CHAPTER - 4

LEGAL REQUIREMENTS OF FINANCING BY ISSUANCE OF ISLAMIC FINANCIAL INSTRUMENTS (IRANIAN CASE STUDY)

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I INTRODUCTION

As we know, financial markets consist of capital markets and monetary markets and both have an important role in financing firms and companies and in both markets financial instruments are used.

On the other hand, Islamic finance is a financial system which is based on Islamic principles and serves the noble goals prescribed by Islam (*Maqasid al-Sharia*), and in the last 40 years it was introduced and developed in Muslim and non-Muslim countries. In this system, Islamic financial instruments named *sukuk*, have an essential function.

Islamic law as a legal system has principles and rules that are named Sharia and the knowledge of it named *Figh* or Islamic jurisprudence have several schools of law and *Immamieh* or *Jafari* or Shia jurisprudence is one of them.

The word *sukuk* comes from the plural of the Arabic word *sakk* which means legal instrument, deed, cheque and it may be said *sukuk* are financial instruments or securities that are structured according to Sharia. *Sukuk* are defined by AAOIFI[1] as *"certificates of equal value representing undivided shares (in ownership of) tangible assets, usufruct, and services or (in the ownership of) the assets of particular projects or special investment activity*". However, they could be better explained as Sharia-compliant financing instruments and alternatives to conventional bonds.

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1 Accounting and Auditing Organization for Islamic Financial Institutions, 'Sharia' Standards No (17), Investment Sukuk' (2010) p 307 <www.global-islamic-finance.com/2009/.../sharia-standard-no-17-investment-sukuk.ht> accessed 12 September 2016.

As capital markets are divided into debt capital markets and equity capital markets, the *sukuk* market falls into the debt capital markets arena because holders of *sukuk* do not have an equity in the financed company itself but have undivided shares in a definite project or asset. Capital markets are also classified into primary markets and secondary markets. In most Muslim countries *sukuk* are only used in primary market but in the Iranian capital market they may be used in both markets.

As some scholars said: "recent innovations in Islamic finance have changed the dynamics of the Islamic capital market with respect to *sukuk* and securities. On international capital markets, *sukuk* have developed into one of the most acceptable Islamic structures for raising finance, which in turn has led to its increasing use in recent years by government and private institutions".[2]

It must not be supposed that financial engineering of *sukuk* is taking place by simply modifying the existing conventional products. In order to be in accordance with Islamic legal requirements and maintaining the other objectives of the capital markets, *sukuk* should essentially be structured in the spirit of creating an Islamic financial system, which is based on Islamic principles and Sharia rules. However, Islamic and Iranian scholars and practitioners take efforts towards structuring products that are legally valid in Islamic law in accordance with *Immamieh* jurisprudence

The topic of this research is the legal requirements of financing by the issuance of Islamic financial instruments (Iranian case study). Although there are a lot of researches in form of articles or books about *sukuk* and Islamic finance, the necessity of our research arises from the fact that most research has ignored Iranian case law and *Immamiah* jurisprudence and is founded on the four schools of Sunni jurisprudence. Another feature of our research is that it comprehensively considers all the requirements together.

Presumptions of our research are: first, unlike many Muslim countries, Iranian law has regulations and legal mechanisms to protect investors and holders of *sukuk*. Second: *Immamieh* jurisprudence is more flexible as compared with other Islamic schools of law and has better solutions for legal issues of financial markets. This ability arise from the open door of *ijtehad* (to form an opinion on a point of religious law) in Shia thought.

Particularly, on financial markets and transactions, the approach of *Immamieh* jurists is different from Sunni jurists. For example, as to the concept and realm of

2 Ketut Ariadi Kasuma and Anderson Caputo Silva "*Sukuk* Markets A Proposed Approach for Development" WPS7133 (2014) p 17 <www.researchgate.net/publication/278646136_Sukuk_Markets_A_Proposed_Approach_for_Development> accessed 30 September 2016.

gharar there are different views among Islamic jurists. So the majority of Sunni jurists believe that commercial insurance with fixed premium, are forbidden based on *gharar*.[3] However, the majority of Shia jurists accept its validity. Differences in views are seen about transferability of debt and sale of it (*bey-o-deyn*), the validity of new contracts and the possibility of guarantee in some *sukuk*.

Therefore, in addition to the requirements of the stock exchange, there are other requirements according to the principles of Sharia that must be considered. These requirements may be classified into two categories: affirmative that must exist and privative or negative that must not to exist. Hence, I will render this presentation in two parts.

II SHARIA AFFIRMATIVE REQUIREMENTS OF FINANCIAL INSTRUMENTS

2.1 Legal Arrangements for Issuance of Financial Instruments (legal nature and structure)

Islamic financial instruments or *sukuk* have binary nature. On one hand, they have a contractual nature that according to selected contractual relationships may have different legal nature and its holder's rights will be different. On the other hand, they are financial Instruments but also securities that may be issued and subscribed in the primary market and sold in secondary markets. Therefore, the Iranian legislator has considered the implications of capital markets and in order to safeguard the health of capital markets and for protection of investors and security of their rights, laid down legal arrangements and a formal structure for issuance of Islamic financial instruments.

