

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

December 2008



HM TREASURY



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

December 2008

© Crown copyright 2008

The text in this document (excluding the Royal Arms and other departmental or agency logos) may be reproduced free of charge in any format or medium providing it is reproduced accurately and not used in a misleading context. The material must be acknowledged as Crown copyright and the title of the document specified.

Where we have identified any third party copyright material you will need to obtain permission from the copyright holders concerned.

For any other use of this material please write to:

Office of Public Sector Information
Information Policy Team
Kew, Richmond
Surrey
TW9 4DU

e-mail: licensing@ospi.gov.uk

HM Treasury contacts

This document can be found in full on our website at:

hm-treasury.gov.uk

If you require this information in another language, format or have general enquiries about HM Treasury and its work, contact:

Correspondence and Enquiry Unit
HM Treasury
1 Horse Guards Road
London
SW1A 2HQ

Tel: 020 7270 4558

Fax: 020 7270 4861

E-mail: public.enquiries@hm-treasury.gov.uk

Printed on 75% recycled paper.

When you have finished with it please recycle it again.

ISBN 978-1-84532-538-1

PU696

Contents

	Page
Executive summary	3
Chapter 1 Introduction	5
Chapter 2 Alternative finance investment bonds	9
Chapter 3 Policy proposals	13
Annex A Regulatory impact assessment	19
Annex B Draft proposed legislation	25
Annex C Section 48A of the Finance Act 2005: alternative finance arrangements	29

Executive summary

This document sets out the proposed legislative framework for the regulatory treatment of 'Alternative Finance Investment Bonds'(AFIBs). AFIBs refer to a type of financial instrument commonly known as sukuk or Islamic bond, but can also refer to any financial instrument with similar characteristics. This consultation paper considers the regulatory policy options for these instruments. This is a joint consultation between HM Treasury and the Financial Services Authority (FSA) (referred to hereafter as 'the Authorities').

Sukuk are one of the most prominent instruments used in Islamic finance. Since 2003, there have been several initiatives by the Authorities to create a 'level playing field' for Islamic finance. For example, the Government has introduced, and has proposals to further introduce, various tax changes with respect to AFIBs.

Classifying Islamic financial instruments, including sukuk, under existing regulatory frameworks has posed challenges in the UK and other jurisdictions. Although many instruments are designed to replicate the economic functions of certain conventional financial products, their legal structure and risk characteristics may be different. It may therefore be difficult to map these products into the existing legal framework. Some of these instruments currently appear to fall within the definition of a Collective Investment Scheme (CIS) as set out in the Financial Services and Markets Act (FSMA 2000). However, alternative interpretations exist, and assessment is currently conducted on a case-by-case basis.

The Authorities are seeking to introduce legislative changes to align the regulatory treatment of AFIBs with conventional debt securities. Four policy options have been identified:

- Option 1: introduce legislative amendments to create a new specified instrument under the RAO and explicitly to exempt these instruments from CIS regulations. Introduce a unique regulatory definition for this purpose.
- Option 2: same as option 1 but AFIBs will be defined by the existing tax definition;
- Option 3: same as option 1 but include AFIBs under the existing specified investment of creating or acknowledging indebtedness; and
- Option 4: is to do nothing.

The preferred option is option 1. As with options 2 and 3, its main benefit is that it treats AFIBs as conventional bonds. This provides clarity about the regulatory treatment and compliance costs for AFIBs and thus facilitates UK issuance of these instruments. It also creates a level playing field between AFIBs and the conventional bonds that they mirror in economic substance. Option 1 produces this benefit in a flexible and simple manner that creates legal certainty. It does not distinguish between private and public issuance of AFIBs.

Option 1 may incur costs associated with upgrading the FSA's technology platforms which record regulatory permissions and other associated systems. The scale of these costs is presently unclear and the FSA are currently conducting a detailed assessment to estimate the costs associated with these changes. If the costs are unavoidable and material, the Authorities will examine the feasibility of other legislative solutions that would avoid such costs (such as those set out in option 3 of this document).

1

Introduction

Background to the consultation

1.1 This document sets out the proposed legislative framework for the regulatory treatment of 'Alternative Finance Investment Bonds'. AFIBs refer to a type of financial instrument commonly known as sukuk or Islamic bond, but can also refer to any financial instrument with similar characteristics. This consultation paper considers the regulatory policy options for these instruments. This is a joint consultation between HM Treasury and the Financial Services Authority (FSA) (referred to hereafter as 'the Authorities').

1.2 The objective of this consultation is to discuss options for the regulatory treatment of AFIBs. In deciding this, the Authorities will have regard to:

- the importance of ensuring that financial instruments are regulated in a consistent, transparent and fair manner;
- the Principles of 'Better Regulation': regulation should be proportionate, accountable, consistent, transparent and targeted; and,
- the support of innovation, competition and efficiency in the financial system.

Background to Islamic finance

1.3 Sukuk are one of the most prominent instruments used in Islamic finance. The term Islamic finance encompasses any type of financial activity that is undertaken in accordance with Islamic law (Sharia). The Islamic finance industry has grown in recent years in the UK, and a number of Sharia compliant financial instruments are now available. According to a recent industry survey, the UK has over £18 billion worth of Sharia compliant assets, the eight largest amount in the world.¹

1.4 The Government's objectives for supporting the development of Islamic finance in the UK are:

- to enhance the UK's competitiveness in financial services by establishing the UK as a gateway for international Islamic finance; and
- to ensure that everybody, irrespective of their religious beliefs, has access to competitively priced financial products.

1.5 Since 2003, there have been several initiatives by the Authorities to create a 'level playing field' for these products. For example, the Government has introduced, and has proposals to further introduce, various tax changes with respect to Alternative finance investment bonds (AFIB).

¹ The Banker magazine, November 2008

Organisation of the consultation

1.6 The main body of the consultation is divided into three sections:

- Chapter 2 - Background – this explains the common features of AFIBs and the existing regulatory approach;
- Chapter 3 - Policy proposals - this sets out the preferred policy proposal; and,
- Chapter 4 - Impact assessment - this looks at the cost and benefits of the policy proposals under consideration.

Responding to the consultation

1.7 This consultation document represents part of a wider process of discussion and engagement with industry. In particular, the Authorities have discussed their ideas with representatives from banking, law, accountancy and consultancy.

1.8 Comments on the specific questions raised in the consultation as well as the regulatory impact assessment are welcome. This consultation began with the publication of this document and will last for a period of 12 weeks. Responses should be sent by email if possible to: islamic.finance@hm-treasury.x.gsi.gov.uk. Or by post to:

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

1.9 Please note, our preference is to receive responses in electronic format only (all email responses will be acknowledged).

1.10 This document can be found on the websites of HM Treasury (www.hm-treasury.gov.uk) and the Financial Services Authority (www.fsa.gov.uk). When responding, please state whether you are responding as an individual or as part of an organisation. If responding on behalf of a larger organisation, please make it clear whom the organisation represents and, where applicable, how the members' views were assembled.

