



association of the  
luxembourg fund industry

**guidelines**

# **Islamic Funds**

## **Collection of best practices for setting-up and servicing Islamic funds**



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## background and definitions

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## Background and definitions

Luxembourg is one of the largest domiciles and servicing locations for international investment funds. Therefore it is only natural that it has also been home to some of the first “Islamic” funds set up and serviced in a non-Muslim country. The first Luxembourg domiciled “Islamic” funds were launched in the early nineties.

Since 2008, there has been a major global focus on this particular market segment and its potential for future development and growth. All major financial centres positioned themselves to various degrees in this market. In Luxembourg, ALFI decided, back in 2008 to create the ALFI Middle East and Islamic Finance working group, which rapidly became a very active group. This was a testimony to the interest shown by the industry in this market segment. Luxembourg for Finance was furthermore tasked by the Ministry of Finance to set up a dedicated task force to look at the possibilities Luxembourg could offer to all areas of the financial sector including, funds, banking, insurance and stock exchange listings. Finally, the tax authorities issued two circulars in relation to Islamic financial products.

The aim of the present document is to give service providers in Luxembourg guidance as to how “Islamic” funds should be set up and serviced. It should also allow fund managers aiming to set up a fund in Luxembourg to understand how the Shariah principles will be applied from an operational perspective to their funds. The document should be considered as a collection of best practices and is neither to be considered as a rule, nor a circular or a regulation.

“Islamic” funds or “Shariah” funds (hereinafter referred to **Islamic** funds) are fund vehicles, which follow the religious laws (hereinafter referred to as “**Shariah**”) laid down by the Holy Qu’ran. For believers, they may therefore be considered as funds with a “religious” connotation, whereby for non-Muslim investors, they frequently fall under the category of ethical or socially responsible funds.

Islamic funds can follow the Shariah to various degrees, depending on the desires of the fund promoters and managers as well as the expectations of the target investor base. Such degrees may vary from strict adherence to the letter and the spirit of the Shariah (“**Shariah compliant funds**”) to a more simplistic approach of funds whose investment strategy is to follow an Islamic index (“**Shariah friendly funds**”).

**legal situation**

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## **1. Law of 17 December 2010 and Law of 13 February 2007**

### **1.1. Applicable laws**

Shariah compliant undertakings for collective investment in transferable securities (“UCITS”) have, as a matter of principle, to be set up in accordance with the provisions of Part I of the law of 17 December 2010 on undertakings for collective investments (the “2010 Law”).

Other UCIs may be established under Part II of the 2010 Law or the law of 13 February 2007 (the “2007 Law”) on specialised investment funds (the “SIF”). Such UCIs must comply with the provisions of the 2010 Law and 2007 Law and any other applicable laws and regulations at all times during their existence. Particular attention should be paid to the eligibility of assets for UCITS created under the 2010 Law. The same laws apply to all Luxembourg UCIs, whether in addition they follow specific rules (such as the respect of Islam, ethical or environmental principles, etc.) or not.

### **1.2. Investment strategies**

The principles of Shariah in the area of Islamic finance such as the prohibition of (i) interest for the mere use of money, (ii) speculation or (iii) financing of a certain number of commodities or activities shall be reflected in the documentation of Shariah compliant UCIs as an investment strategy. Shariah compliant UCIs are thus comparable to ethical or socially responsible UCIs applying similar screening mechanisms on investments.

Any references to interest payment or exposure to non-permitted activities shall be removed and/or excluded from the Shariah compliant UCIs documentation.

Provisions relating to the screening of financial instruments for Shariah compliance and specific advisory mechanisms have to be described in the documentation. Handling of potential deviation to such principles should also be described in the documentation.

### **1.3. Discrepancies between Luxembourg Law and Shariah principles**

Luxembourg’s current legal framework offers flexibility for the implementation of Shariah compliant investment strategies. It must however be noted that Shariah compliant UCIs must at all times comply with applicable Luxembourg laws and regulations and that in case of discrepancies between Luxembourg laws and regulations and Shariah principles, Luxembourg laws and regulations prevail.

### **1.4. Legal documentation**

The documentation of Shariah compliant UCIs should clearly outline the governance as well as the duties and responsibilities of the service providers appointed by such fund or its management company in connection with Shariah compliance. It could furthermore be specified whether the relevant service providers are themselves set up as a Shariah compliant company or not.

Although the service providers do not themselves need to be Shariah compliant, they must offer the services without violating Shariah principles.

The Shariah specific features should be outlined in the prospectus of the UCI with adequate risk warnings (if required) and specified in more detail in the relevant service provider agreements.

### 2. Shariah or Islamic law

For the ease of understanding of the guidelines in this document, the following general definitions of principles are provided.

Shariah or Islamic law governs the financial relationships involving entrepreneurial investment subject to the moral prohibition of (i) interest earnings or usury (“**riba**”) and money lending, (ii) sinful activity (“**haram**”) such as direct or indirect association with lines of business involving alcohol, pork products, firearms, tobacco, and adult entertainment, (iii) speculation, betting, and gambling (“**maisir**”), including the speculative trade or exchange of money for debt without an underlying asset transfer, (iv) the trading of the same object between buyer and seller (“**bay’ al inah**”), as well as (v) preventable uncertainty (“**gharar**”) such as all financial derivative instruments, forwarding contracts, and future agreements.