According to the 'Manner of Issuance of Awragh-ol-Mushareka (partnership instruments) Act' and its regulations, government and public institution and private company can issue *awragh-ol-mushareka* for their projects. The main parties of this instrument are the issuer and buyers of them (that become partners). Moreover, factor or paying agent, trustee, guarantor, market operator, credit ratings institution, advisor and auditor have legal functions in the process of issuance and settlement of partnership instruments. In this instrument, the company or institution that needs to finance, issues the instrument.

But in other *sukuk* such as *ijarah* (leases), *murabahah* (sale with markup), *mudarabah* (partnership between one person who contributes capital and another who provides managerial skills), *salam* or *salaf* (forward sale), *istisna* (contract for

3 M Al-Zarqa *Nizam Al-Ta'min: Haqiqatuh, wa Al-Ra'y Al-Shar'i fih* **(**Mu'assasat AlRisalah, 1994).8; RY Al-Misri *Al-Khatar wa Al-Ta'min: Hal Al-Ta'min Al-Tijari Ja'iz Shar'an?* (Dar Al-Qalam, 2001) 6.

a future delivery of manufactured or constructed asset(s), *wakala* (based on a contract with an agent that makes investment decisions on behalf of the investors), *ijarah-be-shrte tamlik* (hire purchase) and so on, there is other party that is named *bani* (originator) and the goal of issuing *sukuk* is the financing of originator instead of issuer.

However, in Islamic financial instruments or *sukuk*, unlike conventional bonds, the relationship of the main parties is not a relation of creditor and borrower, but, according to each case, is a relation of seller and buyer or leaser and leaseholder or agent and principal or investor and entrepreneur as well as a relation between fellow partners in a joint investment project.

According to Iranian law, the issuance of *sukuk* requires the permission of legal authority - the 'Securities and Exchange Organization' (SEO) - and for grant of this permission, the issuer and originator must provide and render documents, which should follow capital market norms relating to custody, payment and administration, and conclude contracts, which form the core of a Sharia-compliant transaction as well as contractual provisions to provide a periodic return and pay the face amount of the *sukuk* to holders in a Sharia-compliant manner.

2.2 Underlying Contract Confirmed by Sharia

As noted above, all Islamic financial instruments or *sukuk* rely on one or several contracts. The issuance of *sukuk*, other than *awragh-ol-musharakah* (partnership instruments), involve an intermediate institution for issuance of the financial instruments and implementation of contractual arrangements, that is named as *Nehade-vaset* (Intermediary or special purpose vehicle or company (SPV or SPC)). According to Iranian statutes, the originator and issuer of partnership instruments is the same and the issuer of these instruments issues them for financing its special project and consequently the issuer firm and investors (holders of instruments) become co-partners in the assets of the project. However, theoretically the subject of the partnership may be commercial transactions.

In other *sukuk*, the company or firm that needs to finance that named originator, conclude an agreement with an intermediate institution and consequently, according to the subject matter of agreement, one kind of *sukuk* is issued. After issuance of *sukuk* and subscription of them, investors or holders of *sukuk* become co-partners of the funds that are collected. Moreover, a legal relationship is produced between them with an intermediate institution (SPV). By virtue of this relation, the intermediate institution has authority to deal and contract. These contracts, a sort of *sukuk*, may be purchase and sale (in *sukuk-ol-murabaha* and *sukuk-ol-istisna* too), or may be purchase and lease (in *sukuk-ol-ijarah* and *sukuk-ol-ijarah* be *sharte tamlik* or hire-purchase too) or may be purchase and sale and

other commercial transactions (in *sukuk-ol-mudarabah*) and after all, a distribution of earnings between investors (holders of *sukuk*). Ordinarily, there are three legal relationships in each kind of *sukuk*.

The feature of Islamic finance is that the underlying contracts are in compliance with Islamic law or Sharia. To ensure this compliance an advisory committee was established to advise providers which offer Islamic financial products.

In Islamic finance, the investor cannot get interest on his money and money as money cannot earn more money by itself. Money must be put into real business activities to earn extra money. The pool of money, collected through various Islamic financial instruments and or common funds, are channeled to trade, lease or investment activities. In this system, money has been used in real economic activity in order to generate more income. Thus, the profit generated by *sukuk* is the outcome of dealing with a real asset rather than a monetary asset.[4]

2.3 Instrument's Lien on Asset and Holder's Ownership over Underlying Asset

Islamic finance requires that all financial instruments be based on business activity and must have an underlying asset. This asset is an essential element as a subject matter of the underlying contract and absence of an underlying asset will render the contract void and null.[5]

IFSB[6] in its 'Capital Adequacy Standard', has defined sukuk as "certificates that represent the holder's proportionate ownership in an undivided part of an underlying asset where the holder assumes all rights and obligations to such asset".[7] These assets may be in a specific project or investment activity in accordance with Sharia rules and principles. Sukuk differ from conventional interest-based securities or bonds in a number of ways, including:

(a) The funds raised through the issuance of *sukuk* should be applied to investment in specified assets rather than for general unspecified purposes.