Consultation disclosure

1.11 Information provided in response to this consultation, including personal information, may be published or disclosed in accordance with the relevant access to information regimes. These are primarily the Freedom of Information Act 2000 (FOIA), the Data Protection Act 1998 (DPA), and the Environmental Information Regulations 2004.

1.12 If you prefer the information that you provide to be treated as confidential, please be aware that under the FOIA there is a statutory code of practice with which public authorities must comply. This deals with, amongst other things, obligations of confidence. In view of this, it would be helpful if you would explain to us why you regard the information you have provided as confidential. If we receive a request for disclosure of the information we will take full account of your explanation, but we cannot give an assurance that confidentiality can be maintained in all circumstances. An automatic confidentiality disclaimer generated by your IT system will not, of itself, be regarded as binding.

Regulatory impact assessment

1.13 The Regulatory Impact Assessment (RIA) is published with this document in annex B and should be read in conjunction with it. The RIA lays out implementation options for the areas highlighted above and considers qualitative, and where possible quantitative, benefits and costs for implementation.

Amendments to the FSA's handbook

1.14 The consequential amendments on the FSA's handbook as a result of the proposed policy options contained in this consultation have not been considered in detail. If there are legislative changes proposed as a result of this consultation, there will be an assessment of the effects on the FSA's handbook and any proposed changes will be consulted upon.

2

Alternative finance investment bonds

Background to alternative finance investment bonds

2.1 By the end of 2007 the global volume of outstanding sukuk exceeded \$97 billion. The total number of transactions numbered 119 in 2007 (compared with 109 issuances in 2006) and the average transaction size increased to \$270 million (compared to \$175 million in 2006).¹ The UK has become an international centre for listing Sukuk in recent years. As of July 2008, there were 18 AFIB issuances listed in London, valued at more than £6.5 billion. Currently all sukuk listed in the UK are from issuers based outside the EEA.

2.2 Sukuk have been typically issued by corporates or sovereigns in order to raise finance in the domestic or international capital markets. Three quarters of the sukuk issued in 2007 were from corporates, with the remaining quarter from sovereign issuers. Non-traditional issuers such as Toyota and Tesco have issued sukuk in Malaysia and there is evidence to suggest that UK and European corporates are keen to tap markets such as these to diversify their funding and access new sources of liquidity. The majority of sukuk originate from the GCC or South East Asia.² Malaysia has the highest level of sukuk issuance (66% of all sukuk). The UAE issued 58% of all the Sukuk originating from the GCC in 2007 (c.\$11 billion), and Saudi Arabia accounted for a further 30% of issuances in this region (c.\$5.7 billion).

2.3 Sukuk are of particular importance to Islamic financial institutions as they are unable to raise finance via traditional securities markets and commonly issue sukuk for this purpose. Recent reports indicated that up to 26.2% of global issuance is from financial institutions and they are an important source of wholesale funding for these institutions.³

2.4 Sukuk that meet conditions that make them economically equivalent to a conventional bond, and are listed on a recognised investment exchange, are known as AFIBs. Broadly, these conditions replicate the circumstances in which a person subscribes for a conventional listed debt security and from which they receive a return that may include interest and other amounts on redemption.

Sukuk structures

2.5 Sukuk is a generic term used to encompass a broad range of financial instruments designed to conform with the principles of Sharia. Sukuk (a plural noun in Arabic – the singular is sakk) literally means “certificates”. The Sharia prohibition on interest means that the creation of a purely debt based saleable security is not possible. Sukuk are often structured in a way so as to generate the same economic effects as conventional bonds, but in a Sharia compliant manner. This is achieved through the use of assets and various contractual techniques to conform with Sharia principles. The rating agency Moody's describe sukuk as "trust certificates or participation certificates that grant the investor a share of the asset along with the cash flows and risk

¹ IMF Policy Discussion paper PDP/08/03

² Countries which are members of the Gulf Co-operation Council; Saudi Arabia, Bahrain, Kuwait, Oman, Qatar and the UAE.

³ S & P 'the Sukuk market continues to soar and diversify', March 2008

commensurate with such an ownership". This may simplify the position as there are in fact an array of different sukuk.⁴

2.6 Since in principle most sukuk have tangible assets as their underlying, Sukuk are ostensibly similar to classic asset-backed securities. However, an analysis of commercial terms and legal structures shows that sukuk performance may not be governed by asset performance alone. In economic terms, there are three common types of sukuk:⁵

- A: Fixed income sukuk – where the risk is related to the credit risk of the originator;
- B: Asset backed sukuk (ABS) – where the risk is related to the performance of the underlying asset; and,
- C: Hybrid sukuk – which combine credit risk of the originator with underlying asset risk.

2.7 Category A sukuk tend to be asset-based rather than asset-backed. They may have underlying assets, but essentially they require some form of guarantee or contractual stipulation such as a "purchase undertaking" from the issuer. This is similar to a conventional debt security in terms of risk characteristics and performance. The majority of sukuk issued in the market thus far are of this type. Category B sukuk are instruments that are more akin to conventional asset-backed securities. The risk of these instruments is related to the performance of the underlying asset. Hybrid sukuk (category C) have also emerged, with risk profiles linked to both the performance of the underlying asset and the credit risk of the issuer. As sukuk may vary in terms of whether they allow recourse to the issuer or the asset (or a combination of both), credit ratings agencies (CRAs) may assess them differently, choosing to evaluate them in terms of stability of cash flow rather than probability of default.⁶

Regulation of AFIBs: the current approach in the UK

2.8 Classifying Islamic financial instruments, including Sukuk, under existing regulatory frameworks has posed challenges in the UK and other jurisdictions. Although many instruments are designed to replicate the economic functions of certain conventional financial products, their legal structure and risk characteristics may be different. It may therefore be difficult to map these products into the existing legal framework. Some of these instruments currently appear to fall within the definition of a Collective Investment Scheme (CIS) as set out in the Financial Services and Markets Act (FSMA 2000). However, alternative interpretations exist, and assessment is currently conducted on a case-by-case basis.

2.9 Section 235 of FSMA defines a CIS as "any arrangement with respect to property of any description...the purpose or effect of which is to enable persons taking part in the arrangements...to participate in or receive profits of income arising from the acquisition, holding, management or disposal of the property". It is further provided that the arrangements must be such that the participants do not have day-to-day control over the management of the property, and the arrangements must have one or both of the following characteristics:

⁴ The most common are the Mudaraba, Musharaka and Ijara Sukuk, which account for over 95% of the Sukuk issued in 2007. There are at least 14 different contracts that may be used as the basis of Sukuk.

⁵ Credit Rating agencies such as Moody's make a clear distinction between asset-based and asset-backed Sukuk in determining the credit rating of the transaction.