As opposed to conventional finance, where interest represents the contractible cost for funds tied to the amount of principal over a pre-specified lending period, the central tenet of the Islamic financial system is the prohibition of **riba**, whose literal meaning “an excess” is interpreted as any unjustifiable increase of capital whether through loans or sales. The general consensus among Islamic scholars is that **riba** covers not only usury but also the charging of interest and any positive, fixed, predetermined rate of return that is guaranteed regardless of the performance of an investment. Since only interest-free forms of finance are considered permissible by the Shariah, financial relationships between financiers and borrowers are governed by shared business risk (and returns) from investment in lawful activities (“**halal**”). Islamic law does not object to payment for the use of an asset, and the earning of profits or returns from assets are indeed encouraged as long as both lender and borrower share the investment risk together.

Profits must not be guaranteed based on assumption and can only accrue if the investment itself yields income. Any financial transaction under Islamic law assigns to

investors clearly identifiable rights and obligations for which they are entitled to receive commensurate return.

Hence, Islamic finance literally “outlaws” capital-based investment gains without entrepreneurial risk. In light of these moral impediments to “passive” investment and secured interest as form of compensation, Shariah compliant lending in Islamic finance requires the replication of interest-bearing, conventional finance via more complex structural arrangements of contingent claims.

#### 2.1. Islamic Funds

Islamic funds are similar to conventional funds, to the extent that they share common objectives, such as pooling investors, preserving the capital and optimising the return. However, in contrast to conventional funds, Islamic funds must invest in conformity with Shariah principles. To that extent, an Islamic fund has to comply with the following general obligations:

- It is only allowed to carry out Shariah compliant investments;
- Industry and financial screening must be performed to ensure compliance with Shariah;
- A Shariah board or Shariah advisor with at least one recognised Shariah scholar should be appointed;
- Regular Shariah audits or reviews must be conducted either by the Shariah board, the Shariah advisor or by an external specialised and recognised third party;
- In the event non Shariah compliant income is received by the fund, it must be purified by being donated to charitable institutions;
- In no event, not even in case of failed trade and/or late payments, interest can be charged.

Investment funds are defined by the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) as: “Funds are investment vehicles, which are financially independent of the institutions that establish them. Funds take the form of equal participating shares/units, which represent the shareholders’/unitholders’ share of the assets and entitlement to profits or losses. The funds are managed on the basis of either *mudaraba* or agency contract”.

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There are many types of Islamic funds such as Islamic index funds, Shariah private equity funds, Sukuk funds, Shariah compliant hedge funds, Islamic equity funds, Shariah compliant ETFs, Islamic REITs, *murabaha* funds, Islamic commodity funds and *ijara* funds.

It is in principle possible to set up Islamic sub-funds in a Luxembourg domiciled conventional umbrella fund. However, in such a case, it must be ensured that all Shariah principles apply on sub-fund level and that the fund is set-up with a clear segregation of responsibilities on sub-fund level. Investors into the conventional sub-funds of such an umbrella fund may not be impacted directly or indirectly by the Shariah principles.

## 2.2. Shariah screening

When an Islamic fund is contemplating to carry out an investment in equity, screening has to be done to ensure that the underlying company's level of Shariah compliance is acceptable. Screening is essentially applied at two levels: (i) the business activity and (ii) the financial structure.

It is important to remember that screening is not only applied at the time the investment decision is taken but also after the investment has taken place, on a regular basis, to ensure that the target companies are still Shariah compliant.

The business activity screening aims to exclude investments in companies dealing with haram activities/products such as:

- Companies that produce/sell/trade/slaughter/distribute pork-related products;
- Companies that promote pornography or adult entertainment in any form;
- Companies whose activity involves gambling, such as casinos, lotteries, betting companies, Internet gambling;
- Companies active in the conventional banking and insurance;
- Companies primarily active in the pure entertainment business, such as movies, theatre, cinema;
- Companies active in the defence or weapons industry;
- Companies active in the tobacco or alcohol business (this includes producers, sellers and distributors); *and*

- Any other type of company that might be prohibited by the Shariah board.

Although some business activities are very easy to monitor, others are more difficult to determine precisely. Many halal businesses such as grocery stores, supermarkets, airlines, hotels and restaurants may derive part of their profits from prohibited activities such as selling alcohol.

In these cases, Islamic scholars generally allow Islamic funds to invest in such halal businesses on condition that the income derived from that prohibited activity is no more than 5% of the companies' total income and that any dividends received as a result of investing in these companies are purified. The purification principle is relatively straight-forward and involves donating to a charitable organisation 5% of the dividends received from that particular investee company as it is deemed to be attributed to the non Shariah compliant activities (this percentage may vary depending on the opinion of the specific scholars).

Most Islamic scholars agree on the fact that it is very difficult to find investee companies that are completely Shariah compliant with no conventional debt and no interests on their balance sheet. Therefore, the Islamic finance community has developed three general cumulative tolerance criteria to govern Shariah compliant equity investments. There are a few slightly different versions of these criteria and the following is one example.