(b) Since the *sukuk* are based on the real underlying assets, income from the *sukuk* must be related to the purpose for which the funding is used.

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4 Chartered Institute of Management Accountant, 'An Introduction to Islamic Finance' p 11 <www.simaglobal.com/islamicfinance> accessed 15 October 2016.

5 Tan Wan Yean "Sukuk: Issues and the Way Forward" (2009) p 3 <www.iln.com/articles/pub_1674.pdf> accessed 12 September 2016.

6 Islamic Financial Services Board.

7 IFSB "Guiding Principles of Risk Management for Institutions" (December 2005) <www.ifsb.org/standard/ifsb1.pdf> accessed 12 September 2016.

(c) The *sukuk* certificate represents a proportionate ownership right over the assets in which the funds are being invested. The ownership rights are transferred from the original owner (the originator) to the *sukuk* holders or may be acquired from transaction caused by the funds that are produced from issuance of *sukuk*. However, we must distinguish between different *sukuk*. In *sukuk-ol-murabaha and sukuk-ol-istisna and sukuk-ol-salaf* after the purchase and sale of asset, *sukuk-holders* release their ownership over the asset and become partner owners over receivables. But in *sukuk-ol-ijareh* and *sukuk-ol-musharaka* and *sukuk-ol-muzarabah* their ownership over the asset will remain until the due date of the *sukuk*.

That we noted above, is the ideal legal status of *sukuk*. But in practice and in real circumstances, the status is different. As legal formalities and statutory obstacles arise normally, the ownership of the underlying asset does not transfer to *sukuk*-holders and remain in the name of issuer. Hence, some scholars in Islamic finance have classified the *sukuk* into asset-backed and asset-based *sukuk*.

As Dusuki has said, "in asset-backed *Sukuk*, the *Sukuk*-holders are the owners of the asset, and the actual performance of the underlying asset will determine the return to the *Sukuk* holders. If the underlying asset is performing while the originator is facing bankruptcy, the *Sukuk*-holders' payment will be uninterrupted. If the underlying asset is not performing (ie impaired), the *Sukuk*-holders must take the hit because they are the owners of the asset. In other words, as owners of the asset, the *Sukuk*-holders will be exposed to the market risk of the asset in addition to the credit risk".[8]

In contrast, the asset that is presented under asset-based *sukuk* is merely for the purpose of formal Sharia compliance rather than to serve as the source of profit and capital payments. Therefore, the credit risk assessment will typically be directed towards the entity that is obliged to redeem the *sukuk*. Usually, it will be the issuer, however, in some cases this task may fall on the originator, via the existence of a purchase undertaking agreement. In this instance, an analysis of the asset will be inconsequential; rather, the credit quality of the obligor will be the key factor affecting the credit quality and rating of the *sukuk*.[9]

According to Iranian regulations governing Islamic financial instruments, holders of *sukuk* have proportionate ownership in an underlying asset and are co-

8 Asyraf Wajdi Dusuki and Shabnam Mokhtar "Critical Appraisal of Shari'ah Issues on Ownership in Asset-Based *Sukuk* as Implemented in the Islamic Debt Market" Research Paper (No 8/2010) p 10 <www.ifikr.isra.my/documents/10180/16168/8.pdf> accessed 14 October 2016.

9 Ibid.

partners on the return of the asset.[10] Nevertheless, according to that law, the title of assets is in the name of issuer [*Nehade-Vaset* (Intermediary)] and the issuer of *sukuk* in their own name and on behalf of *sukuk*-holders purchase and sale. Indeed in these cases, the issuer has title of the underlying asset and disposal of it. *Sukuk*-holders have equitable or beneficial ownership or have an equitable interest in the assets in the hand of issuer (a special purpose vehicle (SPV)). Moreover, *sukuk* holders have recourse to the issuer if there is a shortfall in payment. From this perspective, *sukuk* in the Iranian capital market are asset-based *sukuk*. It must be noted that according to section 10 of the "Directive on Manufacture Order Instruments" (directive on *sukuk-ol-istesna*) 2013, the ownership of a manufacturing asset remains for the issuer until complete payment of price. According to section 1 of the Directive on *Awragh-ol-Murabaha* 2011, these *sukuk* or *awragh-ol-murabaha* are transferable securities that represent proportionate ownership of the holders in the financial asset that has arisen from the *murabaha* contract.

2.4 Profit and Loss Sharing in the Underlying Investment

The concept of profit and loss sharing is peculiar to Islamic finance, although Islamic finance is not an equity market, which is normally represented by the stock market. This makes Islamic finance distinctive from that of conventional finance. Islamic instruments or *sukuk* ensure returns similar to conventional bonds, while the difference is that the return of *sukuk* is generated from the underlying real asset ownership, not the interest payments obligation as found in conventional bonds.