⁶ Standard and Poor's 'Islamic Finance Outlook' 2008; see also Fitch Ratings 'Criteria Report: Fitch's Approach to Rating Sukuk' 5 March 2007

- the contributions of the participants and the profits or income out of which the payments are to be made are pooled; and,
- the property is managed as a whole by or on behalf of the operator of the scheme

2.10 If AFIBs were treated in the same way as CIS, AFIB issuers would be subject to a wider range of controls, and may need to be authorised. If authorised there would be limits on the range of eligible assets to invest in, gearing and marketing. The marketing restrictions for authorised and authorised CIS also differ. This would arguably put AFIB issuers at a disadvantage to issuers of conventional debt securities. The regulatory regime for CIS is more comprehensive as they are the only product specifically regulated under the Financial Services and Markets Act 2000.

2.11 The Authorities are therefore of the view that classification of Sukuk as a CIS is not appropriate where these instruments possess similar economic characteristics and risk profiles as conventional bonds or asset backed securities (ABS).

Treatment of AFIBs for listing purposes

2.12 The regulatory treatment of an AFIB under the Financial Services and Markets Act 2000 does not conclusively determine the treatment of such an instrument for listing purposes in the UK. Further information can be found on the UKLA webpage:

<http://www.fsa.gov.uk/Pages/Doing/UKLA/global/suk/index.shtml>

3

Policy proposals

3.1 The Authorities' objectives in considering the policy options set out in this paper are the support of innovation, competition and efficiency in the financial system, in addition to the principles for Better Regulation.¹ HM Treasury are seeking to introduce legislative changes to align the regulatory treatment of AFIBs with conventional debt securities. This policy and impact assessment is informed by dialogue between HM Treasury, FSA, relevant trade associations and industry.

Policy proposals

3.2 The purpose of this consultation is to set out the options for the regulatory framework for AFIBs in the UK. AFIBs are innovative financial instruments and there are currently no explicit provisions in the existing regulatory regime designed to accommodate these products. As a result the classification of these instruments for regulatory purposes is dependent on the interpretation of existing legislation. HM Treasury are seeking to introduce legislative changes to align the regulatory treatment of AFIBs with conventional debt securities. Four policy options have been identified:

- Option 1: introduce legislative amendments to create a new specified instrument under the RAO and explicitly to exempt these instruments from CIS regulations. Introduce a unique regulatory definition for this purpose.
- Option 2: same as option 1 but AFIBs will be defined by the existing tax definition
- Option 3: same as option 1 but include AFIBs under the existing specified investment of creating or acknowledging indebtedness
- Option 4: is to do nothing

3.3 The main benefit of treating AFIBs as conventional bonds, where appropriate, is to provide clarity about the regulatory treatment and compliance costs for AFIBs and thus facilitate UK issuance of these instruments. The first three options introduce legislative changes so that the regulatory treatment of an AFIB is generally aligned to conventional bonds. The legislative changes in order to achieve this are set out below.

3.4 The preferred option is option 1. As with options 2 and 3, its main benefit is that it treats AFIBs as conventional bonds. This provides clarity about the regulatory treatment and compliance costs for AFIBs and thus facilitates UK issuance of these instruments. It also creates a level playing field between AFIBs and the conventional bonds that they mirror in economic substance. Option 1 produces this benefit in a flexible and simple manner which creates legal certainty. It does not distinguish between private and public issuance of AFIBs. The legislative changes in order to achieve this are set out below.

3.5 Option 1 may incur costs associated with upgrading the FSA's technology platforms which record regulatory permissions and other associated systems. Whilst there are some indicative

¹ Better Regulations Principles require that regulation should be: necessary, suitable and proportionate, consistent, flexible and risk sensitive.

figures outlined in the Regulatory Impact Assessment, the FSA will be conducting a detailed assessment to estimate the costs associated with these changes. If these costs are material the authorities will examine the feasibility of other legislative solutions that would avoid such costs (such as those set out in option 3 of this document).

Question 1: Do you agree that AFIBs which have similar economic characteristics to conventional debt instruments should be regulated in the same way as those conventional debt instruments, where appropriate?

Question 2: Do you agree that including them as a specified investment under the Financial Services and Markets Act 2000 (Regulated Activities Order) 2001 and amending the Schedule to the Financial Services and Markets Act 2000 (Collective Investment Schemes) Order 2001, affords these instruments a similar regulatory treatment to conventional debt instruments?

Option 1: Introducing a specific regulatory definition of AFIBs

3.6 The first option is to introduce legislative changes so that the regulatory treatment of AFIBs is generally aligned with conventional bonds. The mechanism by which to achieve this would be implement a set of related legislative changes. The main benefit of treating AFIBs as conventional bonds is to provide clarity about the regulatory treatment and compliance costs for AFIBs and thus facilitate UK issuance of these instruments. However, the extent to which UK issuers will issue AFIBs in the future is unclear.

3.7 The first component of this option is to include AFIBs as a specified investment under the Financial Services and Markets Act 2000 (Regulated Activities Order) 2001 on the same basis as instruments creating or acknowledging indebtedness (as set out in Articles 77 and 78 of the RAO). This set of legislative changes will align the regulatory treatment with conventional bonds.

3.8 The second component is explicitly to exempt them from the Financial Services and Markets Act 2000 (Collective Investment Schemes) Order 2001. S235 (5) of FSMA gives HM Treasury the power to exclude certain arrangements from the definition of a Collective Investment Scheme. Accordingly, the Schedule to the Financial Services and Markets Act 2000 (Collective Investment Schemes) Order 2001 should be amended to ensure that such instruments are excluded

3.9 There are difficulties in defining AFIBs for regulatory purposes because these instruments can have a wide range of underlying legal structures. The definition should therefore be wide enough to capture a range of different AFIBs but not so wide that other instruments are inadvertently captured (e.g. equity-type instruments). For option 1 it is proposed that a unique regulatory definition of an AFIB be created. The characteristics of the definition should be consistent with the relevant tax legislation.² The key features of the proposed definition of an AFIB are outlined below:

- **consideration:** the arrangements provide for one person (“the bond-holder”) to pay a sum of money (“the capital”) to another (“the bond-issuer”),

² as set out in Section 48A - Alternative Finance Instrument Bond (AFIB)

- **identification of assets:** the arrangements identify assets, or a class of assets, which the bond-issuer will acquire [use³] for the purpose of generating income or gains directly or indirectly (“the bond assets”),
- **specification of bond term:** the arrangements specify a period at the end of which they cease to have effect (“the bond term”),
- **redemption payment and Additional Payment:** the bond-issuer undertakes under the arrangements to make a repayment of the capital (“the redemption payment”) to the bond-holder during or at the end of the bond-term (whether or not in instalments), and to pay to the bond-holder other payments on one or more occasions during or at the end of the bond term (“additional payments”).
- **the reasonable commercial rate of return clause:** the amount of the additional payments does not exceed an amount which would be a reasonable commercial return on a loan of capital. The provision that limits returns to a ‘reasonable commercial rate’ clause is designed to ensure the amount of the additional payments does not exceed an amount which would be a reasonable commercial return on a loan of capital. This provision will help ensure that equity-like instruments are not presented as debt-like instruments, though there would not necessarily be strict limits on the level of interest that could be paid.
- **security transferability:** the bond-holder is able to transfer the rights under the arrangements to another person (who thereby becomes the bond-holder).