The first criteria aim at restricting the amount of interest-based debt in the balance sheet of target companies. To that extent, companies whose interest-based debt divided by their 12-month average market capitalisation exceeds or is equal to 33% will not be considered as Shariah compliant and are therefore prohibited.

The second criteria aim at restricting investment in companies with excessive accounts receivable. Indeed, companies whose accounts receivable divided by their 12-month average market capitalisation exceeds or is equal to 33% will not be considered as Shariah compliant and are therefore prohibited.

The third criteria aim at restricting investment in companies with excessive amounts of interest-bearing securities and cash. To that extent, companies whose total cash and interest-bearing securities divided by their 12-month average market capitalisation exceeds or is equal to 33% will not be considered as Shariah compliant and are therefore prohibited.

To facilitate the investment decision for Islamic fund managers, many index providers have launched Shariah compliant versions of their indexes (e.g. Nasdaq, MSCI, Dow Jones, FTSE, S&P...). This has been achieved by implementing a technology, which automatically removes from the conventional index all companies that fail to comply with business activity and

financial screenings. It is worth noting that the screening criteria can be different depending on the index. Therefore, depending on the Shariah compliance sensitivity of their investors, Islamic funds might decide to invest in one Islamic index instead of another.

**2.3. Portfolio purification and Zakat**  
Zakat (“Zakat”) and purification are two entirely different, though not unrelated, matters. The literal meaning of Zakat is purification but in reality refers to an Islamic tax - one of the 5 pillars of Islam. The meaning of purification in portfolio management is the cleansing of an investment portfolio of impure elements. Such “impure” earnings must be quantified and then purified.

### 3. Shariah Board or Shariah advisor

#### 3.1. Definition

The Shariah Board (the “**Shariah board**”) can be defined as a collegial body composed of jurists hired by a public or private institution to ensure compliance of transactions with legal and ethical Islam principles (Ould Sass, 2009). In the governance structure of an investment fund, the Shariah board can be thought of as a committee of Muslim Scholars (the “**scholars**”), acting as an advisory board to the fund.

The Shariah board will issue a certification (the “**fatwa**”), i.e. a confirmation that the fund structure and its investment policy are set up with prescribed Shariah principles. Luxemburg domiciled funds may also opt to appoint a single individual who will be the Shariah advisor (the “**Shariah advisor**”) to the fund.

Shariah Boards for different companies will usually have different Scholars. However, the Shariah board consists of those that are knowledgeable in Shariah principles, either from economic, legal or religious standpoints and when working in the finance field, they will usually have Fiqh-al-Muamalat knowledge and experience. They will also usually be members of either AAOIFI (Accounting and Auditing of Islamic Financial Institutions based in Bahrain) or IFSB (Islamic Financial Services Board based in Malaysia).

#### 3.2. Role and responsibilities

The historical functions of a Shariah board or a Shariah advisor are in the ethical-religious legitimisation and the issuance of fatwas certifying the Islamic financial products.

The Shariah board’s or the Shariah advisor’s role consists generally in validating or rejecting target investments that are submitted to its perusal and expertise, as well as contributing to the design of new solutions while trying to help executives make the right choice in terms of products. Those decisions can not be in contradiction with the provisions of the Luxembourg law.

In Luxembourg company law as well as in the laws on investment funds, there are no provisions in relation to the responsibility of a Shariah board or a Shariah advisor. As such and unless the Shariah advisor is also a member of the Board of directors of the fund or the management company, the specific responsibility is not covered by Luxembourg law, but only on the basis of contractual arrangements between the Fund or the management company and the Shariah board or Shariah advisor.

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### 3.3. Qualification and appointment

From a pure legal perspective, there is no requirement for any Luxembourg domiciled Islamic fund to establish or have the approval of a Shariah board. Furthermore, when a fund promoter envisages to establish a Shariah board or appoint a Shariah advisor, neither the laws or regulations nor the *Commission de Surveillance du Secteur Financier* (the “CSSF”) requires specific conditions to this regard. Unless, the Shariah advisor is also a member of the Board of directors of the fund or the management company, the appointment is not subject to individual approval by the CSSF. The CSSF currently considers the Shariah board as an advisory committee or the Shariah advisor as an individual advisor to the fund.

Some suggest that the qualifications of members of Shariah boards are modeled to those previously required for the exercise of *ijtihad*. As such, member of a Shariah board should be a lawyer who has the competence required for *ijtihad* practice<sup>1</sup>. This competence is subject to the need to fulfill very specific conditions. They can be summarised in six conditions for which there is a broad consensus among scholars:

- Good knowledge of the principles of Islamic law;
- Sufficient knowledge of Arabic;
- Master the methodology of reasoning concerning the interpretation of the founding texts i.e. the Qu’ran and Hadith duly authenticated;

- Well educated in terms of standards and rules of caselaw;
- Sufficient knowledge of the issues consensus<sup>2</sup>.
- Approval of his peers as a scholar particularly in terms of *Fiqh*.

Guidelines and standards concerning the Shariah governance system are further described by the two different authorities mentioned before: AAOIFI and IFSB.

In practice, the appointment of the Shariah board or Shariah advisor is based on a decision of the board of directors or the management company of the fund.