In contrast, conventional bonds are normally issued as evidence of debts. Unlike *sukuk*, "bonds do not represent ownership on the part of bondholders in the commercial or industrial enterprises for which the bonds were issued. Rather, they document the interest-bearing debt owed to the holders of the bonds by the issuer, who is actually the owner of the enterprise".[11]

Conventional bonds are structured as debt instruments with fixed interest and the amount of interest is determined as a percentage of the capital and not as a percentage of the actual profits. The issuer of bonds also guarantees the return of the principal when redeemed at maturity, regardless of whether the enterprise was profitable or not. On the other hand, with regarding to the Sharia prohibition on interest of money or '*riba' (or Reba)*, *sukuk* cannot be structured to represent a loan

10 The Regulations Governing the Issue of Ijarah Sukuk 2008, s 1.

11 Muhammad Taqi Usmani (President of the AAOIFI Shariah Council) "Sukuk and their Contemporary Applications" (2007) p 3 <www.kantakji.com/media/7747/f148.pdf> accessed 22 September 2016.

as a bond does except where it is without interest and as *qard-ol-hasanah*. Then, the issuer of *sukuk* use assets and various Sharia contracts to provide alternative instruments to the conventional bond. Consequently, *sukuk* holders are entitled to share in revenues generated by the *sukuk* assets and may be entitled to share in the proceeds of the realization of the *sukuk* assets. This sharing in the proceeds, however, is not fixed up-front. It is rather based on the actual profit realized from the venture.[12] In principle, the ratio of probable profit is equal to the ratio of investment as the ratio of probable loss is the ratio of investment.

In detailed comparison between two financial instruments, it may be said: conventional bonds are financial obligations, in the form of certificates, issued by borrowers to creditors. Bonds have guarantee features in which borrowers guarantee capital repayment with capital charge to the creditors. Financing of the issuer through a loan relationship is the main function of conventional bonds. That loan relationship implies a contract with the characteristic of earning interest in addition to principal, which is known in Sharia as *Reba* and is prohibited in Islam. Bonds are very liquid in nature, as they can be easily traded in secondary markets, when the bondholders need liquidity. Bonds' risks are concentrated on the credit risk of the issuer.[13]

In contrast, *sukuk* represents asset ownership in form of Sharia compliant contracts such as lease, partnership, or sale, in which the return originates from business activities. The return can be either derived from profits of real underlying assets attached to *sukuk* or from sales, lease or partnership of business ventures, which characterizes *sukuk* as an asset-backed financing instrument. Moreover, the risks of *sukuk* are broader than conventional bonds. Because *sukuk* in addition to credit risk, involve other risks such as market risk, asset-quality risk, regulatory risk, and so forth.[14]

Therefore, in the Iranian capital market *sukuk* or Islamic financial instruments are classified into two groups. In the first group as *sukuk-ol-murabaha* and *sukuk-o-salaf* or *salam* and *sukuk-ol-ijara* and *sukuk-ol-istisna*, the return can be predictable. Because, according to the primary agreement between originator and the issuer, the price and expected profit are determined. In the second group as *sukuk-ol-musharakah* and *sukuk-ol-muzarabah*, the return is unpredictable.

12 Dusuki and Mokhtar (above n 8) 8.

13 Nathif Adam and Abdulkader Thomas *Islamic Bonds: Your Guide to Structuring, Issuing and Investing in Sukuk Paperback* (Euromoney Books, 2004) 52.

14 Jhordy Kashoogie Nazar "Regulatory and Financial Implications of *Sukuk's* Legal Challenges for Sustainable *Sukuk* Development in Islamic Capital Market" <www.iefpedia.com/english/wp-content/uploads/2011/jhordy.Kashoogi-Nazar.pdf> accessed 11October 2016.

However, according to Iranian statute, the issuer of *sukuk-ol-musharaka* (partnership instruments) must annually pay a fixed sum to the holders as payment on account.

This rule may be justified. Because according to Iranian statute on requirement of issuance of *sukuk-ol-musharakah*, the issuer must render a proposal for his project, which the experts can confirm its profitability and in this proposal, the amount of anticipated profit and added value of the project must be estimated and on the basis of it, the percent of predictable profit will be determined.

2.5 Guarantees for Redemption of Instruments and Payment of the Profit

One of the legal issues of Islamic financial instruments or *sukuk* is that financial institutes that issue the *sukuk* may guarantee the redemption of *sukuk* and guarantee the repayment of principal of *sukuk* at their face value and payment of their return. And is this guarantee valid in Islamic law or Sharia?

In the view of some Islamic scholars the response is negative, because one of the principles that govern *sukuk* is that capital in equity‐based financing or investment cannot be guaranteed by the manager or other partner. An equity contract must be free from capital guarantee to reflect the very essence of equity investment - that is equity investors must bear the risk of loss of capital.[15]

As quoted in the media,[16] in November 2007 Sheikh Taqi Usmani, one of the world's leading Sharia scholars and chairman of the AAOIFI Board of Sharia Scholars, said that 85% of *sukuk* are not Sharia compliant, mainly because their method for redemption incorporates a purchase undertaking (a promise that the 'obligor' will redeem the *sukuk* by repurchasing the underlying assets at a price representing the face amount of the *sukuk* at maturity or following an event of default). Sheikh Usmani's view was that this promise violated the principle of risk and profit-sharing on which such *sukuk* should be based.[17]

Usmani said on the sidelines of an Islamic banking conference in Bahrain: "You must face the actual consequences of your investment". A promise to pay back

15 Chartered Institute of Management Accountant (above n 4) 8.

16 *Reuters*, 22 November 2007 1:16 AM <www.arabianbusiness.com>.