Question 3: Do you believe the provisions above are sufficient for defining an AFIB for regulatory purposes?

Question 4: Do believe there are any additional provisions that should be included for the regulatory definition of an AFIB?

- **mandatory listing requirement:** It is being proposed that AFIBs should be subject to a mandatory listing requirement on a recognised stock exchange. There is a risk that the legislative changes could lead to regulatory arbitrage (i.e. the risk that the exclusion from being classified as a CIS is exploited by instruments not intended to be excluded). This risk is considered to be low but nevertheless arbitrage could expose consumers to inappropriate risks. In such cases, investors may experience risks from the lack of oversight and control over their investments. This is more likely to be a problem for retail investors, who are less experienced market participants. To mitigate this it is proposed that AFIBs should be subject to a mandatory listing. This will ensure an enhanced level of transparency, reducing the likelihood of regulatory arbitrage. This provision is not considered as unduly burdensome as issuers are likely to seek a listing because this is a pre-requisite to preferential tax treatment. In addition HMT are will review the legislative changes after a period of 2 years to ensure the rules are functioning as intended.

Question 5: Do you believe that the mandatory listing requirement is relevant for the reasons stated above?

³ To note: HMRC are currently informally consulting on making changes to S48A (1) and (2) to cater for ‘asset-based’ sukuk issuance. These changes would be laid by Order-making powers later in the year.

3.10 The advantage of this approach is that it sets out a clear definition and is consistent with the tax definition. The disadvantage is that if the tax definition and regulatory definitions need to be amended, this would need to be done separately, creating an additional administrative burden. It could also potentially lead to the risk of inconsistent definitions for tax and regulatory purposes. Such an approach is, however, flexible enough to take account of any need to distinguish between the tax and regulatory definitions for reasons, which are tax and regulation specific.

3.11 The FSA is assessing the costs of option 1 to their IS systems. If the associated costs are significantly higher than the financial benefits derived from option 1, this would clearly have a large impact on the cost effectiveness of option 1. Under these circumstances, the Authorities will examine the feasibility of alternative legal solutions (such as the outlined in option 3 of this paper).

Option 2: Using the tax definition of an AFIB for regulatory purposes

3.12 As outlined earlier, option 2 would consist of including AFIBs as a specified investment under the Regulated Activities Order (RAO) and exempting them from the CIS Order. The distinction between option 2 and option 1 would be to use the same definition for an AFIB as set out in tax legislation, rather than having a distinct regulatory definition. The RAO would simply cross-refer to the relevant tax legislation which is set out in Section 48A of the Finance Act 2005.

3.13 The benefits are similar to those for option 1. However, there is a risk of future legal and compliance cost uncertainty, compared to option 1 because of changes in the definition for tax purposes rather than regulatory reasons, which reduces the incremental benefit to issuers. Furthermore, the risk of differences in the interpretation of certain provisions between the relevant authorities (in this case HM Revenue and Customs and the Financial Services Authority) could create uncertainty for market participants, again limiting the extent of benefits.

3.14 There are disadvantages to option 2. Firstly, any changes to the definition for tax purposes may have unintended consequences for the regulatory regime. In addition, some of the existing tax provisions are not relevant for regulatory purposes. Secondly there might be differences in the interpretation of certain provision between tax and regulatory authorities leading uncertainty for market participants.

Question 6: Do you agree that, although the regulatory definition of an AFIB should generally be the same as the definition of AFIBs for tax purposes and as set out in section 48A of the Finance Act 2005, it is not appropriate simply to cross-refer to section 48A?

Option 3: similar to option 1 but including AFIB as an existing specified instrument

3.15 This option is similar to similar to option 1, except that instead of creating new specified investment (under article 77a) AFIBs will be included in the list of instruments in an existing specified investment under articles 77 (instruments creating or acknowledging indebtedness) and 78 (government and public securities) of the RAO. The advantage of this option is that it ensures that AFIBs are treated as debt instruments without having to create a unique regulatory category, thereby removing any potential need to upgrade the FSA's IS systems.

3.16 The disadvantage, however, is that it distinguishes between AFIBs issued by the private and the public sector, which it was not initially intended to do. It would also result in the creation of a lengthy article covering a number of different instruments or in the need to define AFIBs in a

separate section of the RAO. Both solutions could create more confusion and uncertainty than option 1. However, although option 1 is the simpler option, option 3 could ultimately achieve the same result.

Option 4: do nothing

3.17 The final option is not to adopt any formal legal or regulatory changes. This would mean that the regulatory treatment of these instruments would be based on the interpretation of existing regulations, which market participants are concerned leads to regulatory and legal uncertainty.

Summary of questions

- 1 Do you agree that AFIBs which have similar economic characteristics to conventional debt instruments should be regulated in the same way as those conventional debt instruments, where appropriate?
- 2 Do you agree that including them as a specified investment under the Financial Services and Markets Act 2000 (Regulated Activities Order) 2001 and amending the Schedule to the Financial Services and Markets Act 2000 (Collective Investment Schemes) Order 2001, affords these instruments a similar regulatory treatment to conventional debt instruments?
- 3 Do you believe the provisions above are sufficient for defining an AFIB for regulatory purposes?
- 4 Do believe there are any additional provisions that should be included for the regulatory definition of an AFIB?
- 5 Do you believe that the mandatory listing requirement is relevant for the reasons stated above?
- 6 Do you agree that, although the regulatory definition of an AFIB should generally be the same as the definition of AFIBs for tax purposes and as set out in section 48A of the Finance Act 2005, it is not appropriate simply to cross-refer to section 48A?

A Regulatory impact assessment

Summary

A.1 Sukuk or Islamic bonds which are structured to have similar economic characteristics as either conventional debt securities or asset-backed securities will meet the definition of an Alternative Financial Investment Bond (AFIB). Sukuk have become an increasingly popular mechanism for raising funds with total global outstanding issuance amounting to \$97.3 billion (end 2007).¹ There are 18 sukuk issuances listed in London, valued at more than £6.5 billion. Currently all sukuk listed in the UK are from issuers based outside the EEA.

A.2 Sukuk can have a variety of underlying legal structures, making it difficult to classify them under the current regulatory framework. At present they are regulated either as CIS or conventional bonds, with the decision made on a case-by-case basis. As indicated in a recent FSA paper the application of CIS regulations is disproportionate and creates a higher regulatory burden to issuers of these securities compared with issuers of comparable conventional securities.² Industry have indicated, during informal consultations that this is holding back the issuance of sukuk in the UK.