According to the standards proposed by the AAOIFI, in case of appointment of a Shariah board as opposed to a single Shariah advisor, a Shariah board should consist of a minimum of three members and should not include among its members a director of the institution or a shareholder having a significative influence.

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1 M. Al-Baali, “Al-Fiqh al-li Madkhal Bounouk-Al-Islamiya,” book published in Arabic by the former Union of Islamic Banks, Cairo, 1983 p.155.

2 Due to the fact that the doctrinal divergence marks relatively the Islamic law, knowledge of the issues of consensus is often referred to as critical by the *oulémas*. It should be noted that in *Fiqh* applicable in Islamic finance consensual *fatwas* cover nearly 90% of cases according Sheikh Nizam Yaqubi, president of several SB of banks and Islamic financial institutions.

### 4. Know your Customer (“KYC”) and Anti Money laundering procedures (“AML”)

The general laws and regulations on KYC and AML as well as the rules relating to counterfeiting of financing of terrorism applicable to Luxembourg domiciled investment funds apply to Islamic funds in the same manner than to conventional funds. Investors into Islamic funds do not need to be of Muslim origin and Luxembourg domiciled

Islamic funds are open to Muslim and non-Muslim investors. However restrictions might apply if applications for subscriptions would be submitted from institutions or organisations engaged in a non Shariah compliant activity. In principle, there is no requirement to verify if the money used to pay for subscription is derived from a Shariah compliant activity.

## fund set-up

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Sales documents of Luxembourg funds may be adapted to some specificities and requirements of Shariah. However there are no strict guidelines neither from Luxembourg supervisory authority nor from any other public or private entity as to the content of the documents required for the set up of an Islamic fund.

Similarly, there is no Luxembourg label or certificate which would confirm the Shariah compliant character of a fund based on the content of its documents.

The below is consequently based on standard best practice.

## 1. Prospectus

There are no specific legal requirements regarding the drafting of the prospectus of an Islamic under Luxembourg law. However, it is a common practice that Islamic funds insert specific provisions in the prospectus in line with Shariah principles and which provisions can be summarized as follows:

### Investment policy and restrictions

- General description of the investment policy in relation to Shariah principles, including definitions of terminology used;
- Ban of investments in any interest bearing assets/debt instruments and as the case may be confirmation that assets will be kept on non-interest bearing accounts;
- Ban on futures or forward contracts, derivative instruments and short sales;
- Prohibition of investment into haram activities (gambling, alcohol, production or sale of pork products, tobacco, arms manufacturing...);
- Description of procedure applying to the sale of assets which become non-compliant (see also “Agreements” below);

### Structure

- Shariah Board (appointment, members, role, competences, practical details of the functioning, remuneration, relation with board/management company) should be described in detail;
- Information as to separate Shariah audit, if any should be given.

### Pricing and valuation

- Adequate disclosure of specific pricing and valuation techniques applicable to Islamic assets should be made;

### Purification

- Cleansing process of impure cash or dividends should be described in full and the charity(ies) potentially benefitting from the purification process should be named.

All the provisions inserted in the prospectus must comply with Luxembourg law. The information should be presented in a clear and easy to understand manner for the investors. In addition, the name of the fund should make a reference to its Shariah compliant investment policy.

## 2. Agreements

Agreements signed between an Islamic fund or its management company and its service providers are similar to those used with respect to Luxembourg conventional funds.

In a contractual relationship, the parties are always free to submit their relations to Shariah principles, as long as such additional clauses do not contravene with rules of Luxembourg public order.

Due to the nature of the Islamic funds, some particular points might need to be mentioned where applicable in the various agreements:

- The agreement with the central administration agent or the investment manager should describe the responsibility and methodology of the portfolio screening for compliance with Shariah principles;
- The management company services agreement should describe the responsibility of the company for the day-to-day management of the affairs of the Islamic fund in accordance with the prospectus and subject to the policies and guidelines issued from time to time by the board of directors upon advice from the Shariah board or Shariah advisor;

- The investment management agreement should provide for the obligation for the investment manager to take all reasonable steps to sell investments made in assets which cease to be in compliance with the Islamic investment guidelines, as soon as reasonably practicable but, always in the best interests of the investors. The definition of ‘reasonable delay’ might be included. As a general guideline, market practice considers 3 months as a reasonable delay. Illiquid assets however might be subject to longer delays. Reference thereto may, as the case may be, also be provided in the prospectus of the fund;
  - The custody agreement should specify that the custodian, in its capacity as depository is not responsible for the screening or checking of compliance with Shariah law and/or Islamic investment guidelines, unless the custodian specifically offers this service and accepts such responsibility. In the latter case, the custody agreement should include specific clauses relating to this service. Furthermore, should the fund opt to settle on actual basis, reference hereto should be made in the agreement (see “Custody and depository bank” hereafter). Finally, penalties and fees in case of failed trades or late settlement should be agreed and included in the agreement as no interest may be charged;
  - The custodian bank cash account opening forms should not contain any reference to interest, neither positive nor negative. Furthermore, the terms and conditions should describe the mechanism used to prevent overdraft as well as penalties in case of breach of the terms and conditions.
- All agreements should be expressly clear on the applicable law and competent jurisdictions in order to avoid any conflict with Shariah law in case such law is prevailing in another jurisdiction.