17 Rahail Ali "An Overview of The *Sukuk* Market" p 10 <www.globelawandbusiness.com/spg/sample.pdf>accessed 20 November 2016.

capital violates the principle of risk-and-profit-sharing on which such bonds should be based. This is, indeed, mirroring the structure of a conventional bond.[18]

This viewpoint is based on a strict interpretation of Sharia' rules and principles and cannot be completely true. First, the different *sukuk* must be distinguished. In *sukuk* as *murabaha* and *salam* and *istesna* with the collected funds from subscription of *sukuk*, the issuer purchases the underlying asset and sells it to originator or third person. Then at maturity he is obliged to distribute the monetary price between the *sukuk*-holders. If the redemption of this *sukuk* and payment of actual profit will be like that, there is no problem in view of Sharia. Since the profit of transaction and return of *sukuk* is predictable and the issuer performs his contractual duty and there is personal security and proprietary security that guarantee the performance of obligations of issuer and obligator, per se it is not contrary to principles of Sharia. Hence, the AAOIFI Board of Sharia Scholars published a six-point paper in 2008 outlining their position on *sukuk*, which included a ruling that purchase undertakings at face value for *musharaka* and *mudarabah sukuk* structures are no longer permissible but for other *sukuk* may be permissible.

Regarding *sukuk-ol-ijarah*, it must be noted that where the contract in the form of hire purchase or lease contract incorporated the condition that the leaseholder is obliged to purchase the asset for a nominated price, this agreement and obligation will be valid. According to the order of prophet Mohamed, all Muslims are bound by their contractual terms (*almomenouna enda shoroutehem*).[19] Of course, the intention of parties must not breach usury rules.

Therefore, IFSB in its 7 Standards, has classified the asset-based *sukuk* into two structures: First, an asset-based *sukuk* structure with a repurchase undertaking (binding promise) by the originator: the issuer purchases the assets, leases them on behalf of the investors and issues the *sukuk*. Normally, the assets are leased back to the originator in a sale and leaseback type of transaction. The applicable credit risk is that of the originator, subject to any Sharia compliant credit enhancement by the issuer. Such structures are sometimes referred to as "pay-through" structures, since the income from the assets is paid to the investors through the issuer.

Such structures are often used in the case of *ijarah* (sale and leaseback) *sukuk* issues. However, a *musharakah* structure may be used that aims at replicating asset

18 Muhammad Taqi Usmani "Most *sukuk* 'not Islamic', body claims" <www.arabianbusiness.com/most-sukuk-not-islamic-body-claims-197156.html> accessed 15 October 2016.

19 Mohammad Alhor Alameli *Vasael Alshia Ela Tahsil Masael Alsharia* V21 (2nd ed, Allolbeyt, 1996) 276.

ownership by setting up a venture (*musharakah*) jointly owned by the *sukuk* issuer (usually incorporated as a SPE) and the originator. The issuer and originator's shareholdings in the *musharakah* represent their respective capital contributions based on a parity agreed at the outset, usually comprised of: (a) capital from the issuer (for example, proceeds of the investors' payment for the *sukuk*); and (b) specific assets and "management skills" from the originator. Should the cash flows generated by the assets under the business plan of the *musharakah* not be sufficient to fund these payments, subject to Sharia permissibility, the issuer may have the option to call on the repurchase undertaking on behalf of the investors.[20]

Second, in an asset-based *sukuk* structure, the so-called "pass-through", a separate issuing entity purchases the underlying assets from the originator, packages them into a pool and acts as the issuer of the *sukuk*. This issuing entity requires the originator to give the holders recourse, but provides Sharia compliant credit enhancement by guaranteeing repayment in case of default by the originator.[21]

The Iranian legislator in order to safeguard the health of capital markets and protect investors and secure their rights, enacts regulations and directives about various Islamic financial instruments or *sukuk* and in all of them lays down duties for issuer and originator and their guarantors. According to the regulation on *sukuk-ol-murabaha* and the regulation on *sukuk-ol-istesna*, the principal and return of these *sukuk* will be paid from the sale of asset to the originator and the issuer must take both personal security and proprietary security from the originator in order to guarantee the performance of obligations of the originator (obligor). The guarantor must be a bank or financial institution.[22]

According to the Iranian regulation on *sukuk-ol-ijarah*, the above-mentioned arrangement must be observed too, moreover, the originator (leaseholder) is obliged to insure the underlying asset by an insurance company.[23] It must be noted that in viewpoint of *immamieh* jurists commercial insurances are valid. In contrast to the views of Sunni jurists', in the view of *immamieh* jurists the insurance contract is not uncertain and is not *gharari*. What the insured is obtaining from insuring his asset is certainty and inner peace.[24]

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20 IFSB, Capital Adequacy Requirements for *Sukuk*, Securitizations and Real Estate Investment, (January 2009) 5 <www.ifsb.org/standard/ifsb7.pdf> accessed 12 September 2016.

