Private equity funds: US and UK features

by Jonathan Baird, Altheimer & Gray, and Karen Fountain, Freshfields Bruckhaus Deringer

Articles | Published on 23-May-2003 | United Kingdom, United States

An overview of the basic structure and characteristics of a private equity fund and a comparison of US and UK models.

Speedread

Private equity funds are now one of the most significant sources for business funding in the US and, increasingly, in the UK and many other European jurisdictions. The article provides an overview of the basic structure of a typical private equity fund, highlights some differences between US and UK funds and outlines some of the US and UK issues involved in forming and marketing a fund.

A private equity fund is an actively managed collective investment vehicle that invests almost exclusively in securities which are not publicly listed or traded or which will cease to be publicly traded after an acquisition by way of a "public to private" transaction. The purpose of the fund is to provide a return to its investors over the life span of the fund, which will typically be around ten years. A fund's focus is normally on capital appreciation rather than income generation, which it achieves by acquiring a portfolio of equity interests in privately-held companies (commonly referred to as portfolio companies) and managing these investments to maximise their value on disposal or exit.

Traditionally, US private equity funds have been divided into two broad categories: venture funds and buyout or leveraged buyout funds. UK and European funds are usually divided along similar lines although, somewhat unhelpfully, the expression "venture capital" is often used in the UK and Europe to describe both venture funds and buyout funds. Private equity funds should be distinguished from hedge funds and mezzanine funds.

The limited partnership is the traditional US fund vehicle and the form most familiar to investors. Limited partnerships are also commonly used by UK and European funds, often with modified features to reflect local tax and regulatory requirements. The key features of a limited partnership are: two categories of partner (the general partner, of which there will only usually be one or two, and limited partners, of which there will usually be many); a partnership agreement governing the relationship between the partners; freedom from many of the legal constraints and formalities usually applicable to corporate entities; and recognition as a partnership, not a corporation, under domestic tax law.

Limited partners are asked to commit a specified amount of capital when they subscribe for an interest in the fund. The capital contributions will be used to make fund investments and pay fund expenses. Once capital has been invested by the fund and the investment realised, the capital generally cannot be reinvested by the fund and will be returned to the limited partners. The timing and manner in which a private equity fund makes distributions to its partners are provided for in the partnership agreement; the provisions are commonly referred to as "the waterfall" and are often the most complex parts of the agreement.

The article also considers the principal documents relating to the formation of a private equity fund and highlights the main regulatory issues in the US and UK.

Private equity funds are now one of the most significant sources for business funding in the US and, increasingly, in the UK and many other European jurisdictions. Over the last ten years, as the US private equity model has become more familiar and investment opportunities for funds more readily apparent, the European investor base has grown considerably and private equity is now recognised in Europe as an important alternative asset class.

This article provides an overview of the basic structure of a typical private equity fund, highlights some differences between US and UK funds and outlines some of the US and UK issues involved in forming and marketing a fund.

WHAT IS A PRIVATE EQUITY FUND?

A private equity fund is an actively managed collective investment vehicle that invests almost exclusively in securities which are not publicly listed or traded or which will cease to be publicly traded after acquisition by way of a "public to private" transaction (*for further information on public to private transactions, see feature article "From public to private: Changing direction", www.practicallaw.com/A29762*). The purpose of the fund is to provide a return to its investors over the life span of the fund, which will typically be around ten years. A fund's focus is normally on capital appreciation rather than income generation, which it achieves by acquiring a portfolio of equity interests in privately-held companies (commonly referred to as portfolio companies) and managing these investments to maximise their value on disposal or exit. Portfolio company exits can take many different forms, including flotations or initial public offerings, trade sales or sales to other funds.

Many private equity funds are sector, size and/or geographically specific. The size of private equity funds themselves may vary from as little as $25 million to billions of dollars, a function of the track record of the principals and the purpose of the fund.

Types of fund

Traditionally, US private equity funds have been divided into two broad categories:

- Venture funds, which invest in early-stage or expanding businesses that generally have limited access to other sources of funding.
- Buyout or leveraged buyout (LBO) funds, which tend to invest in more mature businesses, usually taking a controlling interest and leveraging their equity investment with substantial amounts of third-party debt. Buyout funds are typically significantly larger than venture funds, a reflection of the relative size of their target investments.

UK and European funds are usually divided along similar lines although, somewhat unhelpfully, the expression "venture capital" is often used in the UK and Europe to describe both venture funds and buyout funds.

As the industry has matured and marketing practices have developed, funds have increasingly become labelled according to their purpose, specialisation, ownership and management characteristics and a range of sub-categories and classifications have emerged (*see box "Fund descriptions"*).

Private equity funds should be distinguished from:

- Hedge funds, a wide variety of privately-held investment vehicles which usually have far more wide-ranging, and often opportunistic and short-term, investment policies than private equity funds (for example, they may invest in public, as well as non-public, debt and equity securities). The structure of a hedge fund is generally quite different from a typical private equity fund: for example, a hedge fund is often leveraged at the fund level, whereas an LBO fund's leverage is at the portfolio company level.
- Mezzanine funds, while involved in the same sector as private equity funds, provide subordinated debt as part of the financing packages that support leveraged buyouts and other highly leveraged debt financings. The structure of a mezzanine fund is typically similar to a private equity fund. (*For further information on debt financing, see feature article "Debt finance on acquisitions", www.practicallaw.com/A14011*.)

FUND STRUCTURE

The fund vehicle will usually be a limited partnership. However, a fund is also the sum of numerous other parts, involving a cast of players which includes the fund's managers, investors and investments (*see box "Private equity fund structures" in pdf version and "Dramatis personae" below*).

Limited partnership

The limited partnership is the traditional US fund vehicle and the form most familiar to investors. Limited partnerships are also commonly used by UK and European funds, often with modified features to reflect local tax and regulatory requirements.

The key features of a limited partnership are:

- Two categories of partner:
  - the general partner. There will only usually be one or two general partners, who will have management control of the partnership and unlimited liability to third parties for the partnership's debts;
  - limited partners. There will often be many; they are essentially passive investors without active management rights. A limited partner's liability to the partnership and its creditors is generally limited to the amount of capital that it agrees to contribute to the partnership.
- A partnership agreement governing the relationship between the partners, the content of which is only lightly regulated and which is a matter of negotiation between the partners (*see "Partnership agreement" below*).
- Freedom from many of the legal constraints and formalities usually applicable to corporate entities. This flexibility is a significant attraction.
- Recognition as a partnership, not a corporation, under domestic tax law and, as a consequence, "fiscal transparency", meaning the partners are treated for tax purposes as having invested directly in the underlying partnership assets, with no (or limited) taxation at the entity level.

A fund will generally seek to use a legal form that is tax efficient, marketable and familiar to investors in its target jurisdictions. As there is no single fund type that "fits all", if a fund is targeting investors in a number of different countries, it may use a number of fund vehicles tailored to specific jurisdictions as "parallel funds".

As a broad rule of thumb, funds aimed at US investors will tend to use Delaware limited partnerships and funds targeted at the UK will tend to use either English (or sometimes Guernsey, Jersey or Scottish) limited partnerships. The new UK vehicle of the limited liability partnership has not generally been adopted as a vehicle for such funds as an alternative to the traditional limited partnership. In the US, limited liability companies are increasingly used for hedge funds, but not yet for private equity funds.