### **3. Eligible asset classes**

Shariah compliant vehicles provide for special features, such as prohibition of investment into haram activities, which can easily be integrated into Luxembourg domiciled funds.

Full description of investment policy and investment restrictions need to be included in the prospectus.

The eligibility of specific Shariah compliant asset classes, which are more and more used in addition to traditional equity investments, also needs to be assessed, albeit primarily in relation to UCITS funds. Some Shariah compliant instruments such as sukuk are structurally different from conventional investments and it is therefore not immediately obvious whether they are eligible assets or not.

Sukuk for instance can be asset-based or asset-backed (i.e. granting access to the underlying asset or not). These contractual differences mean that some structures may be UCITS compliant whilst others might, under certain circumstances, leave the investment fund with a physical asset, thereby not being eligible.

The attached table may be used as a guideline to highlight the definitions, characteristics and potential UCITS qualification of the main investment types. This information is not to be considered as legal advice. It is also recommended that each individual asset be assessed based on its contractual documentation in order to assure UCITS eligibility.

Besides the eligibility of assets per se, the fund manager will need to pay particular attention to other Shariah principles such as riba or gharar.

The exclusion of riba i.e. the balance between income gained and risks taken and the prohibition of interests and unjust enrichment may also impact the eligible assets and can for instance be ensured by setting defined ratios for illiquid assets and foreseeing in the fund’s documentation that no interest can be levied. Furthermore, the prohibition of gharar, i.e. the prohibition of speculation and uncertainty, which prescribes that the elements of a contract must be pre-determined may be achieved through express additional investment restrictions included in the sales documents of the fund, thereby limiting the eligible assets.

**Fund administration**

### 1. Accounting and valuation

#### 1.1. Valuation and pricing

As a general rule, all principles laid down by Luxembourg law, regulations and best practice in relation to fund valuation and pricing of Luxembourg domiciled funds apply. In relation to pricing of Islamic assets, the price provider should have a high level of expertise in assets and markets being assessed.

The large market data providers have record prices for most sukuk. But, for other instruments, prices may only be available through internal modelling or brokers.

The governing body of the Islamic investment fund should make sure that the pricing system is robust and will produce accurate results.

Whilst this is valid for all funds, also conventional funds, it must be recognised that Islamic funds hold non-conventional assets and that the pricing of these assets may require support from specialised price providers. In those cases, it is advisable that the board of directors or the management company of the fund validates such prices.

Pricing models should be subject to periodic reviews and these reviews should be carried out at least annually.

The fund's prospectus should clearly state and provide detail on the funds pricing policy and the preferred price providers.

#### 1.2. Islamic instruments

There is a broad range of Islamic assets and instruments. While the major categories of Islamic assets and financial instruments are conceptually simple, they may become complicated in practice when issuers of such instruments combine aspects of two or more types of instruments.

As an illustration of this, AAOIFI issued standards for 14 different types of Sukuk.

ALFI has considered the UCITS eligibility of a wide range of Islamic instruments as detailed on pages 18-21.

This impacts how the securities are set up in the fund administrator's accounting system and how the instruments should be accounted for. Islamic instruments should be set up as distinct assets. As the profit accruals are different from other asset types, new accrual classifications

also have to be created. The general ledger reports should be adapted to reflect the profits and losses from Islamic instruments such as sukuk, murabaha and wakala. All mentions in relation to "interest" should be removed and replaced by "profit" or "loss".

The accounting treatment of Islamic products should be disclosed in the fund's prospectus. The trade capture process may or may not be fully automated, depending on the instrument type. Generally, when an instrument such as sukuk are custodied, then the transaction is handled in a straight-through process in the same manner as a conventional bond.

#### 1.3. Reporting

Luxembourg financial and all other regulatory reporting standards have to be fulfilled.

The fund manager and the Shariah board may decide additional reporting according to AAOIFI guidelines.

Islamic funds do not recognise interest, neither debit nor credit. Reports can therefore not mention interest. As such administrators have to adjust systems or implement "work-around" procedures to report equivalent income or expenditure in reports.

#### 1.4. Purification

Non-permissible income can be "purified". Some funds simply pay a flat purification amount without determining the non-permissible income. For other funds, the fund administrator calculates the non-permissible income in great detail, for example the non-permissible portion of each dividend earned, and the purification amount that entails. Some index providers calculate non-permissible income factors. These factors can then systematically be applied to the dividend earned.

It is generally the responsibility of the Shariah board or the Shariah advisor to ensure that all impure income is calculated by the fund, and that a corresponding percentage is deducted from the earnings, passed on to investors thereby ensuring that these are free of impurities and completely halal. The methodologies for calculation may differ from fund to fund, or from one Shariah board to

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another, where scholars, for whatever reasons, have preferences in the matter. With the advice and counsel of the fund's Shariah board, these amounts may be distributed among suitable charities, or a charitable fund may be established for the purpose; again, under the supervision of the Shariah scholars.

All charitable payments should be screened against blacklists applicable to the domicile of the fund to ensure that anti money laundering and know your customer obligations are thus maintained. To reduce risk in this area, the beneficial charities should be mentioned in the fund's prospectus. In addition, and before any payment is made, the identity of the beneficiaries should be checked in accordance with CSSF circulars relating to potential business relationships with terrorist regimes.

