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THE ART OF CONSTRUCTING AN ISLAMIC HEDGE FUND

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DEVELOPMENT OF HEDGE FUNDS

Alfred Winslow Jones is often credited to have started the first hedge fund in 1949. Jones employed long-short strategy to hedge market risk, i.e. taking long position in the undervalued securities and short position in the overvalued securities¹. He started this as an investment partnership that is widely regarded as the first hedge fund. Remarkably many of the ideas that he introduced over fifty years ago remain fundamental to today's hedge fund industry. Jones structured his fund to be exempt from the SEC regulations described in the Investment Company Act of 1940. This enabled Jones' fund to use a wider variety of investment techniques, including short selling, leverage, and concentration (rather than diversification) of his portfolio.

Jones committed his own money in the partnership and based his remuneration, 20% of the fund profit, as his performance incentive fee. Both practices encourage interest alignment between manager and outside investor and continue to be used today by most hedge funds. Jones pioneered the hybrid use of shorting and leverage techniques that generally increase risk, and used them to hedge against market movements and reduce his risk exposure.



¹ Agrawal, V. & Naik, N. (n.d.), Introduction to Hedge Funds, FT Article

UNDERSTANDING HEDGE FUNDS

A hedge fund can be defined as an actively managed, pooled investment vehicle that is open to only a limited group of investors and whose performance is measured in absolute return units².

To “hedge” is to lower overall risk by taking on an asset position that offsets an existing source of risk. For example, an investor holding a large position in foreign equities can hedge the portfolio’s currency risk by going short currency futures. A trader with a large inventory position in an individual stock can hedge the market component of the stock’s risk by going short equity index futures.

One might define a hedge fund as an information motivated fund that tries to hedge away most sources of risk not related to the price-relevant information available for speculation.

The investment styles of hedge funds have changed significantly over time. Today, a lot of hedge funds do not hedge in the strict sense of the term. Hence, in the current context, the term “hedge” is a bit of a misnomer.

As a matter of fact, there is no universally accepted definition of hedge funds. Hence, they are best described as “private investment vehicles where the manager has a significant personal stake in the fund and enjoys high level of flexibility to employ a broad spectrum of strategies involving use of derivatives, short selling and leverage in order to enhance returns and better manage risk”³. Note that short positions are intrinsic to hedging and are critical in the original definition of hedge funds.



² Conner, G. & Woo, M. (n.d.), An Introduction to Hedge Funds, LSE

³ Agrawal, V. & Naik, N. (n.d.), Introduction to Hedge Funds, FT Article

LEGAL STRUCTURES

Hedge funds are almost always organised as limited partnerships or limited liability companies to provide pass-through tax treatment. The fund itself does not pay taxes on investment returns, but returns are passed through so that individual investors pay the taxes on their personal tax bills. (If the hedge fund were set up as a corporation, profits would be taxed twice.) In the USA, hedge funds usually seek exemptions from a number of SEC regulations. The Investment Company Act of 1940 contains disclosure and registration requirements and imposes limits on the use of investment techniques, such as leverage and diversification. The Investment Company Act was designed for mutual funds, and it exempted funds with fewer than 100 investors. In 1996, it was amended so that more investors could participate, so long as each “qualified purchaser” was either an individual with at least \$5 million in assets or an institutional investor with at least \$25 million. Hedge funds usually seek exemption from the registration and disclosure requirements in the Securities Act of 1933, partly to prevent revealing proprietary trading strategies to competitors and partly to reduce the costs and effort of reporting.

The United States has been the centre of hedge fund activity, but about two thirds of all hedge funds are domiciled outside the USA. Often these “offshore” hedge funds are established in tax-sheltering locales, such as the Cayman Islands, the British Virgin Islands, Bermuda, the Bahamas, Luxembourg, and Ireland, specifically to minimise taxes for non- US investors. US hedge funds often set up a complementary offshore fund to attract additional capital without exceeding SEC limits on US investors. In the UK, the Financial Services and Markets Act 2000 (FSMA) and the Public Offers of Securities Regulations 1995 (POS Regulations) are statutes that influence the creation of UK-domiciled hedge funds. The FSMA specifies restrictions for the marketing of hedge funds (“collective investment scheme”) that are similar to the US, such as number of shareholders and limits on advertising. The POS Regulations makes restrictions on how a hedge fund is structured to be a private placement.