Delaware. In the US, the formation of business entities is a matter of state, not federal, law. Many, if not the majority, of US private equity fund limited partnerships are formed under the Delaware Revised Uniform Limited Partnership Act (Delaware Act). This is a matter of choice, and the promoters of the fund are not required to have any substantive connection with Delaware to form a partnership under Delaware law. A Delaware limited partnership is not required to disclose the identity of its limited partners.

Delaware takes seriously its status as the pre-eminent US state for the formation and incorporation of business entities and the Delaware Act is revised frequently, usually annually. The Delaware courts are also seen as some of the most business-oriented in the US and there is a developed body of Delaware case law regarding limited partnerships. Most of the limited partnership statutes of the other US states are similar to the Delaware Act, although there can be substantive differences.

England and Scotland. English and Scottish law applicable to limited partnerships stems from a combination of:

- The common law of partnership, mostly based on case law.
- The Partnership Act 1890 (1890 Act), which sets out a broad code for UK partnerships generally (and which was intended to bring together the general common law on the topic but has not been updated to any material extent since 1890).
- The Limited Partnerships Act 1907 (1907 Act), which gives statutory recognition to limited partnerships and provides for their constitution and registration as well as modifying the 1890 Act to afford limited partners limited liability.

A fund need not be permanently established in the UK to take the form of a UK partnership. However, a 1907 Act limited partnership must, at the time of its formation, carry out some business in the relevant part of the UK. Thereafter, it is possible to "migrate" a UK limited partnership offshore, although care is usually taken to preserve some connection with the UK to bolster the choice of English (or Scottish) governing law.

The difficulties for the UK industry in using legal entities that are subject to uncertain and, in places, archaic, laws have been stressed by participants over the years. In response, the Law Commissions of Scotland and England and Wales issued a joint consultative paper on possible reform of the laws relating to limited partnerships. However, little concrete action has resulted save for the removal in December 2002 of the "20 partner limit", which restricted the number of partners in any UK limited partnership to 20 persons and was the cause of a proliferation of parallel funds for larger UK private equity partnerships (*www.practicallaw.com/A22808*).

Dramatis personae

The major participants in the formation and operation of a private equity fund are as follows:

Fund principals and sponsors. The fund's principals are responsible for the fund's management and the choice of its investments. Generally, they are the owners or employees of, or partners in, the fund management company or financial institution which is the fund's promoter or "sponsor". The principals' main tasks are to select and secure investments in portfolio companies, to become involved in the management of the portfolio companies acquired by the fund in order to maximise the value of the portfolio companies prior to exit and to achieve successful exits for the fund. Investors will often base their decision to invest in the fund on the identity of the principals and their track records.

The principals and sponsor will often be expected to make a capital contribution to the fund. This may be made through the general partner or by the principals or sponsor subscribing for limited partnership interests. The fund formation documents will sometimes specify a minimum amount of capital or a specified percentage of the capital raised by the fund, which could be anywhere between 1% and 5%, to be committed by the sponsor or principals. Prospective limited partners will often view this obligation to commit capital as a key business term.

General partner. The general partner is ultimately responsible for the management of the partnership. Usually, in a private equity fund, the general partner will be a limited liability entity formed by the fund's principals and/or sponsor.

Limited partners. The limited partners are responsible for contributing the fund's capital (*see "Capital contributions" below*). Limited partners may be institutional investors, pension funds, endowments or wealthy individuals who, given securities law requirements, will usually be sophisticated investors. Once committed, a limited partner will generally not be entitled to withdraw from a fund or transfer its partnership interest, although the general partner will have the discretion to permit transfers. In recent years, with the emergence of secondaries funds (*see box "Fund descriptions"*) there is slightly more scope for limited partners to find buyers for their interests.

Limited partners are not permitted to control or participate in the management of the fund and doing so may prejudice their limited liability (among other things). The Delaware Act specifies a number of activities that a limited partner may undertake in relation to the limited partnership without compromising its status. Failure to adhere to these constraints may result in the limited partner being liable to persons conducting business with the partnership who reasonably believe, based on the limited partner's conduct, that the limited partner is a general partner. In contrast, section 6(1) of the 1907 Act, which prohibits limited partner participation in management, does not include any similar list of "safe harbours" and under UK partnership law limited liability is lost whether or not a third party is aware of a limited partner's participation in management.

A fund may be required to take special measures depending on the identity of its limited partners. For instance, a fund with US pension plan investors may have to address the requirements of the US Employee Retirement Income Security Act of 1974 (ERISA) (*see "ERISA" below*).

Managers and advisers. Most funds (or their general partners) retain a manager or investment adviser (or both) to manage the fund's investments and/or advise the fund on its investment strategy. The manager is usually a limited liability entity. The manager may be part of an established "branded" fund management group or an affiliate formed by the fund's principals. In the US, the expressions manager or adviser are often used interchangeably, with persons expressed to be advisers carrying out a management role as would be understood in the UK (and vice versa). In the UK, the distinction can be significant in terms of the different obligations and regulatory capital requirements applicable to managers and investment advisers. Care must therefore be taken to ensure that the structure of a fund management group operating in the UK, and in particular the balance between its offshore and onshore activity, is efficient in regulatory capital terms.

Advisory committees. Some funds have an advisory committee or board consisting of representatives of the limited partners and who are usually selected by the general partner. The committee's role is to consult with and provide advice to the general partner of the fund on a range of issues, in particular, conflict of interest or valuation questions. However, this role is to an extent limited by the legal constraints on management of the fund by limited partners.

Other funds may have supervisory boards or investment committees made up of representatives of the manager and/or the principals and persons who, although often not investors in the fund, have expertise relevant to the investment purposes of the fund.

FUND ECONOMICS

The key economic building blocks of a fund's structure are:

Capital contributions

Limited partners are asked to commit a specified amount of capital when they subscribe for an interest in the fund. The capital contributions will be used to make fund investments and pay fund expenses. Limited partners will not generally be asked to contribute all (or, indeed, any) of their capital commitment at the time of their initial subscription (other than in the case of a UK limited partnership where section 4(2) of the 1907 Act requires that some, albeit nominal, contribution must be made on admission as a limited partner). A fund manager will generally not want to have excess cash sitting idle: that may negatively impact the fund's rate of return as the fund is not designed to manage cash assets.

Instead, a fund will call for, or drawdown, capital contributions, on an as needed basis, generally as the fund makes investments, and commonly on ten days' notice. A fund may also "excuse" certain limited partners (who may be subject to restrictions on the investments they may make) from drawdowns in respect of certain acquisitions.

Failure by a limited partner to make a capital contribution when requested can have serious adverse consequences for a fund. Partnership agreements will usually deal severely with a defaulting limited partner, with possible consequences of default including the forfeiture of the limited partner's interest or the forced sale of its interest. However, the ability of funds to enforce such provisions in certain jurisdictions, including the UK, may not always be ensured due to restrictions on the enforceability of penalty clauses and similar rules of law.

Usually, the partnership agreement will provide for an "investment period", for instance, the first five years of a ten-year fund, after which time new investments will not be made. Following expiration of the investment period, capital calls will generally only be made to fund "follow on" investments in existing portfolio companies or to pay partnership expenses. It may be that, over the life of a fund, a limited partner is not required to contribute all of its committed capital.

Once capital has been invested by the fund and the investment realised, the capital generally cannot be reinvested by the fund and will be returned to the limited partners. However, exceptions are frequently made to permit the reinvestment of capital from short-term investments that are realised within a limited period of time, such as one year.