A.3 The main benefit of the proposals to treat AFIBs as conventional bonds is to provide clarity about the regulatory treatment and compliance costs for AFIBs and thus facilitate UK issuance of these instruments. However, the extent to which UK issuers will issue AFIBs in the future is unclear.

A.4 The proposed changes would enable AFIB issuers to benefit from not being subject to CIS regulations, such as being authorised and regulated by the FSA and rules on marketing. In terms of costs, AFIB issuers would be subject to marginally higher one-off costs from being listed as a debt security, but marginally lower on-going costs.

A.5 This issue has particular significance for the growing number of UK based Islamic financial institutions. These institutions cannot raise finance via traditional securities markets and commonly issue instruments such as Sukuk for this purpose. It is important to ensure these firms have the access to a variety of wholesale funding sources similar to conventional financial institutions.

What are the policy objectives and the intended effects?

A.6 The objective is to ensure that innovative financial instruments are treated in similar way to existing financial products with similar economic characteristics. In this instance introducing legislative change will ensure AFIBs are subject to proportionate regulatory treatment as compared with conventional bonds.

¹ S&P Ratings Direct Mar 2008

² Please see p. 25-26 of the FSA's publication 'Islamic Finance in the UK: Regulation and Challenges' November 2007

What policy options have been considered?

A.6 Four options have been considered.

- Option 1: introduce legislative amendments to create a new specified instrument under the RAO and explicitly to exempt these instruments from CIS regulations. Introduce a unique regulatory definition for this purpose.
- Option 2: same as option 1 but AFIBs will be defined by the existing tax definition
- Option 3: same as option 1 but include AFIBs under the existing specified investment of instruments creating or acknowledging indebtedness
- Option 4: is to do nothing

A.7 Option 1 is preferred as it will align the regulatory treatment of AFIBs with debt securities. This approach removes the legal risks related to the uncertainty of the existing framework. It would also remove the risk that changes to tax legislation could create unintended consequences for the regulatory framework (as set out in option 2). Option 1 achieves the desired outcome in a simple and flexible manner, which will create legal certainty. It has several advantages over option 3, for example does not distinguish between AFIBs issued by the private and the public sector and avoids the creation of a lengthy article covering a number of different instruments and AFIBS do not have to be defined in a separate section of the RAO. Although option 1 is the simpler option, option 3 could ultimately achieve the same result.

A.8 The Authorities are cognisant of the possible additional costs associated with option 1 and will assess relevant alternative options (such as the outlined in option 3 of this paper) if these costs are found to be burdensome. By way of indication, the implementation of MIFID, a much larger exercise than that proposed under option 1, cost £1 million. The FSA are conducting a detailed assessment of potential costs to their systems as a result of the proposed legislative changes and while these may not be identical to the costs associated with MIFID implementation, they are may be material.

Summary of analysis and evidence

Option 1- Creating a new specified investment under the RAO and introduce a unique regulatory definition of an AFIBs

A.9 Benefits: The main benefit of treating AFIBs as conventional bonds is to provide clarity about the regulatory treatment and compliance costs for AFIBs and thus facilitate UK issuance of these instruments. Using the existing regime as the baseline, introducing legislation would enable AFIB issuers to benefit from savings as they would not be captured by the on-going requirements of CIS regulations. In terms of costs, AFIB issuers would be subject to marginally higher one-off costs from being listed as a debt security (approximately £10,000 per issuance³), but marginally lower on-going costs (approximately £10,000 per issuance per year). For example, in present value terms, for an AIFB of duration 5 years, total cost savings for an issuance are estimated to be around £35,000 per annum.⁴

A.10 Key non-monetised benefits: If cost savings are achieved it is likely that additional products will be introduced into the market. This will provide potential issuers especially Islamic financial institutions with greater flexibility over the instruments which they hold as assets on their balance sheets and greater scope to securitise assets. Investors will benefit from additional opportunities to diversify their portfolio of assets. Legal clarity would be benefit for issuers for a

³ Based on an issuance of £300 million

⁴ As set out in the FSA's Collective Investment Schemes (COLL) Handbook

number of reasons. Principally it would remove the potential legal risk arising for issuers unintentionally not adhering to CIS regulations. This could potentially result in enforcement action being taken by regulatory bodies. There would also be additional benefits from not being classified as a CIS such as avoiding the stricter controls on operating duties and responsibilities which would be inappropriate for this type of instrument. Additionally for authorised CIS there would be less prescriptive rules on borrowing and types of investment.

A.11 Costs: There may be relatively substantial costs related to upgrading the FSA's technology platforms due to the creation of a new specified investment. These are currently being investigated by the FSA.

A.12 Key non-monetised costs: There is a small possibility that the legislative changes could lead to regulatory arbitrage (i.e. the risk that the exclusion from being classified as a CIS is exploited by instruments not intended to be excluded). This risk is considered to be low but nevertheless arbitrage could expose consumers to inappropriate risks. To mitigate this, it is proposed that AFIBs should be subject to a mandatory listing requirement as this will enhance transparency. HM Treasury will review the rules in 2 years time in order to ensure that the regime is functioning as intended.

Option 2-creating a new specified investment under the RAO using the existing tax definition for regulatory purposes

A.13 The costs and benefits of this option would be similar to option 1. The main risks are that the definition of an AFIB could change for tax-specific reasons and, conversely, an inability to make regulation-specific changes to the definition. This means there is a risk of future regulatory and legal uncertainty, which reduces the incremental benefit to issuers.

Option 3-same as option 1 but include AFIBs under the existing specified investment of 'instruments creating or acknowledging indebtedness'

A.14 The costs and benefits of this option for market participants would be similar to option 1. The main difference is that there would be no costs associated with upgrading the FSA's technology platforms, which would be required if a new specified investment category is created.

Option 4-do nothing

A.15 The regulatory situation is not expected to change, with legal uncertainty remaining. Using the existing UK regime as the baseline, there would be no additional benefits or costs.

Evidence base

Background

A.16 The purpose of this consultation is to clarify the regulatory framework for AFIBs in the UK. AFIBs are innovative instruments with similar characteristics to conventional debt securities, and there are currently no explicit provisions in the existing regulatory regime designed to accommodate these products. As a result the regulatory classification of instruments such as Sukuk is dependent on the interpretation of existing legislation. HM Treasury are seeking to introduce legislation to ensure that AFIBs are treated in a similar manner to conventional debt securities for regulatory purposes.