Outside the US, UK, and tax-haven countries, the situation for hedge funds is wide-ranging. In Switzerland, hedge funds need to be authorised by the Federal Banking Commission, but once authorised, hedge funds have few restrictions. Swiss hedge funds may be advertised and sold to investor without minimum wealth thresholds. In Ireland and Luxembourg, hedge funds and offshore investment funds are even allowed listings on the stock exchange. On the other extreme, France has greatly restricted the establishment of French hedge funds, and French tax authorities frown upon offshore investing⁴.



⁴ Conner, G. & Woo, M. (n.d.), An Introduction to Hedge Funds, LSE

INVESTMENT STRATEGIES OF HEDGE FUNDS

Hedge fund strategies encompass a broad range of risk tolerance and investment philosophies within a wide array of instruments, including debt and equity securities, commodities, currencies, derivatives, real estate and other investment vehicles. The horizon of hedge fund investment strategies has seen unprecedented expansion in recent years. Investment terms are driven in large part by the fund's strategy and level of liquidity.

Below is a description of some of the common hedge fund strategies:

Equity Long-Short

An equity long-short strategy is an investing strategy, used primarily by hedge funds, that involves taking long positions in stocks that are expected to increase in value and short positions in stocks that are expected to decrease in value. Taking a long position in a stock simply means buying it: If the stock increases in value, you will make money. On the other hand, taking a short position in a stock means borrowing a stock you don't own (usually from your broker), selling it, then hoping it declines in value, at which time you can buy it back at a lower price than you paid for it and return the borrowed shares. Hedge funds using equity long-short strategies simply do this on a grander scale. Thus, an equity long-short strategy consists of buying an undervalued stock and shorting an overvalued stock. Ideally, the long position will increase in value, and the short position will decline in value. If this happens, and the positions are of equal size, the hedge fund will benefit. That said, the strategy will work even if the long position declines in value, provided that the long position outperforms the short position. Thus, the goal of any equity long-short strategy is to minimize exposure to the market in general, and profit from a change in the difference, or spread, between two stocks.

An example of this is of a hedge fund that takes a \$1 million long position in ABC and a \$1 million short position in XYZ, both large pharmaceutical companies. With these positions, any event that causes all pharmaceutical stocks to fall will lead to a loss on the ABC position and a profit on the XYZ position. Similarly, an event that causes both stocks to rise will have little effect, since the positions balance each other out. So, the market risk is minimal. Why, then, would a portfolio manager take such a position? Simply because he or she thinks ABC will perform better than XYZ⁵.



⁵ Barclay Hedge (2012), Equity Long-Short, Available from: <https://www.barcleyhedge.com/hedge-fund-strategy-equity-long-short/>

Credit Funds

Credit funds make debt investments based on lending inefficiencies. Credit funds include distressed debt strategies, fixed income strategies, direct lending and others. Distressed debt involves investment in corporate bonds, bank debt, and occasionally common and preferred stock of companies in distress. When a company is unable to meet its financial obligations, or is in a liquidity crisis, its debt is devalued⁶. The greater the level of risk assumed, the higher the potential return. Distressed debt sells at a very low percentage of par value. If the once-distressed company emerges from bankruptcy as a viable firm, the once-distressed debt will sell for a considerably higher price⁷. Fixed income funds invest in long-term government, bank and corporate bonds, debentures, convertible notes and capital notes, and their derivatives, which pay a fixed rate of interest. Many fixed income funds have lower risk tolerances than distressed debt funds and place capital preservation as a higher priority, leading to more diversification and volatility-reducing strategies. A common fixed income hedge fund strategy is fixed income arbitrage⁸.



Global Macro Fund

Global macro refers to the general investment strategy of making investment decisions based on broad political and economic outlooks of various countries. Global macro strategy involves both directional analysis, which seeks to predict the rise or decline of a country's economy, as well as relative analysis, evaluating economic trends relative to each other. Global macro funds are not confined to any specific investment vehicle or asset class, and can include investment in equity, debt, commodities, futures, currencies, real estate and other assets in various countries⁹. This strategy aims to profit from large economic and political changes in various countries by specialising in bets on interest rates, sovereign bonds and currencies. Unexpected macro-economic news, central bank actions, trading activity, political risk and information asymmetry are but some of the ways in which securities can be temporarily driven above or below their long-term values and expectations. Long and short positions are taken in global equity, bond, commodity and currency markets, both in the underlying cash as well as in the derivatives markets depending on whether a particular segment is undervalued or overvalued. Investment managers, including hedge funds, who undertake global macro strategies, tend to use both quantitative analysis and qualitative evaluations to understand global relative price movements, liquidity, volatility, business cycles and other macro-economic conditions, so as to profit from them.