In the US, subject to some exceptions, a limited partner is generally not liable to repay returned capital (although some partnership agreements include limited partner "clawback" provisions which require a limited partner to repay distributions, if necessary, to cover certain fund expenses). In contrast, a limited partner in the UK that receives back any part of its capital contribution before dissolution of the partnership is liable for the debts and liabilities of the partnership up to the amount of capital paid back (*section 4(3), 1907 Act*). The rigours of the UK prohibition on the withdrawal of capital can be substantially mitigated, however, by taking steps to characterise part of the limited partners' contributions as "advances" rather than capital. Such advances may then be returned to the limited partner before dissolution of the partnership without putting the limited partner on risk for repayment of those sums. Advances to capital ratios of 99.9:0.1 are not uncommon.

Distributions

The timing and manner in which a private equity fund makes distributions to its partners is provided for in the partnership agreement. This has led to a number of different permutations, although US and UK market practice has developed certain basic models that are frequently used.

Waterfall. A fund's distribution provisions, commonly referred to as the "waterfall", are often the most complex part of the partnership agreement, with considerable scope for creativity and subtlety (*see box "Waterfall" in pdf version*). In substance, they will operate to share profits between the investors and the management team (that is, the principals and any sponsor) so that the management team earns a return disproportionate to its capital investment. The management team's profit entitlement is commonly referred to as the "carried interest" (or "carry", "promote" or "override") and is its incentive to make the fund a success.

First, the fund will pay back the limited partners' capital contributions and, frequently, a minimum preferred return on those contributions. The preferred return (or "hurdle rate") is usually expressed as an annual percentage rate or internal rate of return (often 8%).

Next, provided that the principal has been repaid and the hurdle is achieved, profits will then usually be allocated between the investors and the management team, typically in an 80/20 split. The waterfall will often operate to provide the management team a "make-up", or "catch up" share of profits after the preferred return has been paid until, in aggregate, the carried interest percentage has been paid in respect of all the profits of the fund, and not just those in excess of the preferred return. In that case, the preferred return is really a "disappearing preferred return", because the make-up will ensure that all profits are eventually allocated in the 80/20 split. However, some funds pay a "pure" or "permanent preferred return", where only profits in excess of the preferred return are split 80/20, with no general partner make-up.

Cash generated by the fund that is not attributable to portfolio investments (such as interest on idle funds) will often be distributed to the partners in proportion to their partnership interests so that no carried interest is paid on those distributions.

Some US funds also provide for "tax distributions" to be made prior to any other distributions. These are payments from the fund to its partners, or often just the general partner, to cover the tax payable on allocated profits. (In the absence of a tax distribution, a partner may be required to pay tax in respect of allocated profit without having received any distributions from the fund.)

Within this basic structure, there are many variables, in particular regarding the satisfaction of the "hurdle" and the point at which the, management team starts to share in the carried interest. For example European funds commonly require that investors are paid all their invested capital and any preferred return on that total capital before any carried interest is paid. By contrast, in the US and, to an extent, in the UK where this approach is now beginning to be accepted, funds are not required to return to investors all their invested capital and preferred return before the management team receives its carried interest. Instead, distributions will be made on a "deal by deal" basis by reference to "realised investments" (for example, investments disposed of and those permanently written off), so that once the investors have been repaid the capital invested in those realised investments plus all or some of the partnership expenses funded by invested capital and any preferred return on that invested capital and funded expenses, the management team will receive out of the remaining balance a carried interest in the profits attributable to the realised investments. This approach usually means that the management team will receive carried interest payments sooner than would otherwise be the case.

However, each successive distribution will usually be calculated on an aggregated "built up" or "fund as a whole" basis, so that any losses from a realised investment must be set off against the gains made on previously realised investments for the purpose of calculating the overall carry entitlement. As a result, later losses can wipe out earlier gains so that, on a "fund as a whole" basis, the investors' overall return may fall below the hurdle rate, meaning that earlier carried interest payments may prove to have been overpayments. To deal with this situation (which can also arise with the "European" waterfall but is less likely to do so), many funds impose a "clawback" on the fund's general partner, which requires the general partner to repay any excess carried interest that it receives (usually on an after-tax basis). This obligation is often supported by guarantees from the management group or principals or an escrow of part of the carried interest.

It used to be typical for US funds to structure carried interest payments on a purely deal by deal basis, so that the management team would receive its carried interest in respect of a successful investment irrespective of the fund's past or future failures. Given strong investor resistance, this approach has now all but disappeared.

Timing. The timing of distributions will be at the discretion of the general partner, unless the partnership agreement provides otherwise. A partnership agreement will often provide that a distribution should be made to limited partners within a specified period following the disposal of a portfolio company, subject to the retention of amounts that the general partner decides are necessary for operation of the fund and payment of its expenses. While distributions will often be made in cash, the partnership agreement will usually provide that distributions can also be made to limited partners "in kind", for example, marketable securities of portfolio companies that have been brought to the market by way of flotation.

A fund's remaining assets must be distributed on its winding-up, usually in accordance with its distribution waterfall, subject to payment of the fund's expenses and the impact of any clawback arrangements.

Tax efficient carried interest

In a US fund, the carried interest will generally be payable to the fund's general partner as an allocation of the fund's profits. For teams of principals based in the UK, however, the tax efficiency of the carried interest is dependent on securing a UK tax treatment that does not seek to:

- Characterise the carried interest as income received by them in connection with their employment within the management group.
- Attribute to them any part of the income and gains of the fund unless and until the fund's returns meet the relevant "hurdle rate" and the carried interest starts to be payable to the management team.

The British Venture Capital Association (BVCA) has agreed with the Inland Revenue a "model" partnership carried interest structure to which it will afford this desirable tax treatment provided that other Inland Revenue requirements are met (including that the principals are remunerated at full arms' length rates for their activities as employees or directors of the manager entity). The agreed BVCA model (available at *www.bvca.co.uk*) envisages the carried interest being routed to the principals through a separate limited partnership interest rather than through the general partner interest. Although the Inland Revenue does not rule out affording similar treatment to alternative carry structures, it does not commit to doing so. Most UK-based teams of principals therefore stick closely to the BVCA model and route the carry through a separate "special" limited partnership interest (*see box "Private equity fund structures" in pdf version*).

Management fee

The fund's manager will usually be paid a management fee on a semi-annual basis, in addition to the payment of carried interest. The fee is intended to cover the fund's operating costs and the managers' salaries.

In a US fund, the manager will usually be paid the fee directly by the fund. At first, and later if the fund is not profitable, the fee will usually be funded from the capital contributions made by the limited partners. In the UK, the general partner will more usually receive a priority distribution out of profits equal to the fee and will then be responsible for paying the fee to the manager out of this profit share. Before profits arise the general partner will be entitled to "borrow" the amount required to meet the fee out of drawings from the limited partners against their commitments, to be repaid out of the priority profit share in due course. The tax efficiency of this arrangement arises from the fact that in some jurisdictions an investor may not receive any tax deduction for management fees he has paid. However, if the general partner's share of profits is increased, the investor's share of profits will be correspondingly reduced, as will the tax applicable to such profits.

The fee is typically between 1% and 2½% per annum of the capital committed to the fund for the period up to the expiration of the investment period, following which it is usually reduced to a percentage of the capital actually invested by the fund.

The manager or general partner of the fund or their affiliates will often also receive fees in relation to investments made or planned to be made by the fund, for instance, investment banking fees, break fees or "monitoring" fees for services provided to portfolio companies. Typically, the recipient will be permitted to retain these fees provided that they are set off in whole or in part against the management fee or the general partner's enhanced share of profit.