A.17 Sukuk have become an increasingly popular mechanism for raising funds, particularly in the Middle East and Asia. By the end of 2007, volumes of globally outstanding sukuk totalled \$97.3bn. The total number of transactions numbered 119 (compared with 109 issuances in 2006). Three quarters of the sukuk issued in 2007 were from corporates, with the remaining

quarter from sovereign issuers. Non-traditional issuers such as Toyota and Tesco have issued sukuk in Malaysia and there is evidence to suggest UK & European corporates are keen to tap markets such as these to diversify their funding and access new sources of liquidity. As of July 2008, there were 18 sukuk issuances listed in London, valued at more than £6.5 billion. Currently all sukuk listed in the UK are from issuers based outside the EEA.

A.18 Sukuk is a generic term used to encompass a broad range of financial instruments designed to conform with the principles of Islamic law (Sharia). In general Sharia prohibits the use of interest in financial transactions. AFIBs are therefore structured in a way so as to replicate the function of conventional bonds or asset-backed securities. This is achieved through the use of innovative techniques.

A.19 Classifying Islamic financial instruments under existing regulatory frameworks has posed challenges. Although sukuk are designed to replicate the economic function of conventional financial products, their legal structures are different and it has therefore proved difficult to map these products into the existing legal framework. The industry and the FSA, have raised concerns that this could lead to the application of disproportionate regulations to issuers of these securities (by treating them as CIS rather than debt),⁵This issue was highlighted in the FSA's November 2007 paper.⁶ The classification of sukuk under the current legislative framework is conducted on a case-by-case basis.

A.20 There are differences in cost depending on whether an instrument is treated as debt or as a CIS. CIS regulations include being authorised and regulated by the FSA and rules on marketing. CIS issuers incur an authorisation cost and periodic fees. Listed bonds incur the cost of listing, with both one-off and on-going payments, and the cost of producing an annual report. The result is that issuers of bonds are subject to marginally higher one-off costs from being listed as a debt security, but marginally lower on-going costs. The FSA will be conducting a detailed assessment to estimate the costs associated with these system changes.

A.21 Until now no UK issuers have issued sukuk. There are a number of sukuk listed in the UK but these issuers are from non-EEA jurisdictions. The government believes that legal uncertainty as well as tax and operational issues are an obstacle to the development of this market.

A.22 These aforementioned obstacles are problematic for Islamic financial institutions as they are unable to raise finance via traditional securities markets and commonly issue sukuk for this purpose. Recent reports indicated that up to 26.2% of global issuance is from Islamic financial institutions and they are an important source of wholesale funding for these institutions..

Legislative proposals and options

A.23 HM Treasury are seeking to introduce new legislation to ensure that AFIBs are treated in a similar manner to conventional debt securities for regulatory purposes. This policy and impact assessment is informed by dialogue between HM Treasury, FSA, relevant trade associations and industry.

A.24 The first option is to introduce legislative changes so that AFIBs are afforded a similar regulatory treatment to that of conventional bonds. The mechanism by which to achieve this would be to implement a set of related legislative changes.

A.25 The first component of this is to include AFIBs under the Financial Services and Markets Act 2000 (Regulated Activities Order) 2001 on the same basis as instruments creating or acknowledging indebtedness (as set out in Articles 77 and 78 of the RAO). There are two alternatives to achieve this, either by creating a new specified investment (article 77a), or

⁵ Collective Investment Scheme (CIS) as set out in the Financial Services and Markets Act (FSMA 2000).

⁶ http://www.fsa.gov.uk/pubs/other/islamic_finance.pdf

including AFIBs in the list of financial instruments under an existing specified investment (articles 77 and 78).

A.26 The second component is explicitly to exempt them from the Collective Investment Scheme regulations. S235 (5) of FSMA gives HM Treasury the power to exclude certain arrangements from the definition of a Collective Investment Scheme. Accordingly, the Schedule to the Financial Services and Markets Act 2000 (Collective Investment Schemes) Order 2001 should be amended to ensure that such instruments are excluded. This set of legislative changes will align the regulatory treatment with conventional bonds. There are difficulties in defining AFIBs for regulatory purposes because these instruments can have a wide range of underlying legal structures (see annex 2). The definition should therefore be wide enough to capture a range of different AFIBs but not so wide that other instruments are inadvertently captured (e.g. equity-type instruments). For option 1 above it is proposed that a unique regulatory definition of an AFIB be created. The characteristics of the definition should be consistent with the relevant tax legislation.⁷

A.27 It is being proposed that AFIBs should be subject to a mandatory listing requirement. This intention of this provision is to enhance transparency and reduce the likelihood of regulatory arbitrage. This provision is not considered as unduly burdensome as issuers are likely to seek a listing because this is a pre-requisite to preferential tax treatment.

A.28 The second option is similar to the first option in that it introduces the same set of legislative changes as outlined above except that the existing tax definition is used. This will ensure there are no inconsistencies between tax and regulatory rules but could lead to inflexibility.

A.29 The third option is similar to option 1 except that instead of creating a new specified investment (under article 77a), AFIBs will be included in the list of financial instruments under an existing specified investment (articles 77 and 78 of the RAO).

A.30 The last option would be to do nothing. No formal legislative amendments would be made. The regulatory treatment of these instruments would be dependent on the interpretation of existing legislation, which market participants are concerned leads to regulatory and legal uncertainty.

Benefits

A.31 Option 1: The first option is to introduce legislative changes so that AFIBs are afforded a similar regulatory treatment to that of conventional bonds. The main benefit of treating AFIBs as conventional bonds is to provide clarity about the regulatory treatment and compliance costs for AFIBs and thus facilitate UK issuance of these instruments. However, the extent to which UK issuers will issue AFIBs in the future is unclear.

A.32 The advantage of this approach is that it sets out a clear definition, consistent with the tax definition. This would enable the growth of the market, and the broad definition would allow a variety of products. Islamic financial institutions could access new sources of finance as they cannot issue traditional bonds.

A.33 The proposed changes would enable AFIB issuers to benefit from not being subject to CIS regulations, such as being authorised and regulated by the FSA and rules on marketing. In terms of costs, AFIB issuers are subject to marginally higher one-off costs from being listed as a debt security (approximately £10,000 per issuance), but marginally lower on-going costs (approximately £5,000 per issuance per year).

⁷ as set out in Section 48A - Alternative Finance Instrument Bond (AFIB)

A.34 Option 2: A separate definition for AFIB would not be created, instead the existing tax definition would be used. The benefits are similar to those for option 1. However, there is a risk of future legal and compliance cost uncertainty, compared to option 1 because of changes in the definition for tax purposes rather than regulatory reasons, which reduces the incremental benefit to issuers. Furthermore, the risk of differences in the interpretation of certain provisions between the relevant authorities (in this case HM Revenue and Customs and the Financial Services Authority) could create uncertainty for market participants, again limiting the extent of benefits.

A.34 Option 3: Same as option 1.

A.35 Option 4: The final option is not to adopt any formal legal or regulatory changes, consequently we don't expect any change in benefits.