⁶ Lore, J.S. (2015), Forming and operating a hedge fund, Capital Fund Law Group, Available from: <https://bit.ly/2ImYOX9>

⁷ Baldrige, R. (2018), Why hedge funds love distressed debt, Investopedia, Available from: <https://www.investopedia.com/articles/bonds/08/distressed-debt-hedge-fund.asp>

⁸ Lore, J.S. (2015), Forming and operating a hedge fund, Capital Fund Law Group, Available from: <https://bit.ly/2ImYOX9>

⁹ Lore, J.S. (2015), Forming and operating a hedge fund, Capital Fund Law Group, Available from: <https://bit.ly/2ImYOX9>

Market neutral funds

Market neutral funds are similar to equity long-short funds; they seek returns that are totally independent of market performance. These funds attempt to minimize or eliminate market volatility. One strategy would be holding equal long and short positions within the same sector. The important distinction between market neutral and long/short is that market neutral portfolios strictly aim for a portfolio beta of 0, while long/short portfolios can have a net long bias or a net short bias depending on the portfolio manager's market view. Similar to long/short, market neutral funds may use leverage to enhance returns and they may use derivatives to hedge the overall portfolio.

For example, a fund manager may go long in the 10 biotech stocks that are expected to outperform and short the 10 biotech stocks that may underperform. Therefore, in such a case the gains and losses will offset each other in spite how the actual market does. So even if the sector moves in any direction the gain on the long stock is offset by a loss on the short¹⁰.

Merger arbitrage

In such a hedge fund strategy the stocks of two merging companies are simultaneously bought and sold to create a riskless profit. This particular hedge fund strategy looks at the risk that the merger deal will not close on time, or at all. Because of this small uncertainty, this is what happens: The target company's stock will sell at a discount to the price that the combined entity will have, when the merger is done. This difference is the arbitrageur's profit. The merger arbitrageurs care only about the probability of the deal being approved and the time it will take to close the deal¹¹.

Convertible Arbitrage

This is another complex strategy in which managers aim to make money from the volatility and mispricing of convertible bonds. They typically buy a convertible bond — a bond allowing the holder to exchange it for common stock — and then strip out equity exposure by shorting the underlying equity. They then buy credit default swaps to hedge default risk on the bond, and hedge exposure to interest rates and foreign currencies through treasury futures or swaps, leaving them exposed to the bond's equity option¹².



¹⁰ WallStreetMojo, Hedge fund strategies, Available from: <https://www.wallstreetmojo.com/hedge-fund-strategies/>

¹¹ WallStreetMojo, Hedge fund strategies, Available from: <https://www.wallstreetmojo.com/hedge-fund-strategies/>

¹² Reuters (2009), Factbox: Hedge fund strategies explained, Available from: <https://www.reuters.com/article/us-hedge-strategies-factbox-sb/factbox-hedge-fund-strategies-explained-idU5TRE57R2XW20090828>

SHARIAH ANALYSIS OF HEDGE FUNDS

Hedge funds are privately-owned companies that pool investors' monies and reinvest them into complicated financial instruments. Their goal is to outperform the market. They are expected to be smart enough to create high returns regardless of how the market does. The objective of a hedge fund is not against Shariah principles. Mitigating one's risk as much as possible and trying to gain a favourable return is acceptable. However, this must be achieved within the confines and guidelines of Shariah. The problem with conventional hedge funds is the financial instruments used to perform the hedging techniques. A hedge fund which uses Shariah compliant financial instruments to hedge positions has the potential to be Shariah compliant.

There are numerous evidences to support compliant risk management techniques. The Chapter of Yusuf in the Qur'an describes how Prophet Yusuf (peace be upon him) interpreted the dream of the king of Egypt prophesying that that Egypt would face seven years of drought after seven years of prosperity. He went on to advise the king to develop an economic strategy and a risk management technique to hedge against the drought.