Organisational expenses

The organisational or formation expenses of a fund will frequently be paid by the fund itself up to a specified limit, with any excess for the account of the general partner or set off against the management fee.

FUND DOCUMENTS

The principal documents relating to the formation of a private equity fund include:

Offering memorandum

The offering memorandum, or private placement memorandum, is used by the majority of funds as the principal marketing document. Because interests in the fund will not be publicly offered or listed, there are limited formal specifications for the contents of the memorandum in either the US or the UK. The contents may vary from fund to fund but generally include the following:

- A description of the purpose and investment policies of the fund.
- Details of the projected size of the fund and any maximum and minimum limitations on the amount of money to be raised.
- Details of the backgrounds and track records of the principals of the fund together with an explanation of why they believe they have the experience to make the fund a success.
- Details of any committed investment in the fund or by way of "side by side co-investment" with the fund by the general partner, manager or their affiliates.
- A description of the principal terms of the fund: in essence, a summary of the partnership agreement (*see "Partnership agreement" below*).
- Increasingly, a "risk factors" section, setting out the most significant risks associated with an investment in the fund.
- A statement of the restrictions on the offering and sale of interests in the fund imposed for regulatory and securities laws reasons.

The offering memorandum will be subject to the securities laws of the jurisdictions in which it is distributed (*see "Regulatory concerns" below*).

Partnership agreement

The terms of the contractual relationship between the limited partners are set out in the partnership agreement. Both the Delaware Act and applicable UK laws include default provisions that will govern the internal relations of the limited partnership in the absence of contrary measures (*see "Limited partnership" above*). Most private equity funds will not wish to rely on any of the default rules and will instead provide in detail for their internal governance in elaborate partnership agreements. The governing law of the partnership agreement will be the law of formation of the partnership.

The partnership agreement is often heavily negotiated between the general partner and the limited partners at the time of the fund's formation. Naturally, the leverage that a prospective limited partner has to influence the terms of the fund will depend on the amount of capital that it plans to commit. Some institutional investors have detailed requirements and opinions regarding the contents of the agreement.

In addition to the financial arrangements between the partners (*see "Fund economics" above*), some of the key areas covered by the partnership agreement are:

- Investment purpose. Approaches vary from the inclusion of fairly specific investment criteria to references to the investment purpose as specified in the offering memorandum (*see "Offering memorandum" above*).
- Investment restrictions. The agreement will usually set some express limits on the investments that the fund may make, for example by:
    - prohibiting more than a specified portion of the fund's capital commitments (often between 15% to 25%) from being invested in any one portfolio company;
    - prohibiting hostile transactions;
    - other than in the case of funds of funds (*see box "Fund descriptions"*), prohibiting investments in other private equity funds;
    - restricting borrowing;
    - limiting foreign investments;
    - restricting investments in companies affiliated with the principals;
    - in some cases, imposing ethical restrictions on investments.
- Closing dates. The date on which the fund first accepts investors is generally referred to as the "initial" or "first" closing date. The agreement will often provide for subsequent closing dates on which additional limited partners may be admitted (provided that they pay for an appropriate share of the investments already made, and expenses incurred, by the fund, usually with interest; these "catch up" payments are usually paid on to the original limited partners and the manager). Subsequent closing dates can generally be held only during a period of up to one year following the initial closing date, because investors will want the principals to concentrate primarily on the fund's investment objectives, rather than raising additional capital.
- Term. A life span of ten years from the initial closing date of the fund is most common, often with limited extensions to the term permitted to provide for an orderly winding up of the fund.
- Early termination. The agreement will usually provide for the early termination of the fund (or for the curtailment of new investment) by the decision of limited partners owning a specified proportion of the fund's interests if certain specified events occur. These can include the failure of specified principals to remain involved in the fund's management or the material breach of the partnership agreement by the general partner. Some funds also now permit a "no-fault divorce", subject to a prescribed financial settlement with the management team, if approved by a high proportion of the limited partners.
- Time and attention/non-competition. As the limited partners will be concerned that the management team devotes sufficient attention to the fund, the agreement will usually include provisions such as prohibitions on the formation of similar partnerships until the investment period has expired or the fund is at least 75% fully invested.

- Indemnity. The partnership agreement will usually include a wide-ranging indemnity and limitation of liability in favour of each of the general partner, the limited partners, the manager, the advisory committee and each of their respective officers, employees and agents, except where a person has been grossly negligent or has acted in bad faith or, where there is a UK-regulated manager or adviser, in breach of the Financial Services and Markets Act 2000 (FSMA) (*see "UK" below*).
- Transfers and withdrawals. Transfers of limited partnership interests and withdrawals by limited partners will usually be restricted by the agreement, except where the continued involvement of the limited partner may cause regulatory problems.
- Reporting. Funds are usually required to provide periodic financial, tax and other information to investors.

Side letters

The general partner may also enter into side letters with specific investors that set out additional arrangements. For example, an institutional investor may be required to invest in funds that observe specified ethical investment limitations, and the fund may agree in a side letter to observe those restrictions. Traditionally, the recipients of side letters were the principal investors in the fund or large institutional investors to whom the general partner was prepared to provide certain preferential treatment. However, as limited partners have become more demanding, requests for side letters have increased and it is common for limited partners to demand "most favoured nation" (MFN) side letters that guarantee the limited partner the same rights as each other recipient of a side letter. The growing burden placed on fund management by side letters, especially the inappropriate or inadvertent extension of specific requirements through MFN arrangements, has led to an increased focus on side letter management and attempts to address limited partners' genuine concerns in a more organised manner, such as building into the partnership agreement items commonly requested in side letters.

Management/advisory agreements

The management agreement sets out the terms on which the fund's manager is appointed and provides management services and investment advice to the fund and/or the general partner. The agreement will usually set out the manager's duties, limitations on its other activities, provide for the payment of fees and expenses and for the indemnification of the manager and its officers and employees. A copy of this agreement will usually be made available to prospective investors in the fund.

In a US fund, the management agreement is usually between the fund and the manager. For UK and European funds, the management agreement will often be between the general partner and the manager for tax reasons and, sometimes, to ensure efficient regulatory structuring (*see below and "Management fees" above*). For UK funds with a separate investment adviser there will also be a separate advisory agreement setting out the adviser's responsibilities.

Where the management group wishes to avoid extensive UK regulation it is not uncommon for a UK fund or its general partner to be managed by an offshore manager which is itself advised by an onshore affiliated investment adviser who will take advantage of the group exemption in the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 (*SI 2001/544*). In this situation, the advisory agreement should be between the manager and the adviser. However, for such a structure to be effective, the UK adviser must avoid engaging in any activity outside the group exemption (which is far from all encompassing) and the offshore manager must have genuine substance (that is, it must genuinely perform the act of decision-making offshore and not simply rubber-stamp the acts of UK-based persons). The need for substance means that this approach may not be viable for small teams who will struggle to maintain a genuine offshore presence.

Subscription booklet

Prospective investors in the fund will usually be asked to complete a fairly complex package of documents consisting of a subscription agreement and an investor questionnaire, often referred to as the "subscription booklet".

The subscription agreement consists of the formal offer to subscribe by the investor and will commonly include the following:

- Provisions regarding the mechanics of the subscription by the investor and conditions precedent to the investment.
- A power of attorney in favour of the general partner (in order to facilitate the execution of documents relating to the fund).
- Representations and warranties from the fund to the investor. These will cover subjects such as formation of the fund and compliance with regulatory matters.
- Representations and warranties from the investor to the fund. These will cover the status, suitability and investment intent of the investor (which are in large part designed to ensure that the fund complies with applicable regulatory requirements and to protect the fund against lawsuits by persons who make unsuitable or uninformed investment decisions).