The fund administrator should in principle always publish the fund's net asset value net of purification adjustments. Where a fixed percentage is applied to calculate the impure dividend amount, that dividend is accrued on a monthly or quarterly basis and paid to the selected charity at the end of the agreed period – usually every quarter.

The matter of Zakat is complicated by any number of factors that lie outside the control of the Islamic fund, the person's income, family matters, health, etc. Since these factors are particular to the circumstances of each investor, the matter of Zakat is very often left to the investors themselves.

Islamic funds established under Luxembourg law are open for investment to both Muslim and non-Muslim investors.

Therefore it is recommendable that the amounts to be purified are dealt with on investor level, i.e. the amount shall be calculated and communicated to investors who may opt or not to purify their investments. Even when the matter is left to the individual investor, the fund may consider requesting its Shariah board to prepare guidelines for the calculation of Zakat on profits earned through investments in funds. These guidelines should then be published to inform investors.

#### **1.5. Transfer agency and Islamic calendar**

There are no specific rules applying to transfer agency services offered to Islamic funds. The KYC and AML procedures applying to Luxembourg domiciled funds also apply to Islamic funds. In general, there is no requirement to screen the compliance of money resulting from subscriptions with Shariah principles. However and as mentioned before, in case the fund promoters decided to leave the purification and Zakat process on the level of the investors, the transfer agent must be in a position to communicate all relevant information to the investors.

Luxembourg domiciled Islamic funds may be managed out of, investing into and distributed in Islamic countries. In a number of those countries, normal working days are from Sunday to Thursday (UAE, Bahrain) or from Saturday to Wednesday (Saudi Arabia, Oman). Unless special service arrangements are agreed with the Luxembourg administrator and custodian bank, the calendar of working days of Luxembourg applies.

**custody and depository bank**

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### 1. Safekeeping and settlement

A large number of Islamic assets are registered with the international clearing houses and the settlement of such assets is similar to the settlement of conventional assets.

However and depending on the level of compliance with Shariah principles, the Shariah board or Shariah advisor may, in order to satisfy investor expectations, require Islamic assets to be held on segregated accounts, either at individual or omnibus account level. In such cases, Islamic assets should not be commingled with conventional assets.

To comply in full with Shariah principles, trades should be settled on an actual basis. In other

terms, this means that the fund manager may use assets, including cash, only once they have been credited to the account. However in some markets, contractual settlement might be standard or market practice. It is advisable that the custody agreement provides in detail for the settlement procedures to be applied. In case of late settlement, no debit interest may be charged to the fund. If previously agreed upon and adequately documented, predetermined penalty fees may apply and be charged to the fund.

Corporate actions and income resulting from such actions should be processed on actual basis.

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### 2. Oversight (depository bank) and monitoring

For all Luxembourg domiciled funds, the standard oversight obligations apply, independently if the fund is an Islamic fund or a conventional fund. Unless otherwise provided for by the agreements between the fund and the depository bank, the latter is not responsible for the monitoring of Shariah compliance.

As mentioned before, special pricing of unlisted securities and instruments should be previously agreed upon by the fund manager and the service providers and adequately documented in the fund's corporate documents.

At present, a large majority of Islamic funds are equity funds, which follow specific Islamic indices. Screening of compliance is therefore easy. However a grace period, i.e. a period during which the fund manager has to sell an asset should it be qualified as no longer Shariah compliant should be agreed upon and properly documented.

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### 3. Banking and credit

To be fully compliant with Shariah principles, it is advisable that the general terms and conditions applying to account opening are adjusted in order to eliminate all provisions in relation to debit and credit interest. Islamic fund promoters may expect the custodian to segregate the cash accounts from the cash accounts of its conventional clients.

The cash accounts may not go into overdraft. Credit facilities, should they be required may only be offered through specific Islamic products and techniques. Similarly, cash management should only be operated through the use of Islamic cash management products and techniques such as commodity murabahas.

## appendices

**Eligibility of Shariah compliant instruments in a UCITS context**

The information detailed below is not to be considered as legal advice. The document intends merely to provide an indication on a possible use of Shariah compliant structures in a UCITS context. Due to the lack of standardisation and regional differences each

individual instrument and its legal documentation needs to be analysed also in view of the law by which it is governed as well as the UCITS law, related CSSF Circulars and ESMA guidelines.