In the following Qur'anic verse, documenting transactions by contracting parties is encouraged to manage risk, particularly credit risk:

'O you, who have believed, when you contract a debt for a specified term, write it down. And let a scribe write [it] between you in justice. Let no scribe refuse to write as Allah has taught him. So let him write and let the one who has the obligation dictate. And let him fear Allah, his Lord, and not leave anything out of it...'

(Qur'an 2:282).

The core objective of documentation is to mitigate the risk of any party denying what was agreed upon, which may lead to a loss of capital.



SHARIAH ANALYSIS OF INVESTMENT STRATEGIES

Long/Short Equity

The long-short equity strategy as practiced by hedge funds involves short-selling. Short-selling is the sale of a security by a seller who doesn't own such security and borrows it on the anticipation that its price will decline and he/she will buy it after a period of time at the lower price to make a profit. In the actual market practice, the investor can arrange to have their broker borrow the stock from someone else, and then the borrowed stock is delivered to effect the sale. To cover their short position, the investor must subsequently purchase the stock and return it to the party that loaned the stock. According to AAOIFI (The Accounting and Auditing Organisation of Islamic Financial Institutions) standards, short-selling is not Shariah compliant. Shariah Standard No.21 on Financial papers states:

3/6 It is not permissible to sell shares that the seller does not own (short sale), and the promise of a broker to lend these at the time of delivery is of no consequence.

The standard explains the above prohibition by arguing that the basis for the impermissibility of the sale of shares is that the seller does not own the underlying stock leading to the sale of something that is not within the liability of the seller nor in his ownership, and this is prohibited according to the Shariah. Furthermore, the AAOIFI standards are of the view that it is not permissible to lend shares (Shariah Standard No.21 3/9) because the share at the time of repayment-in consideration of what it represents- does not represent the same thing that it did at the time of lending due to the constant change in the assets of the corporation. Thus, it would not be a symmetrical return of assets to the lender which a loan is essentially supposed to be.

Another issue with short-selling is profiting from something which you do not bear the physical-asset risk for. According to Islamic principles, risk and reward cannot be separated. An investor cannot be rewarded with profit or a return without bearing the risk. The Islamic legal maxim states:

“Al-Kharaj bi al-daman” (profits come with liability)

“Al-ghunm bi al-ghurm” (reward comes with risk)

Thus, short selling breaches the core legal maxims of Islamic finance, making them non-compliant with Shariah. From the above, we learn that short-selling has three main concerns:

- i) selling what is not owned leading to *Gharar* and deception
- ii) securities lending and borrowing which incorporates *Riba* (interest)
- iii) the separation of risk and reward.



Shariah screening of equity

Another issue with the conventional long/short equity strategy is the high possibility of purchasing non-Shariah compliant equity and stocks.

Stock purchases must pass a qualitative and quantitative Shariah screening with ongoing scholarly oversight before they can be deemed compliant investments. Initially, companies involved in any of the following activities will be filtered out as non-Shariah compliant:

- Conventional financial services (conventional banking and conventional investments)
- Trading in risk and *Gharar* (insurance companies)
- Gambling, *Qimar* and *Maysir* activities (casinos)
- Alcohol and prohibited beverages
- Pork related products and non-halal food production, packaging, processing or any direct activity linked to unlawful consumables
- Tobacco related products
- Illicit adult industry (pornography)
- Entertainment (music, cinema)

Any stock or equity which passes the above filter, will have its financials assessed to see if they meet the following criteria:

- Total interest and non-compliant activities income should not exceed 5% of total revenue.
- Interest taking deposits must be less than 30% of the market capitalisation
- Interest bearing debt must be less than 30% of the market capitalisation
- Total market value of non-cash and non-debt assets should be at least 30% of the total value of all the assets¹³.



¹³ AAOIFI (2015) puts a condition that the total market value of non-cash and non-debt assets should be at least 30% of the total value of all the assets. Thus, if the primary asset of a company is neither cash nor debt, and the total market value of all non-cash and non-debt assets is at least 30% then the stocks of such company can be freely traded at any price.

Thus, a company with a composition of up to 70% cash and receivables is permissible to trade. A company with cash and receivables above 70% can only be traded in accordance with the principles of Bay al-Sarf (if cash is majority) or Bay al-Dayn (if receivables is majority).