The investor will be required to specify the amount of its commitment in the subscription agreement. Subscriptions are generally irrevocable. For certainty's sake, a long-stop date may be included by which the offer to subscribe will lapse if not accepted by the fund.

The investor questionnaire is designed to elicit information to ensure that the investor is accepted by the fund in compliance with applicable regulatory requirements or, more accurately, so that the fund can avoid certain onerous rules (*see "Regulatory concerns"below*).

Non-US funds that plan to offer interests to US investors will want to ensure that they comply with US requirements and, consequently, will address those requirements in their subscription documents.

Legal opinion

It is fairly common for the fund's legal advisers to address a legal opinion to the limited partners. This will usually cover the formation and good standing of the partnership, the general partner, the manager, the due admission of the limited partners to the partnership and compliance with applicable laws. The opinion may also address the limited liability of the limited partners and the tax status of the partnership.

Management team documents

The relationship between the principals of the fund and with any sponsor of the fund will, in the case of a US fund, often be governed by the organisational documents of the general partner and the manager, and in the case of UK funds, the ownership and organisational structure of the special limited partner which is paid the carried interest (which might, for example, be another limited partnership, a trust or a jointly owned offshore entity) (*see box "Private equity fund structures" in pdf version*). The arrangements may be fairly complex, in particular as regards the allocation of the fund's carried interest between the principals, often including "vesting" and "leaver" provisions.

These are "behind the scenes" documents that do not tend to be seen by investors in the fund. One US exception is the guarantee by the principals of a general partner's clawback obligations, which will generally be provided to investors.

REGULATORY CONCERNS

When setting up a US or a UK fund, participants need to consider the impact of a wide range of regulatory issues:

US

A US fund will generally aim to avoid some fairly onerous US legal and regulatory restrictions by careful structuring of the offering and sale of its interests and by management of the persons permitted to invest in the fund.

ERISA.ERISA is a significant concern for any fund, whether or not located in the US, that proposes to raise money from US pension plans or other US employee benefit plans. In order to protect participants in employee benefit plans, ERISA imposes strict fiduciary standards on the management of plan assets. In the case of a private equity fund with an ERISA plan as an equity investor, these may include all the fund's assets.

Although some funds do operate as plan asset funds, the ERISA restrictions are generally regarded as too onerous by many private equity managers. Therefore, in order to access ERISA plan funds, but at the same time avoid the application of ERISA's fiduciary duty requirements, a private equity fund will generally use one of the following ERISA exemptions:

- The "insignificant interest" exemption, which applies when benefit plan investors (which include non-ERISA plans and non-US plans) own less than 25% of the value of each class of the equity interests of a fund, disregarding equity interests held by the general partner and its affiliates. This is a fairly easy test to apply, but limits the amount of capital that a fund can raise from benefit plan investors if it has at least one ERISA plan investor.
- The "venture capital operating company" (VCOC) exemption, which applies if at least 50% of the investments of a private equity fund, measured by cost, are in "qualified venture capital investments", which are investments in entities engaged in the production or sale of a product or service (other than the investment of capital) with which the fund has specific contractual rights substantially to participate in or influence the conduct of management of the entity.

Investment management laws. The Investment Company Act of 1940 (ICA) imposes significant requirements on the management and operation of "investment companies", a broadly defined term that would include most private equity funds in the absence of an exemption. Funds invariably will not want to be subject to the ICA, because investment companies must be registered with the US Securities and Exchange Commission (SEC) and the costs and operating implications of investment company status would render the fund all but unworkable. The two most important exemptions in the ICA are:

- Section 3(c)(1), which exempts a fund that has no more than 100 "beneficial owners" of its securities at any time during its life and that has not made and does not plan to make a public offering of its securities. Some fairly complex special rules and "look through" provisions apply to the calculation of the 100 beneficial owner limit.
- Section 3(c)(7), which exempts a fund whose equity owners consist entirely of "qualified purchasers", irrespective of number, provided that the fund has not and does not plan to make a public offering of its

securities. Broadly speaking, "qualified purchasers" include individuals with $5 million or more of investments and entities with $25 million or more of investments.

Section 3(c)(1) and 3(c)(7) funds can be, and often are, set up in parallel by promoters.

The general partner and manager of, and any other adviser to, the fund must determine whether they are required to register with the SEC under the Investment Advisers Act of 1940 (IAA) or with state regulators under applicable state law. Many funds can take advantage of an exemption to registration under the IAA for advisers who have fewer than 15 clients and do not generally hold themselves out to the public as investment advisers. For these purposes, a fund will generally count as one client and the number of investors in the fund is irrelevant (so long as the adviser does not give specific advice to individual limited partners or manage the fund based on the investment objectives of individual limited partners). An investment adviser that is the "alter ego" of another registered adviser may have to take into account the other adviser's clients in determining whether the exemption is available. The laws of a number of states include similar exemptions.

Selling limited partnership interests. The offer and sale of interests in a private equity fund will be an offer and sale of "securities" for the purposes of the US Securities Act of 1933 (Securities Act). Therefore, the securities must be registered with the SEC (a highly unattractive proposition) unless an exemption from registration is available. Most offerings of interests in private equity funds are made pursuant to the safe harbour for private placements in Rule 506 of Regulation D under the Securities Act, which permits sales to an unlimited number of "accredited investors" (especially wealthy individual and institutional investors) and up to 35 non-accredited investors.

It is important to note that, whether or not an offering and sale of securities is registered under the Securities Act, it will be subject to the US anti-fraud rules. Care must be taken to ensure that the offering materials for a fund are accurate and not misleading.

In certain circumstances, persons offering or selling interests in private equity funds may be required to register as broker-dealers with the SEC under the Securities Exchange Act of 1934. However, this can be avoided under the so-called "issuer exemption" or by using a placement agent that is already a registered broker-dealer.

UK

The following regulatory issues apply:

Investment management and advisory activities. Providing management, advisory and arranging services to a fund or its investors in or from the UK are regulated activities for the purposes of section 19 of the FSMA and the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 (RAO) which may be carried out only by FSMA authorised persons unless an exemption applies.

In addition, a fund may constitute an unregulated collective investment scheme (CIS) and, if so, establishing or operating it from the UK will also be regulated activities under FSMA and the RAO (*see below*). English limited partnerships will generally have CIS status, although Delaware and certain other overseas limited partnerships may be able to take advantage of an exemption from CIS status available for certain "bodies corporate" which are not open-ended investment companies under paragraph 21 of the Schedule to the Financial Services and Markets Act 2000 (Collective Investment Schemes) Order 2001. The general partner of a limited partnership will normally be its "operator" for this purpose. However, using a FSMA authorised entity as general partner would often be unattractive in that it would expose the regulated entity, which may well generally have significant revenue flows and assets (not least to maintain its regulatory capital), to unlimited liability. UK funds who, for this reason, wish to use an unauthorised entity as the general partner will generally require either to ensure that such unauthorised entity is resident, and conducts the operator function, offshore, and therefore outside the UK regulatory net, or, where this is not possible, to appoint an authorised or offshore person other than the unauthorised general partner to be the operator instead. Shifting operator status can be achieved by providing in the partnership agreement for the entire management and administrative function of the general partner (but not its economic rights or unlimited liability) to devolve directly on a separate (offshore or authorised) manager, in which case the operator status will shift to that manager for UK regulatory purposes.