21 Ibid.

22 The Regulations Governing the Issue of Murabaha *Sukuk* 2012, s 5.

23 The Regulations Governing the Issue of Ijarah *Sukuk* 2008, s 12.

24 Morteza Motaheari *A Study About Insurance on Islamic Jurisprudence* (Mighat, 1983) 81-82.

In *sukuk-ol-musharakah*, an issuer and an originator are the same. According to article 22 of the Iranian regulation on *sukuk-ol-musharakah*, the issuer is obliged to redeem the *sukuk* and pay off returns of the *sukuk* at definite maturities and is obliged to mortgage the necessary proprietary security. According to article 1 of this directive, a guarantor is the legal person that guarantees the repayment of principal and return of *sukuk*. The source of obligations of the issuer is that in his proposal of project and business plan, he guaranteed the profitability of his project and investors have relied on his statements. If the project produced positive results, he must observe the rights of investors and if the project failed, according to one Sharia principle, one who was deceived, has a right of recourse against the deceiver (*almaghrour yarjeo ela man gharrahu*).[25]

III PRIVATIVE OR NEGATIVE REQUIREMENTS

3.1 Prohibition of Reba (usury)

Reba is translated into English as usury but the two words are not synonymous. The word "*Reba*" literally means "excess" or "addition". According to Islamic jurisprudence terminology, *riba* is any excess or surplus without due consideration, while usury is profit greater than the lawful rate of interest.[26]

In Islamic law, there are two kinds of *Reba*. First, *Reba-ye-gharzi* in loan contracts, where this term indicates that a borrower pays an amount or gives property in excess of principal. Second, *Reba-ye-muameli* in barters and exchanges, where the term indicates that its subject matter is goods by weight or measurable goods when the same goods are exchanged. *Reba* is confined to these categories of transactions. However, in Islamic law, *Reba* can arise when there is an exchange of two similar items or assets such as money for money or rice for rice.[27]

In the money market, the leading practice from which interest originates is the exchange of money for money, that is, money lending .This is because the most important underlying principle of conventional banking is that money creates money or that money has a premium, known as interest. This practice (known in Arabic as *Reba*) is the antithesis of Islamic finance because Islamic law, from the beginning, has categorically denounced it. However, *Reba* is one of the major prohibited elements in Islamic finance and explicitly prohibited in the Quran and

25 Mohammad Hosein Bojnourdi, *Alghavaed Alfeqhya* V1 (Alhadi, 2000) 270.

26 Zamir Iqbal and Abbas Mirakhor *An Introduction to Islamic Finance, Theory and Practice* (2nd ed, John Wiley & Sons Ltd, 2011) 58.

27 Jafar Ibn hasan Helli *Sharaye-ol-Islam* (2nd ed, Alvafa, 1983) 299.

tradition of the prophet of Islam as undisputed sources of guidance of all Muslims. Hence, according to Islamic law getting of *Reba* or usury is a mortal sin or main crime that in Quran is described as war against God.[28] Furthermore, in Islamic jurisprudence any agreement or stipulation in a contract that culminates in *riba* is void and null.[29]

In the Iranian capital market, issuance of conventional bonds was prohibited because these bonds represent a loan relationship that the issuer as borrower must pay a sum in excess over principal to bondholders. Instead, Islamic finance instruments or *sukuk* as alternatives to conventional bonds are permitted because they are not based on loan but based on beneficial transactions or commercial ventures and *sukuk*-holders receive the profit of a commercial activity. It must be noted that the Iranian Securities and Exchange Organization, in addition to the mentioned *sukuk*, produced *sukuk-ol-gharzolhasanah* that represent a loan without any interest and holders with goodwill, give a loan to an originator in order to use it for entrepreneurial activity.[30]

A mechanism of returns on financial instruments in a manner that does not result in *Reba*, is one of main problems in the Iranian capital market. Given the considerable inflation in the Iranian economy, the amount of returns must be such to persuade investors to subscribe *sukuk*. Hence, most issuers of *sukuk* anticipate and declare fixed rates as returns of *sukuk* that are more than the formal rate of inflation. This method is suspicious and may be *Reba*. Nevertheless, this suspicion is not justifiable in transactions where its profit may be calculated after the primary agreement between an originator and the issuer (SPV) and before the issuance of *sukuk* as *sukuk-ol-murabaha* and *istisna* and *salaf* and *ijarah*.[31] However, in other cases as *sukuk-ol-musharakah* (partnership), the issuer for getting permission of issuance from SEO, must render his business plan and a proposal for his project; the experts can confirm its profitability and in this proposal the amount of anticipated profit and added value of project must be estimated and on the basis of it, the percent of predictable profit will be determined.[32] Of course, the amount of money that will be paid to *sukuk* holders before maturity date is on account and the fixed profit of the project will be definite after profit-and-loss account.

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28 The Holy Qur'an, Sura Baghara, section 278.

