2)(f)) could be treated as AFIBs, with a view to amending the definition in advance of the 2-year review of the AFIBs regime. See further issue raised below in respect of "Business Angel-led Enterprise Capital Funds".

3. Schedule to the draft Statutory Instrument (Consequential Amendments)

We have several points on or corrections to provisions in the Schedule to the draft Statutory Instrument, as annexed to the Feedback Statement.

Corrections:

---

[1] Because section 48A of the Finance Act 2005 also applies only to arrangements where the bond is subscribed in cash.

[2] Generally, if non-equity securities are received as consideration in a takeover then, if they are not Qualifying Corporate Bonds, they are treated in the same way as shares received in a takeover.

- Paragraph 3(e), amending the RAO:[3] the word "issues" should be "issued";
- Paragraph 7(c), amending the FPO:[4] insert a comma before "15A".

Business Angel-led Enterprise Capital Funds

The disadvantage of the mandatory listing requirement for AFIBs is emphasised by the somewhat absurd changes to the provisions in the RAO and FPO concerning Business Angel-led Enterprise Capital Funds. That regime is all bout excluding from the CIS provisions of the FSMA, certain types of CIS which invest in unlisted securities (or listed securities of companies whose equity is unlisted). It is odd then to extend safe harbours to allow them to invest in sukuk but only those which are listed!

[3] The Financial Services and Markets Act 2000 (Regulated Activities) Order 2001, as amended, commonly referred to as the Regulated Activities Order.

[4] The Financial Services and Markets Act 2000 (Financial Promotion) Order 2005, as amended, commonly referred to as the Financial Promotion Order.