Selling limited partnership interests. To market private equity funds in the UK, sponsors and their placement agents must comply with three interrelated sets of restrictions:

- Unless authorised under FSMA or an exemption otherwise applies, the promoter must not breach the prohibition on carrying out a regulated activity in the UK (*section 19, FSMA*). As "arranging deals in investments" is a regulated activity in the UK, unauthorised persons need to take particular care in the conduct of their UK marketing campaigns.
- The overseas person exemption in article 72 of the RAO is available where a person carries on regulated activities in the UK otherwise than from a permanent place of business in the UK. However, the exemption does not cover, for example, all "arranging" activities. It is not uncommon, therefore, for offshore managers to use a UK authorised firm to conduct all promotional and arranging activities in the UK.
- Any communication of an invitation or inducement to participate in the fund must not breach section 21 of FSMA. This requires that such promotions are either issued or approved by an authorised person or fall within an exemption.

  The range of available exemptions is extensive and will allow fairly free marketing to professional investment firms and institutions. As regards wealthy individuals, there are now exemptions for marketing to "certified sophisticated investors". Such certification must be given by an authorised person but it can be a person in the same group as the fund's promoter or sponsor. For written and solicited communications there are also exemptions for communications directed to "certified high net worth individuals" and for "follow-up" and, in certain circumstances, "one-off" communications. As a result, there is now more scope than previously for marketing to wealthy individuals.

  Where a fund is not a CIS it will be possible to expand the range of persons to whom marketing literature can be sent by having an authorised person approve such promotions. However, when a fund is a CIS, as will often be the case, authorised persons may approve promotions for distribution to a range of persons only a little more extensive than would be possible under the exemptions available to unauthorised persons.
- Any offering of interests in the fund must not constitute an offer to the public under the Public Offers of Securities Regulations 1995 (POS Regulations) (as it would be impractical to seek to comply with the POS Regulations' prospectus requirements in conventional fund documents).

The POS Regulations generally only apply to offers of shares and debentures issued by bodies corporate and investments entitling people to such securities. As such they would not usually catch offers of partnership interests in private equity funds. However, the POS Regulations can sometimes apply as regards non-UK partnerships since the definition of "share" includes a share in any body corporate or unincorporated body constituted under the law of a country or territory outside the UK (which may include certain overseas entities such as Delaware limited partnerships). In any event, one or more of the exemptions contained in the POS Regulations to the definition of "offer to the public" will usually apply, given the limited number and identities of target investors and the minimum subscription amounts normally required.

Jonathan Baird is a partner in Altheimer & Gray's Chicago office. He is an English solicitor and a New York attorney. Karen Fountain is a partner in Freshfields Bruckhaus Deringer's London office. *The authors would like to thank James Cruger and Susan Daley, both partners in Altheimer & Gray's Chicago office, for their assistance with this article.*

Fund descriptions

Funds are often described according to their purpose, sector or background. These are some of the more common fund labels:

- **Biotech**, **hitech** and **nanotech** funds focus on portfolio companies in those particular technology sectors.
- **Captive** or **semi-captivefunds** are funds established by, and with strong links to, a particular investor, for instance a financial institution. Many investment banks formed their own captive funds in the 1990s to invest both their own and their clients' assets.
- **Feeder funds** are funds that are specifically created to invest in a single private equity fund. The use of feeder funds is increasingly popular to access the demand of wealthy private individuals. Feeder funds can offer such investors access to popular funds they would otherwise not have (many funds formed by principals with proven track records may be oversubscribed) as well as enabling demand to be aggregated, allowing high minimum subscription levels to be met collectively. Another advantage (from the manager's perspective) is that they often enable the manager of the feeder fund to maintain the confidentiality of its client list from the manager of the underlying private equity fund in which the feeder invests.
- **Funds of funds** are funds that are specifically created to invest in a range of other private equity funds. Like feeder funds, they often offer access to investment opportunities not otherwise available to an investor. In addition, they allow investors to diversify their portfolio between various management teams, which they might be unable to do so individually, lacking the expertise and resources to build and manage individual diversified portfolios.
- **Mega funds** is increasingly used to describe the large buyout funds raised by the more successful established teams, often comprising hundreds of millions of dollars.
- Many funds claim to be **mid-market** buyout funds. However, the range of transactions that are claimed to fall within the mid-market is now so broad as to make the categorisation somewhat meaningless.
- **New Gen** or **spin-outfunds** are funds where the management team is raising its first fund on its own, having previously been with another, more established, fund management group.
- **Pan-European funds** target investments across a range of European jurisdictions rather than focusing on a single country.
- **Secondaries funds** seek to make rapid returns for their investors by focusing on acquiring both interests in, and asset portfolios from, other private equity funds part-way through the investment cycle of such funds.

END OF DOCUMENT

Islamic finance: UK law overview

by ***Debashis Dey*** *and* ***Xuan Jin***, ***White & Case***

Practice note: overview | **Maintained** | International, UK, United Kingdom

This note gives an introduction to the basic principles of Islamic law (or Sharia) that affect finance transactions. It looks at what constitutes Sharia compliance in relation to finance and highlights some differences with conventional finance. It considers the current challenges for the Islamic finance market and its likely future development.

Introduction

Islamic finance is a relatively niche but rapidly growing part of the world finance industry. Sharia-compliant finance includes bank and non-bank financial institutions, capital markets, money markets and insurance. In many Muslim majority jurisdictions, Islamic banking assets have been growing faster than conventional banking assets. There has been a surge of interest in Islamic finance from non-Muslim jurisdictions such as the UK, Luxembourg, South Africa and Hong Kong, demonstrated by the sovereign sukuk issuances out of these jurisdictions, as well as the increased participation of non-Muslim institutions and investors in Islamic finance products.

Despite the growth of the Islamic finance market (due in large part to increased standardisation of documentation and practices), the industry continues to face a number of challenges, including the fact that there are very few appropriately qualified *Sharia* scholars and advisors and that there is no global consensus on Sharia. This lack of consensus, combined with a higher level of innovation required in order to enable Islamic finance products to produce financial returns which are similar to those of conventional, or non-Sharia compliant, finance transactions (see *What is Islamic finance?*), and relatively low transaction volumes when compared with conventional finance, mean that documents for the Islamic finance market (including ***sukuk***) tend to be tailor-made for individual transactions.

Although Islamic finance documentation has become increasingly standardised and there is now a greater degree of consensus among Sharia advisors (at least in respect of certain Islamic financing structures and principles that have become more generally accepted than others, particularly in the sukuk market), the industry is still some way off achieving the same level of LMA standardisation as is seen in the conventional syndicated loan market (see *The future*), although such uniformity is not necessarily needed or appropriate for the Islamic finance industry. There is no 'one size fits all' solution for the Islamic finance market as a whole, and there likely never will be. Accordingly, Islamic finance transactions tend to have higher transaction costs, longer implementation timeframes and a greater degree of complexity than conventional finance techniques designed to achieve equivalent economics, the cumulative effective of which is to act as a barrier to entry for investors, financiers and those seeking to raise finance through Sharia-compliant means.

What is Islamic finance?

At its broadest, Islamic finance covers all financing activity that enables individuals, institutions, governments and financiers in general to invest or raise finance in conformity with Sharia principles (see *Sharia compliance*). In practice, Islamic finance involves using traditional investment techniques and structures that comply with the principles of Sharia to create arrangements that work in ways that are analogous to, and which replicate the economics of, modern conventional finance (see *Key principles* and *Basic transaction structures* below).