Name	1. Arbun	2. Ijarah	3. Istisna'a
Definition	The Arbun replicates the payout of a call option.	The Ijarah contract is a lease contract for a specified asset or the usufruct of a specified asset.	<ul style="list-style-type: none"> <li>■ Contract whereby one party requests the other party to manufacture or build an item (aircraft, school...) according to agreed specifications;</li> <li>■ Double Istisna'a contract whereby an Islamic bank sells the asset to a buyer which wants to purchase a specific manufactured thing. The bank draws two Istisna'a contracts: one with the buyer (first contract) and one (second contract) with the manufacturer which manufactures/builds the item agreed upon in the first Istisna'a contract.</li> </ul>
Characteristics	The contract entitles (but does not oblige) the investor to purchase assets at an agreed price at any time up to contract maturity. The investor must make a non-refundable down-payment at inception.	<p>The Ijarah contract can be transferred at a negotiated price. There are two main forms of Ijarah contracts.</p> <p><b>1. Ijarah</b> Ijarah is an operating lease whereby the bank acts as the lessor and conveys to the lessee, in return for a payment or series of payments, the right to use the asset for an agreed period of time. The operating lease does not include a promise that the legal title in the leased asset will pass to the lessee at the end of the lease term, and substantially all the risks and rewards incidental to ownership of the asset remain with the bank throughout the period of the lease.</p> <ul style="list-style-type: none"> <li>■ Application of Ijarah contract - Sukuk Ijarah</li> </ul> <p><b>2. Ijarah Muntahia Bittamleek</b> Ijarah Muntahia Bittamleek (Ijarah ending with an option to buy) is a financing lease where the bank conveys to the lessee, in return for a payment or series of payments, the right to use the asset for an agreed period of time, and at the same time, transfers substantially all the risks and rewards incidental to ownership of the asset to the lessee. Here, the bank will buy and lease out the equipment required by the customer for an agreed rental fee for a specific pre-defined period, at the end of which the customer is provided with a purchase option to acquire the ownership of the asset.</p> <ul style="list-style-type: none"> <li>■ Application of Ijarah Muntahia Bittamleek contract Sharia'h compliant Mortgage Backed Securities</li> </ul> <p>The bank may also enter into a sale and leaseback agreement with the customer whereby the bank will purchase the asset from the customer and leaseback under Ijarah or Ijarah Muntahia Bittamleek arrangement.</p>	<ul style="list-style-type: none"> <li>■ Deferred delivery of finished product(s) which has(ve) undergone a transformation process;</li> <li>■ In the Double Istisna'a contract, the bank takes the risk of manufacture of the item;</li> <li>■ Payment arrangements freely determined by the parties. Determination of the delivery date not required at the time of the contract: <ul style="list-style-type: none"> <li>• Simple Istisna'a: no interest-based contract.</li> <li>• Double Istisna'a: the bank receives remuneration (and not an interest) as it is liable towards the buyer for the construction of the item.</li> </ul> </li> </ul>
Potential UCITS qualification	OTC Financial Derivative Instrument	<ul style="list-style-type: none"> <li>■ Ijarah Sukuk; please refer to Sukuk analysis.</li> <li>■ Sharia'h compliant Mortgage Backed Security; in general, could qualify as an eligible transferable security for UCITS.</li> </ul>	<ul style="list-style-type: none"> <li>■ Probably not eligible under UCITS as the underlying is a commodity/object.</li> </ul>
Comments	<ul style="list-style-type: none"> <li>■ Eligibility of counterparty to be considered;</li> <li>■ Eligibility criteria for UCITS derivatives compliant OTC to be analysed.</li> </ul>	<ul style="list-style-type: none"> <li>■ Eligibility criteria to be checked on a case by case basis.</li> </ul>	