29 Jafar Ibn hasan Helli (above n 27) 324.

30 The Regulations Governing the Issue of Qarz-al-Hasan *Sukuk* 2012.

31 The Regulations Governing the Issue of Ijarah *Sukuk* 2008, s 19; The Regulations Governing the Issue of Murabaha *Sukuk* 2012, s 17.

32 The Executive Bylaw Governing the Issue of Participation Certificates by the Companies Listed on the Stock Exchange 2003 ss 1 and 22.

3.2 Lack of Gharar (probability with risk)

According to Sharia, *gharar* is another element that must be avoided in any financial transaction. In Sharia literature, *gharar* refers to ignorance and ambiguity or uncertainty or risk that could result in dispute among parties to a contract. Avoidance of *gharar* or unreasonable risk is a principle of Islamic law that is founded on the hadith of the Prophet Muhammad, which prohibits sale with *gharar* or sale of goods without knowledge or with ambiguity or unreasonable risk.[33]

However, *gharar* is the second important element in financial transaction with the aim of avoiding deception and protecting the rights of contracting parties, minimizing disputes and reducing the opportunity of exploitation of one party by another in transactions, so that no one or both parties are cheated or aggrieved.[34]

Gharar in practice relates potentially to issues such as pricing, delivery, quantity and quality of assets that are the subject matter of contract and would affect the degree or quality of consent of the parties to a contract. Unlike *riba*, which is determined by a fixed formula, the determination of *gharar* is based on many factors. This is because, the parameter of knowledge or consent and the risk tolerance by society is not fixed. Above all, Islamic contract law has accepted the distinction between major uncertainty (*Gharar fahish*), which is prohibited at all times, and minor uncertainty (*Gharar yasir*), which is tolerated by society.[35] But it may be said that the impermissible *gharar* is unreasonable risk or uncaused uncertainty.

In the capital market, transparency is required because ambiguity or concealment may injure the health of capital markets and moreover, it may introduce unreasonable risk into transactions that according to Sharia are *gharari* and void.

3.3 Illegality of Sale of Debt for Debt

One other issue of the capital market is the legal possibility of sale of debt. The result of this debate appears in the permitting of the sale of *sukuk* in the secondary market. Of course, in equity-based *sukuk* such as *sukuk-ol-ijarah,* where the *sukuk* represent the undivided ownership in the business venture or asset, there is no debt in their tradability but sale-based *sukuk* such as *Murabahah*, are evidence of the

33 Mohammad Ibn Ali ALsadouq *Oyun Akhbar Reza* V2 (Maktaba Heidarieh, 2010) 50.

34 Muhammad Iman Sastra Mihajat "Contemporary Practice of Riba, Gharar and Maysir in Islamic Banking and Finance" (2016) 2 IJIMB Rev 4.

35 Ibid.

sukuk holders' right to receive the payment of *Murabahah* sale price, which is debt in nature.

In general, the majority of Islamic jurists including the Sunni and Shia jurists, are unanimous in allowing selling debt to the debtor.[36] They only differ about selling the debt to a third party for the reason that the seller will not be able to deliver the sold item to the buyer. The "sale of debt" has always been a point of contention among past and present Islamic jurists. However, there is no consensus among those who forbid it. The reason generally touches on the risks to the buyer, *gharar*, absence of delivery (*qabadh*) and *Reba*.[37]

While most Sunni jurists consider those transactions legally void; most Shia jurists reject that reason and subject to requirements, consider sale of debt legally valid and enforceable.[38] Therefore, the tradability of the *Sukuk* on the secondary market in Iran is permissible but transactions of *sukuk* in the secondary market must comply with Sharia requirements and the most important requirement is that the price must be in cash, because, in the view of Shia jurists the sale of debt for debt is void.[39] Then, as a matter of principle, the transactions of *sukuk* in the capital market, especially in the secondary market, must not as such lead to a sale of debt for debt.

3.4 Absence of Simulation

Simulation in contracts may be absolute or relative. In absolute simulation, where the contracting parties do not intend to be bound by the contract at all, the contract is void. In relative simulation, the real transaction is hidden; the contracting parties conceal their true agreement; it binds the parties to their real agreement when it does not prejudice third persons or is not intended for any purpose contrary to law, morals, etc. If the concealed contract is lawful, it is absolutely enforceable, provided it has all the essential requisites: consent, object, and cause. As to third persons without notice, the apparent contract is valid for purposes beneficial to them. As to third persons with notice of the simulation, they acquire no better right to the simulated contract than the original parties to the same.

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36 Wahbah Al-Zuhaili *Al-Fiqh al-Islami wa Adillatuhu* V4 (Dar al-Fikr, 1989) 433.

37 Securities Commission of Malaysia "Resolutions of The Securities Commission Shariah Advisory Council" (2nd ed, 2006)17.

38 Mohammad Hasan Najafi, *Javaher-ol-Kalam* fi Sharhe Sharayeol Islam, V24 (Islamieh, 1989) 345.

39 Ibid.

Concluding and executing a true transaction is a crucial element in *sukuk* operation, as it provides the legal effects of the transaction. The real intention of parties of *sukuk*, especially the originator and issuer must be that their relationship with investors is based on a commercial contract. Moreover, the profit and return of *sukuk* really must be from the revenue of commercial activities and must not be interest of money. Therefore, executing a true sale is a crucial element in *sukuk* operation, as it constitutes a real transfer of ownership from the originator to the *sukuk* holders via the SPV.