Costs

A.36 Option 1: Because a new specified investment would be created there could be costs associated with upgrading the FSA's technology platforms. These costs may be material in the context of this consultation. There are various systems, which capture the scope of permissions of regulated firms. Creating a new specified investment could mean widening the scope of permissions for certain firms and the various systems linked to this would need to be upgraded. By way of indication, the implementation of MIFID, a much larger exercise than that proposed under option 1, cost £1 million. The FSA will be conducting a detailed assessment of potential costs to their systems as a result of the proposed legislative changes and while these are unlikely to be identical to the costs associated with MIFID implementation, they are may be material. The Authorities are cognisant of the possible additional costs associated with option 1 and will assess relevant alternative options (such as the outlined in option 3 of this paper) if these costs are found to be burdensome.

A.37 There is a risk that the legislative changes could lead to regulatory arbitrage (i.e. the risk that the exclusion from being classified as a CIS is exploited by instruments not intended to be excluded). This risk is considered to be low but nevertheless arbitrage could expose consumers to inappropriate risks. In such a cases, investors may experience risks from the lack of oversight and control over their investments. This is more likely to be a problem for retail investors, who are less experienced market participants. To mitigate this it is proposed that AFIBs should be subject to a mandatory listing requirement and that HM Treasury will review the rules in 2 years time in order to ensure that the regime is functioning as intended.

A.38 Option 2: similar to option 1. Although this would ensure regulatory and tax definitions are consistent, many of the tax provisions are irrelevant for regulatory purposes. Subsequent changes to the tax definition may be in appropriate for regulatory purposes.

A.39 Option 3: same as option 1 except it would not be necessary to upgrade the FSA's technology platforms.

A.40 Option 4: Without government intervention, the regulatory treatment would be determined by interpreting existing legislation, with no change in compliance costs.

Competition assessment

A.41 Options 1, 2 and 3 remove a barrier to entry in the form of legal uncertainty, although option 2 does so to a lesser extent since there may be subsequent changes to the definition of an AFIB due to tax reasons. We are unsure of the extent of entry into the market, and new issuance, however.

B

Draft proposed legislation

The Financial Services and Markets Act 2000 (Regulated Activities) (Amendment) Order 2009

In the opinion of the Treasury, one of the effects of the following Order is that an activity which is not a regulated activity (within the meaning of the Financial Services and Markets Act 2000⁽¹⁾) will become a regulated activity;

The Treasury make the following Order in exercise of the powers conferred on them by sections 22(1) and (5), 426, 427 and 428(3) of, and paragraph 25 of Schedule 2 to, the Financial Services and Markets Act 2000:

Citation, commencement and interpretation

1. – (1) This Order may be cited as the Financial Services and Markets Act 2000 (Regulated Activities) (Amendment) Order 2008.
- (2) This Order comes into force on [].
- (3) In this Order, “the Act” means the Financial Services and Markets Act 2000 and “the Principal Order” means the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001⁽²⁾.

Amendment of the Principal Order

- 2.—(1) The Principal Order is amended as follows.
- (2) After Article 77 (Instruments creating or acknowledging indebtedness) insert –

“Alternative finance investment bond

- 77A.—(1) Rights under an alternative finance investment bond.
- (2) Arrangements fall within this article if –
- (a) the arrangements provide for a person (“the bond-holder”) to pay a sum of money (“the capital”) to another (“the bond-issuer”),
 - (b) the arrangements identify assets, or a class of assets, which the bond-issuer will acquire for the purpose of generating income or gains directly or indirectly (“the bond assets”),
 - (c) the arrangements specify a period at the end of which they cease to have effect (“the bond term”),
 - (d) the bond-issuer undertakes under the arrangements –
 - (i) to make a repayment of the capital (“the redemption payment”) to the bond-holder during or at the end of the bond-term (whether or not in instalments), and
 - (ii) to pay to the bond-holder other payments on one or more occasions during or at the end of the bond term (“additional payments”),
 - (e) the amount of the additional payments does not exceed an amount which would be a reasonable commercial return on a loan of the capital, and

⁽¹⁾ 2000 c.8.

⁽²⁾ S.I. 2001/544, to which there are amendments not relevant to this Order.

- (f) the arrangements are a listed security on a recognised investment exchange (within the meaning of section 285 of the Act).
- (3) For the purposes of paragraph (2) –
- (a) the bond-issuer may acquire bond assets before or after the arrangements take effect,
 - (b) bond assets may be property of any kind, including rights in relation to property owned by someone other than the bond-issuer,
 - (c) the identification of the bond assets mentioned in subparagraph (2)(b) and the undertakings mentioned in subparagraph (2)(d) may (but need not) be described as, or accompanied by a document described as, a declaration of trust,
 - (d) the bond-holder may (but need not) be entitled under the arrangements to terminate them, or participate in terminating them, before the end of the bond term,
 - (e) the amount of the additional payments may be –
 - (i) fixed at the beginning of the bond term,
 - (ii) determined wholly or partly by reference to the value of or income generated by the bond assets, or
 - (iii) determined in some other way,
 - (f) if the amount of the additional payments is not fixed at the beginning of the bond term, the reference in subparagraph (2)(e) to the amount of the additional payments is a reference to the maximum amount of the additional payments,
 - (g) the amount of the redemption payment may (but need not) be subject to reduction in the event of a fall in the value of the bond assets or in the rate of income generated by them, and
 - (h) entitlement to the redemption payment may (but need not) be capable of being satisfied (whether or not at the option of the bond-issuer or the bond-holder) by the issue or transfer of shares or other securities.”

Amendment of the Financial Services and Markets Act 2000 (Collective Investment Schemes) Order 2001

3.–(1) The Schedule to the Financial Services and Markets Act 2000 (Collective Investment Schemes) Order 2001⁽³⁾ is amended as follows.

(2) For paragraph 5(1)(a) substitute—

“(a) investments of the kind specified by article 77 (instruments creating or acknowledging indebtedness) or article 77A (alternative finance investment bonds) of the Regulated Activities Order which are —”

⁽³⁾ S.I. 2001/1062, amended by S.I. 2006/3384; there are other amending instruments but none is relevant.

EXPLANATORY NOTE

(This note is not part of the Order)

This Order inserts a new article 77A into the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 (S.I. 2001/544) (“the principal Order”) to make alternative finance investment bonds a specified investment for the purposes of the Financial Services and Markets Act 2000 (c.8) (“the Act”).

The main effect of this Order is to regulate a form of Sharia compliant investment bond (known in the plural as ‘sukuk’ and in the singular as ‘sakk’) that is, in economic substance, similar to a debt security in an equivalent manner to conventional debt securities, where appropriate. Sukuk arrangements allow assets to be held for the benefit of investors in certificates issued by a company. The benefits may include the payment of a return that is economically equivalent to interest and redemption of the certificates out of the proceeds from the disposal of the assets.

This Order applies to sukuk which meet conditions that make them economically equivalent to a conventional bond and which are listed on a recognised investment exchange.