Name	4. Mudaraba	5. Murabaha	6. Musharakah
<p><b>Definition</b></p>	<p>The Mudaraba contract is a type of partnership contract that employs the principle of profit/loss sharing. This form of contract is structured between the supplier of finance and an entrepreneur whereby one party provides the finance to a second entrepreneurial party (known as the <i>mudarib</i>) who invests and manages the capital according to some pre-agreed business plan. The profits of the business are distributed according to a pre-determined ratio between both parties, with the partners at liberty to determine the ratio of profit allocation. Any financial loss is incurred only by the finance provider with the entrepreneur incurring the opportunity cost of time and labour.</p>	<p>The Murabahah contract is the most popular financing technique in Islamic Finance and is a form of exchange contract. The Murabahah contract is essentially used as a tool for financing the purchase of specific assets. Under the contract the counterparty providing the financing (bank) purchases the required assets and sells them to the buyer at a pre-agreed marked-up price.</p> <p>The payment can be settled in installments or as a lump sum within an agreed period. The profit is identified as soon as the purchase-sale transaction is complete. The financier's assets are receivables (debts) and cannot be traded at a discount according to the Shari'ah. The Murabahah contract is therefore only transferable at face value.</p> <ul style="list-style-type: none"> <li>■ <i>Applications of Murabahah contract</i> Commodity Murabahah Deposit</li> </ul>	<ul style="list-style-type: none"> <li>■ Partnership whereby two or more partners contribute to both capital and management to execute a potentially successful project.</li> <li>■ Three types of Musharakah: <b>Permanent:</b> the partners invest permanently and receive benefits regularly; <b>Temporary:</b> the partners invest for a short specified period and receive a share of the profits, as well as investment back at the end of the agreed period; and <b>Diminishing:</b> the partners invest on a long period of time but withdraw themselves gradually from the project: gradual reimbursement of their participation in the project.</li> </ul>
<p><b>Characteristics</b></p>	<p>The Mudaraba contract is a non-debt creating mode of finance.</p> <p>The principal amount of finance is not guaranteed and there is no requirement for the entrepreneur to pay a fixed amount of profit.</p> <p>The Mudaraba contract can be transferred at a negotiated price.</p> <ul style="list-style-type: none"> <li>■ <i>Applications of Mudaraba contract</i> <ul style="list-style-type: none"> <li>• Sukuk Mudaraba</li> <li>• Government Mudaraba Certificates</li> <li>• Fund Management</li> </ul> </li> </ul>	<p>The Commodity Murabahah Deposit is a form of a short-term fixed income deposit based on a Murabahah contract.</p> <p>The Commodity Murabahah Deposit mechanism works as follows. Example: The investor appoints Bank A to act as its Agent in the transaction under an Agency Agreement. On behalf of the investor Bank A purchases a commodity on a cash basis and sells the commodity for immediate delivery on a deferred basis to Bank B. Bank B issues a Letter of Undertaking in favour of the investor for the deferred amount (principal plus fixed income). The purchase and sale of the commodity are carried out simultaneously at pre-determined prices and there is no market risk exposure toward the underlying commodity. On the deferred payment date Bank B will credit the investors account with the deferred amount. The investor risk exposure in this transaction is counterparty risk <i>vis-à-vis</i> Bank B.</p>	<ul style="list-style-type: none"> <li>■ Each partner has management rights in proportion to its investment;</li> <li>■ Profits are shared according to an agreed ratio, whereas the losses are shared in proportion to the capital invested by the partners.</li> </ul>
<p><b>Potential UCITS qualification</b></p>	<ul style="list-style-type: none"> <li>■ Sukuk Mudaraba - refer to Sukuk analysis;</li> <li>■ The Government Mudaraba Certificate is a tradable non-interest bearing Certificates issued by sovereign states and could be eligible for UCITS;</li> <li>■ Each investment fund managed under a Mudaraba contract would need to be analysed for compliance with the UCITS criteria for eligible investment funds.</li> </ul>	<p>It is important to emphasize that the commodity trading mechanism underlying the deposit does not result in any market risk on the commodity traded. However CSSF approval shall be obtained on a case by case basis.</p> <p><i>Accounting treatment</i></p> <p>Islamic banks in the UK and in Malaysia classify these financial instruments as "Deposits from Customers" in their balance sheet and the accrued returns payable to the customer are classified under "other liabilities". This is in line with a substance over form approach.</p> <p>Subject to CSSF approval the Commodity Murabahah Deposit would only qualify as an eligible deposits for UCITS provided that the credit institution has its registered office in the EU or if in a non-EU state that it is subject to prudential rules equivalent to those laid down in Community law.</p>	<ul style="list-style-type: none"> <li>■ In principle: non eligible for a UCITS – except if certificates are issued (see Sukuk Musharakah below).</li> <li>■ In addition, a UCITS may not be one of the partners – no vocation to take control/no exercise of significant influence over the management of an issuing body.</li> </ul>

Name	7. Tawarruq	8. Sukuk	9. Salam
Definition	Reverse Murabahah: please see Murabahah analysis under item 5.	<ul style="list-style-type: none"> <li>■ Sukuk are certificates, representing a beneficial ownership in an underlying asset (e.g. tangible assets, usufructs, services or equity of particular projects or special investment activity).</li> </ul>	Salam is a sale whereby the seller undertakes to supply some specific goods to the buyer at a future date in exchange of an advanced price fully paid at spot.
Characteristics		<ul style="list-style-type: none"> <li>■ Sukuk holders are entitled to a share in the profits generated by and in the realization of the Sukuk underlying assets;</li> <li>■ Sukuk are usually issued by special purposes vehicles (SPV), which hold the rights related to the underlying assets for the investors, in exchange of the payment by such investors of the price of the Sukuk. Such mechanism is similar to the securitisation in conventional finance.</li> </ul>	<ul style="list-style-type: none"> <li>■ First of all, it is necessary for the validity of Salam that the buyer pays the price in full to the seller at the time of effecting the sale;</li> <li>■ Salam can be effected in those commodities only the quality and quantity of which can be specified exactly;</li> <li>■ Salam cannot be effected on a particular commodity or on a product of a particular field or farm;</li> <li>■ It is necessary that the quality of the commodity (intended to be purchased through salam) is fully specified leaving no ambiguity which may lead to a dispute;</li> <li>■ It is also necessary that the quantity of the commodity is agreed upon in unequivocal terms;</li> <li>■ The exact date and place of delivery must be specified in the contract.</li> </ul> <p>Salam cannot be effected in respect of things which must be delivered at spot.</p>
Potential UCITS qualification	Use probably limited to situations where conventional UCITS is allowed to borrow (up to 10%) under certain conditions.	<p>Either no embedded derivative included then may be eligible subject to analysis of sukuk documentation to determine if conditions for transferable securities are complied with.</p> <p>Sukuk Al Istisna'a: seems not able to be listed (therefore a UCITS could potentially only invest in such a Sukuk under the 10% trash ratio, if compliance with the conditions thereof is ensured).</p> <p>It has to be checked whether the Sukuk embeds a derivative, and if such is the case, if the latter is eligible:</p> <p>Sukuk which underlying would be indices on Istisna'a, Musharakah or Tawarruq might also be eligible.</p>	Problematic as direct invested: real commodities trade does seem to be required.
Comments		The holder receives return on the profit and not a fixed interest payment.	

December 2012  
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**Islamic Funds - Collection of best practices  
for setting-up and servicing Islamic funds**