3.5 Prohibition of Illegal Transactions

Another important requirement is that Islamic finance must not involve any prohibited activities. These activities may include the sale or purchase of assets and services that are prohibited under Sharia principles such as the sale or purchase of non- halal food and drink as well as production and distribution of non-halal foods such as pork, non-slaughtered animals or animals which were not slaughtered according to Islamic rules, intoxicating drinks, pornography, narcotic products. Illegal transactions are not only limited to production or buying or selling but also include all chains of production and distribution, such as the packaging, transportation, warehousing and marketing of these prohibited goods and services.

Prohibited activities also include activities related to the balance sheet of the company such as the borrowing or raising of more capital through interest-based transactions such as overdrafts and conventional bonds.

Therefore, this requirement has two aspects: first, the funds that are collected from the subscription of *sukuk* must not channeled into prohibited activities. Second, the financing of enterprises must not be from illegal sources or prohibited modes.

3.6 Prohibition of Unjust Enrichment

The relationships of parties of *sukuk* should be a just bargain and should not result in unjust enrichment that one party enjoys to the detriment of the other party and without enough consideration. This is a rational principle in the Holy Quran that has to be emphasized. Where God says: *"O you who believe! do not obtain your property among yourselves falsely, except that it be trading by your mutual consent".*[40]

40 The Holy Qur'an, Sura Nisa, section 29.

IV CONCLUSIONS

1. *Sukuk* or financial instruments have an important role in the financing of companies and business activities. Since the *sukuk* are Sharia compliant bonds, the most important legal issues are observance of Sharia principles and regard to requirements that are laid down by the Sharia. The process of development of Islamic financial instruments or *sukuk* in Islamic countries indicates that modes of interpretation and implementation of Sharia principles and rules have an important role in the development and efficiency of *sukuk*.

While, the Middle Eastern countries apply stricter interpretations of the Sharia, South East Asia countries, particularly Malaysia apply more flexible interpretations of Sharia. However, the Islamic Republic of Iran is one of the Muslim countries that according to *Immamiah* or Shia jurisprudence (one of the Islamic schools of law) has developed its financial markets with more flexibility specially in using various financial instruments. Shia jurists have more flexible views in interpreting aspects of the Qur'an than Sunni jurists. Hence, Iran is a country that has left Islamic finance under the legislative umbrella of the current financial market laws. Therefore, unlike many Muslim countries, Iranian law has regulations and legal mechanisms to protect investors and holders of *sukuk*.

2. In contrast to most Middle Eastern countries, where many equivalents of conventional financial instruments including derivative products are still lacking, in the Iranian capital market they are well recognized and used in the derivatives market. The Sharia Committee could justify them according to Sharia principles.

3. Some scholars suggest: Lack of standardization, narrow liquidity, and concerns regarding insolvency regimes are key impediments, among others, to further growth of the *sukuk* asset class.[41] It seems that the Iranian legislator could eliminate two impediments by providing legal arrangements and contractual mechanisms for the resale of *sukuk* in the secondary market as well as the possibility of redemption of *sukuk* at any time before the due day at the face value of *sukuk*. Furthermore, in regulations and directives related to each *sukuk*, personal guarantees and enough proprietary guarantees could be provided in order to secure repayment of principal and return of *sukuk*.

4. *Immamieh* or Shia jurisprudence is more flexible as compared with other Islamic schools of law and has better solutions for the legal issues of financial markets. This ability arises from the open door of *ijtehad* (to form an opinion on a point of religious law) in Shia thought.

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41 Kusuma and Silva (above n 2) 1.

The approach of *Immamieh* jurists is different from Sunni jurists, particularly about financial markets and transactions. For example, as to the concept and realm of *gharar* there are different views between Islamic jurists. So the majority of Sunni jurists believe that commercial insurance with fixed premiums, are forbidden based on *gharar*. However, the majority of Shia jurists express its validity because setting the insured's mind at rest is the subject matter and main goal of the insurance contract. The other differences in views are seen about legal nature of money, the possibility of sale of debt for cash (*bey-o-deyn*), the validity of new contracts and the possibility of guarantee in all *sukuk*.

5. What is said by some Sunni scholars is that "Sharia considers money as a tool to measure value, and not an asset in itself. Thus, receiving income from money (or "interest") is forbidden. Under Sharia, one should not sell or trade debts, and conventional lending is not permissible".[42] In the view of Shia jurists, money is property per se, and may be lent and borrowed but getting surplus and interest on the loan is forbidden. However, the debt, whether its subject was money or other property, could be sold to the debtor or third person in cash and at the same or lesser value. The result mainly appears in secondary markets; according to some viewpoints sale of most *sukuk* in secondary markets is impossible but according to other viewpoints it is possible and legally may be valid.

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42 Ibid 2.

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