The market divides up into:

- **Project and asset finance.** Islamic finance has been well-established as part of the project and asset finance industry for many years, driven by high investment in infrastructure in the Middle East.
- **Retail finance.** The UK retail market took off with the abolition of the double Stamp Duty Land Tax charge on Sharia-compliant mortgages in 2003. The Islamic Bank of Britain, the first stand-alone Sharia-compliant retail bank in the UK, was granted its licence in September 2004. Many mainstream banks in the UK now offer Sharia-compliant products to the UK's estimated 2 million Muslim consumers.
- **Fixed income securities.** Sukuk are used for fund-raising on the capital markets, and this has been the most rapidly growing and innovative segment of the Islamic finance market to date (see *Sukuk* below).
- **Derivatives and structured products.** There is a nascent market in Sharia-compliant derivatives, which has undergone significant development and growth over the past few years with investors now starting to add such products to their portfolios, led by many of the larger conventional banks operating through their Islamic windows (for more information, see *Article, Islamic derivatives*).

Sharia compliance

There are two primary sources of Sharia which provide a framework for life as a Muslim:

- The Quran, which is believed by Muslims to be the word of God.
- The Sunnah, the recorded 'example' of the life and deeds of the prophet Mohammed.

There are also several derived sources of Sharia, including:

- Scholarly consensus (*ijma*) which requires the agreement of all the Muslim scholars at the level of juristic reasoning (*ijtihad*) in one age. In practice, this means that its scope is limited to matters that are clear according to the Quran and the Sunnah.
- Legal analogy (*qiyas*) which can be used to derive rulings for new matters.

The interpretations of Sharia vary, often along geographic lines. This lack of international consensus is one of the key challenges facing the developing market.

Sharia committees

Islamic banks and conventional banks that invest some of their capital in Islamic finance through an Islamic finance 'window', or which advise on and arrange Islamic finance transactions, typically have a religious board or committee composed of Islamic scholars (the Sharia committee), who are usually, by background, academics who are well versed in and recognised by market participants as experts in Islamic studies.

Such Sharia committees examine proposed transactions for compliance with Sharia and, in the case of Islamic banks, review the overall activities of the bank. When it has reviewed a transaction, a Sharia committee will issue a religious pronouncement or opinion (a fatwa) pertaining to the Sharia compliance of the transaction. The issue of the fatwa by the relevant Sharia committee(s) appointed to a transaction is usually a condition precedent to the transaction proceeding.

The fact that there are only a limited number of appropriately qualified Sharia scholars means that the same scholars often sit on the Sharia committee of a number of different financial institutions. In practice, this means that there tends to be a consensus regarding the interpretation of Sharia between those financial institutions.

The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) has published a number of governance standards for Islamic finance scholars. It continues to publish new standards and revise existing ones. Subjects include:

- Conduct of scholars on banks' Sharia committees.
- Regulation of scholars' shareholdings.
- Number of boards on which a scholar can serve.

For more information, see *Legal update, AAOIFI to develop new governance standards for Islamic finance scholars.*

Additionally, the Islamic Financial Services Board (IFSB) is an international standard-setting organisation that promotes the development of the Islamic financial services industry by issuing global prudential standards and guiding principles for the banking, capital markets and insurance sectors of the Islamic finance industry. The IFSB also conducts research and coordinates initiatives on industry related issues, and organizes roundtables, seminars and conferences for regulators and industry stakeholders.

AAOIFI

The *Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI)* is a non-profit organisation that prepares accounting, auditing, governance, ethics and Sharia standards for Islamic financial institutions. Their mission statement is the "Standardization and harmonization of international Islamic finance practices and financial reporting in accordance to Sharia."

It publishes standards relating to a number of types of transactions including:

- Guarantees
- Sukuk
- Mudaraba
- Murabaha

For more information, see *AAOIFI: new and revised Sharia-compliant standards for Islamic financial institutions*.

IFSB

The Islamic Financial Services Board (IFSB), based in Kuala Lumpur, is an international standard-setting body of regulatory and supervisory agencies that have vested interests in ensuring the development and stability of the global Islamic financial services industry. It defines Islamic finance broadly to include banking, capital market and insurance. In advancing this mission, the IFSB promotes the development of a prudent and transparent Islamic financial services industry through introducing new, or adapting existing, international standards consistent with Sharia principles and making recommendations for the adoption of such standards. As at April 2017, the 183 members of the IFSB comprise 70 regulatory and supervisory authorities, seven international inter-governmental organisations, and 106 market participants (financial institutions, professional firms, industry associations and stock exchanges) operating in 57 jurisdictions.

Since its inception, the IFSB has issued twenty-seven Standards, Guiding Principles and Technical Notes for the Islamic financial services industry, including in the areas of:

- Islamic insurance (Takaful)
- Islamic finance regulations
- Ratings of Sharia-compliant financial instruments
- Murabaha transactions
- Development of Islamic money markets
- Disclosure requirements for Islamic capital market products

Key principles

Key principles of Sharia relevant to finance transactions include:

Interest (riba)

Sharia regards money as simply a means of exchange, without intrinsic value. Money cannot be used to make money as this would be unfair exploitation of both the borrower (who must pay a return to the lender, even if his endeavour fails) and the lender (who receives only the agreed return, even if the borrower's endeavour is hugely profitable).

Interest is not the only example of riba, but it is the classic one. Payment or receipt of interest is strictly prohibited, and any obligation to pay interest is considered void under Sharia. The prohibition on riba does not however preclude making a return on an investment, with a return on exchange or ownership of assets being facilitated by money as the payment mechanism.

Although LIBOR violates Sharia (being an interest rate index), it was reluctantly permitted by some Sharia experts because there was no other alternative. The Islamic Interbank Benchmark Rate (IIBR) was launched by Thompson Reuters as an alternative to the interest-based index LIBOR. IIBR provides an objective indicator for the average expected return on Sharia-compliant short-term interbank funding and financial instruments. In contrast to LIBOR, the IIBR uses expected profits from short-term money and a forecasted return on the assets of the bank receiving the funds. These amounts are considered returns on investments and not interest on loans, and therefore are acceptable under Sharia. However, some Sharia experts have questioned whether this alternative is necessary because in Sharia-compliant transactions, LIBOR is just a number that is referenced to determine a return rate and not to calculate interest. For more information on the IIBR, see *Legal update, First Islamic Interbank Benchmark Rate Launched*.

Speculation (maisir)

Sharia prohibits and treats as void transactions that rely on chance or speculation, rather than effort, to produce a return. Importantly, this principle does not prohibit the ordinary commercial speculation involved in a business enterprise. Commercial risk-taking forms a critical part of many Sharia-compliant finance transactions.

However, this can create problems in relation to contracts that are seen as tantamount to gambling, which includes some conventional *derivative* transactions such as *swaps*, *futures* and *options* (conventional derivatives also present other problems, as certain derivative payments can be characterised as riba) For more information on how these issues have been addressed, see *Article, Islamic derivatives: What are Islamic derivatives?*.

Uncertainty (Gharar)

Sharia prohibits and treats as void contracts that are uncertain in order to ensure full disclosure by all parties. The test for uncertainty is much more stringent than the test under English law. All the fundamental terms of a contract (such as subject matter, price and time of delivery) must be absolutely certain at the outset.

A contract that contains conditions precedent may fall foul of this principle. For that reason, conditions precedent are normally set out as unilateral undertakings, separate from the main agreement. Similarly, a contract where uncertainty may be derived from the subject matter may be considered void, for example, uncertainty as to whether an insured event will occur and certain forward contracts and options.