Credit fund

Credit funds are non-Shariah compliant as they are debt fuelled interest-based investments. Bonds, notes and similar products are debt instruments incorporating *Riba* (interest). The AAOIFI Shariah Standard No.21 expounds on the rulings of bonds:

“The issuance of all kinds of bonds is prohibited when these bonds include stipulations for the return of the amount of loan and excess in any form, whether such excess is paid at the time of the satisfaction of the principal amount of loan, is paid in monthly or yearly instalments or in another manner and whether this excess represents a percentage of the value of the bond, as in the case with most types of bonds, or a part of it, as is the case with zero-coupon bonds. Likewise, prize bonds are also prohibited. This applies irrespective of the bonds being private, public or governmental.”

These financial instruments are premised on the exchange of two monetary payments; the investor pays upon purchasing a bond and receives periodical payments from the issuer as per the agreement in the bond. Unequal payments in homogenous currencies is tantamount to *Riba al-Fadhl* (known as interest due to surplus and excess). This originates when a *Riba* item is exchanged for the same item in an unequal amount. These bonds are prone to *Riba al-Fadhl*.

Credit funds also use a variety of non-compliant conventional derivatives in the investments. Shariah scholars have objected on common derivatives for the following reasons¹⁴:

1. In futures transactions, because neither counter-value, i.e., money or goods, is present at the time of contract, the sale is not genuine but merely an exchange of promises. A sale is only valid under Shariah law as long as only the price or delivery, but not both, is contractually deferred.
2. Futures and option trading that involve speculation incorporate *Qimar* (gambling) and *Gharar* (speculative uncertainty).
3. Option trading is merely the right to buy or sell, for which charging fees is considered to be non-compliant.
4. Futures trading, where both counter-values are deferred, is an impermissible exchange of one debt for another, i.e., *bay' al-kali bil kali* (a sale of two deferred counter-exchanges).

Merger arbitrage as a concept has the potential to be Shariah compliant provided that the contracts used in purchasing and selling the equity are compliant and the underlying equity has been screened for Sharia compliance.

The convertible arbitrage strategy is not compliant with Shariah as they involve convertible bonds and credit default swaps which are non-Shariah compliant financial instruments.



¹⁴ Kunhibava, S. (2010), Derivatives in Islamic Finance, Research paper 7, ISRA

SHARIAH COMPLIANT ALTERNATIVES

The following are Shariah compliant alternatives to short selling:

Bai Al Arbun

In this method the fund manager, after analysing the market, picks a stock whose market price will fall at a future date. The fund company makes a part payment and takes the delivery of the stock, however, with a promise to complete the purchase by paying the remaining amount within the stipulated time or the fund company has to return the stock and forfeit the down payment of token money.

Sale and Promise

The Malaysian Shariah Council developed a method where the central exchange buys a security from seller along with a promise to purchase it back whenever the exchange sells at a future date. Similarly the exchange sells the stock to a buyer with a promise from buyer to resell the stock to the exchange whenever the exchange demands it. However, the seller's rights to recall and buyer's right to resell are embedded in the regulations and they have the right to execute it at their convenience.



Tahawwut

Another hedging mechanism recognised in Islamic finance is *Tahawwut*. The *Tahawwut* (Hedging) Master Agreement is a relatively new concept in Islamic Finance which was introduced in March 2010 by the Bahrain-based International Islamic Financial Market (IIFM) in cooperation with the International Swaps and Derivatives Association, Inc. (ISDA) and gives the global Islamic financial industry the ability to trade Shariah-compliant hedging transactions such as profit-rate and currency swaps, which are estimated to represent most of today's Islamic hedging transactions¹⁵.

The Agreement is a Master Agreement or framework agreement which sets out terms upon which the parties can subsequently enter risk management arrangements. Entering into the Master Agreement does not give rise to any transactions. After the parties have entered into the Master Agreement, they may subsequently enter into further arrangements which will be subject to and governed by the Master Agreement. These arrangements will either be (a) actual transactions (e.g. a *murabaha* transaction) – these are referred to in the Master Agreement as Transactions and the document setting out the terms of such a Transaction is called a Confirmation – or (b) undertakings or agreements to enter into a transaction in the future (subject to satisfaction of any condition, such as exercise of the undertaking by the other party).