New article 77A(2) provides that arrangements fall within article 77A if they meet a number of conditions. Broadly, these conditions replicate the circumstances in which a person subscribes for a conventional listed debt security and from which they receive a return that may include interest and other amounts on redemption. Such conventional instruments are already made a specified investment by virtue of Article 77 of the Principal Order.

Under typical arrangements for an alternative finance investment bond, the issuer uses the subscription proceeds of the bond to acquire assets, which are held for the benefit of the bond holder. Income generated from the assets is distributed to the bond holder and, on maturity of the bond, the assets are sold under pre-existing arrangements and the proceeds returned to the bond holder. The statutory conditions in new article 77A are intended to replicate such typical arrangements.

In order to achieve this, new article 77A(2) defines arrangements that fall within the article as those where a “bond holder” pays a sum of money (“capital”) to a “bond issuer”. It requires the arrangements to specify the assets that are acquired and managed by the bond issuer to generate a return for the bond holder. Such income or gains may be generated directly, for example by leasing property held by the bond issuer, or indirectly, for example by the bond issuer participating in a joint venture.

At the end of the period for which the arrangements have effect, the bond issuer must make a “redemption payment” to repay the capital. Other payments made by the bond issuer to the bond holder, including any premium paid on redemption, are termed “additional payments”. It is required that these additional payments do not exceed a “reasonable commercial return” from making a loan. This is to exclude arrangements where the return to bond holders is linked to the profits of a business and which in economic terms are more like partnerships or conventional collective investment schemes. A further requirement, that the bond is listed on a recognised investment exchange, is designed to counteract the possibility of regulatory arbitrage in respect of conventional debt securities, which would result in a reduction of consumer protection. The requirement for such a provision, and for additional payments not to exceed a reasonable commercial return, will be reviewed after this Order has been in force for two years.

New article 77A(3) expands upon and qualifies the conditions set out in new article 77A(2) and allows for a range of types of alternative investment bond. Thus:

- (a) The assets may be acquired before or after the arrangements set out in the new article 77A(2) begin;
- (b) The assets may be in the nature of rights, such as a share in a partnership;
- (c) The arrangements may be accompanied by a declaration of trust, as is typically the case, but they do not have to be;
- (d) The bond holder may or may not be entitled to terminate the arrangements;
- (e) The return from the bond may be fixed, floating or determined in some other way;
- (f) If not fixed at the beginning of the bond term, the reasonable commercial return, which is a specified condition for arrangements to fall within new article 77A(2), is a reference to the maximum amount of the additional payments made to the bond holder;

(g) The redemption payment is not required to be the full amount of the face value of the bond. This provision, together with (g) above, reflects the fact that alternative finance investment bonds do not constitute a debt – bond holders are not absolutely guaranteed to receive the expected amount of additional payments, or the full redemption payment, and have recourse only to the bond assets;

(h) The bond may be convertible into, or exchangeable for, shares or securities.

Article 3 of this Order makes an amendment to the Financial Services and Markets Act 2000 (Collective Investment Schemes) Order 2001 (S.I. 2001/1062) (“the Collective Investment Schemes Order”) that is consequential on the amendment to the Principal Order.

Sukuk, and conventional bonds, have similarities in some respects to collective investment schemes. Conventional bonds are, however, excluded from the definition of a collective investment scheme as set out in the Act. Thus Article 3 amends paragraph 5 to the Schedule of the Collective Investment Schemes Order to afford alternative finance investment bonds that satisfy the conditions of the new article 77A of the Principal Order the equivalent treatment to conventional bonds which are specified investments as provided in article 77 of the Principal Order.



Section 48A of the Finance Act 2005: alternative finance arrangements

48A Alternative finance arrangements: alternative finance investment bond: introduction

(1) Subject to section 52, arrangements fall within this section if –

- (a) the arrangements provide for one person (“the bond-holder”) to pay a sum of money (“the capital”) to another (“the bond-issuer”),
- (b) the arrangements identify assets, or a class of assets, which the bond-issuer will acquire for the purpose of generating income or gains directly or indirectly (“the bond assets”),
- (c) the arrangements specify a period at the end of which they cease to have effect (“the bond term”),
- (d) the bond-issuer undertakes under the arrangements –
 - (i) to dispose at the end of the bond term of any bond assets which are still in the bond-issuer's possession,
 - (ii) to make a repayment of the capital (“the redemption payment”) to the bond-holder during or at the end of the bond-term (whether or not in instalments), and
 - (iii) to pay to the bond-holder other payments on one or more occasions during or at the end of the bond term (“additional payments”),
- (e) the amount of the additional payments does not exceed an amount which would be a reasonable commercial return on a loan of the capital,
- (f) under the arrangements the bond-issuer undertakes to arrange for the management of the bond assets with a view to generating income sufficient to pay the redemption payment and additional payments,
- (g) the bond-holder is able to transfer the rights under the arrangements to another person (who thereby becomes the bond-holder),
- (h) the arrangements are a listed security on a recognised stock exchange (within the meaning of section 1005 of ITA 2007), and
- (i) the arrangements are wholly or partly treated in accordance with international accounting standards as a financial liability of the bond-issuer (or would be if the bond-issuer applied those standards).

(2) For the purposes of subsection (1) –

- (a) the bond-issuer may acquire bond assets before or after the arrangements take effect,
- (b) bond assets may be property of any kind, including rights in relation to property owned by someone other than the bond-issuer,
- (c) the identification of the bond assets mentioned in subsection (1)(b) and the undertakings mentioned in subsection (1)(d) and (f) may (but need not) be described as, or accompanied by a document described as, a declaration of trust,
- (d) a reference to the management of assets includes a reference to disposal,

- (e) the bond-holder may (but need not) be entitled under the arrangements to terminate them, or participate in terminating them, before the end of the bond term,
- (f) the amount of the additional payments may be –
 - (i) fixed at the beginning of the bond term,
 - (ii) determined wholly or partly by reference to the value of or income generated by the bond assets, or
 - (iii) determined in some other way,
- (g) if the amount of the additional payments is not fixed at the beginning of the bond term, the reference in subsection (1)(e) to the amount of the additional payments is a reference to the maximum amount of the additional payments,
- (h) the amount of the redemption payment may (but need not) be subject to reduction in the event of a fall in the value of the bond assets or in the rate of income generated by them, and
- (i) entitlement to the redemption payment may (but need not) be capable of being satisfied (whether or not at the option of the bond-issuer or the bond-holder) by the issue or transfer of shares or other securities.

(3) An order under section 1005 of ITA 2007 (recognised stock exchanges: designation) may designate a stock exchange for the purposes of that section in its application for the purposes of this section only.]¹

Note –

See Part 2, Miscellaneous, Misc X for a list of recognised stock exchanges designated solely for the purposes of FA 2005 s 48A (alternative finance investment bonds).

ISBN 978-1-84532-538-1



9 781845 325381