Unjust enrichment/unfair exploitation

Sharia prohibits and treats as void contracts under which one party unfairly exploits the other or gains unjustly at their expense.

For example, in Sharia-compliant finance, some financiers will not charge, and most will not retain, late payment fees when customers are in default (typically, such fees are donated to charity).

Unethical purpose

The purpose of the finance must be one that is permitted by Sharia and for the benefit of society. For example, Sharia-compliant finance cannot be raised for the construction of a casino or a bar, which would be considered unethical.

Sharing profit, loss and risk

A distinctive feature of Islamic finance is that profit cannot be assured, so an Islamic financial institution must assume at least part of the risk of a given transaction. However, taking security is permitted in order to guard against negligence, wilful wrongdoing or breach of contract by parties to the contract.

Key differences between conventional and Sharia-compliant finance

Risk

The financier in a conventional financing will seek to ensure that, so far as possible, it does not take on any commercial (as opposed to counterparty credit) risk relating to the borrower or to the activity or asset it is providing finance for.

By contrast, in an Islamic finance deal, the financier's assumption of some commercial risk relating to the asset or the customer will be necessary to ensure Sharia compliance (see *Sharia compliance* above). This means that Sharia compliant transactions may be exposed to costs that non-compliant transactions are able to avoid.

In particular the fact that many Sharia compliant transactions involve the finance provider owning an asset for a period of time means they are likely to be exposed to a number of *risks* avoided in a conventional financing. These risks may include:

- Liability for death and injury.
- Deemed warranties as to the title, condition and usability of an asset.
- Destruction or non-delivery of the relevant asset leading to reduced or non-payment from the end user.
- Environmental liability (for example the risk that an investor might have to bear the costs of compliance with the CRC Energy Efficiency Scheme may be increased by using Sharia compliant structures. For more information, see *Practice note, CRC Energy Efficiency Scheme: issues for finance transactions: Islamic finance*.)

The challenge for the financier is to ensure that the commercial risk does not exceed that which is necessary and yet is sufficient to maintain Sharia compliance. In practice, such Sharia-specific commercial risks are often mitigated and borne by the obligor through ensuring that indemnities and servicing undertakings are contained in the relevant sukuk documents which place the financial liability in respect of any realization of such commercial risks back on the obligor.

Where a financing has both conventional and Sharia-compliant tranches, careful structuring and co-ordination are needed as the two elements must be kept separate to avoid tainting the Sharia-compliant tranche with riba or undermining the traditional risk protections in the conventional tranche (see *Interest (riba)* above).

Tax treatment

UK tax law, broadly, works on the basis of form over economic substance. The tax treatment of Sharia-compliant structures may therefore not follow the treatment of their conventional finance alternatives. In practice, this can make Sharia-compliant finance a more expensive fund-raising method than conventional finance.

In recent years, UK tax legislation has been amended so that the rules now provide for certain Sharia-compliant finance arrangements to be taxed in the same way as their conventional equivalents under the alternative finance arrangements regime (Chapter 6 of Part 6, Corporation Tax Act 2009). The alternative finance regime has now been extended to sukuk (see *Sukuk, tax and regulatory treatment*). However, some inconsistencies remain and equivalent treatment cannot be assumed as it does not apply uniformly across all Sharia-compliant structures.

For more information on tax treatment of Sharia-compliant transactions, see *Practice note, Sharia-compliant transactions: tax*.

The future

Sukuk issuance is the fastest-growing segment of the Islamic finance market. However, the Islamic finance industry faces a number of challenges, including:

- **Skills shortage.** There are very few appropriately qualified Sharia scholars (it can take up to 30 years before a person is considered qualified, although there is no universal agreement on what makes a person "qualified" in this context). As the market grows, however, there are a growing number of bankers, accountants, financial advisors and lawyers who are familiar with Sharia principles and their application in Islamic finance.
- **No global consensus on Sharia.** There is no international consensus on Sharia interpretations, especially in relation to innovative products.
- **Lack of standardisation.** Lack of consensus on Sharia, a high level of innovation required in order to enable Islamic finance products to produce financial returns akin to their conventional counterparts and relatively low transaction volumes when compared with conventional finance mean that documents for the Islamic finance market (including the sukuk market) tend to be tailor-made for individual transactions, leading to higher transaction costs, longer implementation timeframes and a greater degree of complexity than conventional finance techniques designed to achieve equivalent economics. Such lack of standardization effectively acts as a barrier to entry for investors, financiers and those seeking to raise finance through Sharia-compliant means.

  Such increased costs, timeframes and complexity should diminish as transaction volumes increase and stakeholders become more familiar with Islamic finance products. However, there is no “one size fits all” structuring or Sharia solution for the Islamic finance market as a whole, and there likely never will be, although steps have been taken by industry bodies and governments to increase standardization.

  The LMA bought out a Users' Guide to Islamic finance documents in March 2007 (last updated in 2013) but has not produced and has no current plans to produce *pro forma* documentation. A number of other standard form documents exist in the market, see *Practice note, Islamic finance: standard documents*.

  The Malaysian government has attempted to implement standardization in terms of local consensus on Sharia at a national level by establishing a centralised Sharia supervisory board at the Central Bank of Malaysia, to ensure that every Malaysian domestic sukuk is in full compliance with nationally accepted Sharia principles. To date, no other jurisdiction or region globally has developed a similar regional supervisory body or agreed on a set of regionally accepted Sharia principles.
- **Limited secondary market for sukuk.** Until fairly recently, there has been a limited secondary market for sukuk as investors have traditionally tended to hold their investments until maturity. However, the secondary market has grown considerably in recent years as interest from the non-Islamic international institutional investor community has increased, due in large part to increased standardization of sukuk documentation, increased consensus among Sharia scholars in respect of the Sharia-compliance of certain commonly utilized sukuk structures (such as the Sukuk al-Ijara) and, accordingly, increased volumes of sukuk issuances globally, leading to international investors (both Islamic and non-Islamic) better understanding the product. The continuation of this trend will likely result in increased secondary market trading of sukuk.
- **Need for assets.** Much Sharia-compliant finance is assets-based, relying in some way on an income stream generated from assets. In practice, this can limit fund-raising to the assets available.

- **Restrictions on hedging.** Traditional hedging techniques using derivatives are not always Sharia-compliant (for example, some derivatives fall foul of the prohibition of gambling). This means that hedging risks relating to currency, fair value or profit volatility is not easily achieved in Sharia-compliant finance (for more information on how this is being addressed see *Practice note, Islamic derivatives*).
- **Insurance.** Development of Sharia-compliant insurances as an integral part of transactions, particularly in the project finance sphere. For more information see, *Practice note, Understanding Takaful: Ethical and Fair Islamic Insurance*.
- **Tax disadvantages.** There have been moves to address tax disadvantages of Sharia-compliant finance. For more information see Practice notes, *Sharia-compliant transactions: tax* and *Sharia-compliant transactions: VAT*.

Despite these challenges, the outlook for Islamic finance is bright. As Sharia jurisprudence becomes more settled, and Islamic finance documents and transaction structures become more standardised, there will be a reduction in transaction costs and increases in efficiencies. In turn, this may result in further increases in Islamic finance transaction volumes and raise awareness and understanding of market participants that Islamic finance is an accessible method of raising finance and accessing a wider pool of investors thereby driving further growth of the Islamic finance market.

END OF DOCUMENT