In order to assist market participants, the IIFM Shariah Advisory Panel has indicated the following guidelines regarding Shariah compliance:

- (i) Transactions should be entered into only for the purpose of hedging actual risks of the relevant party.
- (ii) Transactions should not be entered into for purposes of speculation, i.e. actual settlements of assets and payments must take place. Cash settlement should relate to actual transactions involving a deliverable asset.
- (iii) The asset must be halal.
- (iv) No interest (whether called interest or an alternative name but which represents interest) is to be chargeable under a Transaction¹⁶.

Ijlal Alvi of the IIFM discusses the *Tahawwut* Master Agreement in the ISRA-TR Islamic Commercial Report and states:

¹⁵ Raqaba, The role of tahawwut in Islamic finance, available from: <https://www.raqaba.co.uk/?q=en/content/role-tahawwat-islamic-finance>

¹⁶ ISDA and IIFM (2010), Explanatory Memorandum Relating to the ISDA/IIFM Tahawwut Master Agreement, available from: <http://www.iefpedia.com/english/wp-content/uploads/2011/11/Explanatory-Memo-Tahawwut-Master-Agreement.pdf>



“The *Tahawwut* Master Agreement covers all trade transactions between the parties involved. It incorporates the three pillars designed to ensure that in an event of a default or early termination, the exposures of the parties under all outstanding transactions are aggregated and netted, in order to prevent any possible disputes. These pillars are:

1. Single Agreement
2. Flawed Asset & Conditionality
3. Close-out and netting

The *Tahawwut* Master Agreement is designed for a suite of products globally and is developed to accommodate a range of Islamic hedging products based on *Murabahah* and *Wa'd*. It also has several differences when compared to ISDA’s 2002 Master Agreement such as:

- No compensation or interest on defaulted or deferred payments and deliveries
- No interest payable
- Additional representations for Shariah compliance
- Governing law and dispute resolution
- Early termination
- Dual close-out mechanism based on indexing, as Net Present Value or Discounted Cash Flow calculation are not allowed in Islamic finance
- Clauses to cover all transactions including the defaulting party’s “in the money” profit transactions



Conclusion

Hedging involves reducing overall risk by taking on an asset position that offsets an existing source of risk. Its strategies encompass a broad range of risk tolerance and investments, such as but not limited to, debt and equity securities, commodities, currencies, derivatives, and real estate vehicles. The most widely used equity long-short strategy involves simultaneously taking long and short positions in stocks. Such a strategy is not compliant with Shariah as short selling involves *Gharar* and *Riba*. Another common strategy is credit funds. Credit funds include distressed debt strategies, fixed income strategies, direct lending and others. Credit funds are non-compliant with Shariah due to the existence of bond trading which also involves *Riba*.

Other common strategies include market neutral funds, merger arbitrage and convertible arbitrage. The Shariah compliance of such strategies depends on the instruments employed.

The overall objective and concept of a hedge fund is not against Shariah principles. Mitigating one's risk as much as possible and trying to gain a favourable return is acceptable. However, this must be achieved within the confines and guidelines of Shariah. The problem with conventional hedge funds is the financial instruments used to conduct the hedging. A hedge fund which uses Shariah compliant financial instruments to hedge positions has the potential to be Shariah compliant. Some Shariah compliant instruments include *Bai al Arbun*, sale and promise and *Wa'dan*. The *Tahawwut* master agreement is a big development to assist in formulating risk management strategies in the Islamic finance sector. Despite this, much more work is required to develop this sector within the Islamic finance space.

ABOUT SRB

Since our humble beginnings more than 13 years ago we've grown to include more than 100 companies across a host of industries, thousands of transactional programs, multi-disciplinary teams and a combined scholarly workforce of 35 Sharia Scholars from 19 countries. And we're not done yet: our Sharia Advisory and Sharia Audit services will continue to improve—serving local and international businesses to help them maintain and manage Shari'a compliance.

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Disclaimer

This is a preliminary Shariah research and is by no means a definitive conclusion or fatwa on the aforementioned subject. This paper was written to develop knowledge and research on this complex subject from a Shariah perspective. We hope that this paper will prompt and engage global Islamic finance bodies, Shariah scholars and Muslim economists to analyse, comment and build upon the arguments expressed.