

THE ISLAMIC FINANCE
AND MARKETS
LAW REVIEW

THIRD EDITION

Editors

John Dewar and Munib Hussain

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This article was first published in October 2018
For further information please contact Nick.Barette@thelawreviews.co.uk

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Published in the United Kingdom
by Law Business Research Ltd, London
87 Lancaster Road, London, W11 1QQ, UK
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www.TheLawReviews.co.uk

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Enquiries concerning editorial content should be directed
to the Publisher – tom.barnes@lbresearch.com

ISBN 978-1-92228-61-4

Printed in Great Britain by
Encompass Print Solutions, Derbyshire
Tel: 0844 2480 112

The publisher acknowledges and thanks the following law firms for their learned assistance throughout the preparation of this book:

ADNAN SUNDRA & LOW

AFRIDI & ANGELL

ALLEN & OVERY

ANDERSON MÖRI & TOMOTSUNE

BAKER McKENZIE LLP

DE BRAUW BLACKSTONE WESTBROEK

MATOUK BASSIOUNY & HENNAWY

MILBANK, TWEED, HADLEY & McCLOY LLP

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JAPAN

*Naoyuki Kabata and Satoshi Kato*¹

I LEGISLATIVE AND REGULATORY FRAMEWORK

Japanese law does not provide a special legal framework for supporting and regulating Islamic finance. Consequently, Islamic finance needs to be implemented under the legal framework for conventional finance in Japan. Under the laws and regulations governing conventional finance, an Islamic finance product that has legal characteristics that are equivalent to those of a conventional finance product or that is otherwise substantially equivalent or similar to a conventional finance product might be permitted as a type of conventional finance product. Further, certain types of Islamic finance products are plainly permitted pursuant to special clauses of the laws and regulations governing conventional finance. The scope of such permitted Islamic finance products has gradually been expanded over the past 10 years.

i Legislative and regulatory regime

Islamic banking

There is no special legal framework for banks that engage in Islamic finance. In general, Japanese law requires an entity engaging in the business of deposits, lending or money transfers (exchange transactions) to be licensed. A deposit or money transfer business (exchange transaction business) must have, in principle, a banking licence pursuant to the Banking Act of Japan (BA). A licensed bank may also engage in the lending business. However, when a person or entity only conducts a lending business (i.e., not concurrently with a deposit-taking business), that person or entity is required to be registered as a money lending business operator under the Money Lending Business Act of Japan (MLBA).

In addition, a sale transaction with instalment payments and a lease transaction with rent payments, which provide functions that are economically similar to lending, are regulated differently. Under the Instalment Sales Act of Japan (ISA), sales transactions with instalment payments can be conducted with or without registration depending on the specific type of transaction at issue. By contrast, lease transactions with rent payments can generally be conducted without any licence or registration.

Generally, transactions that target a customer in Japan from a foreign country are subject to the same licence requirements stated above. As a result, a foreign bank that engages in the banking business involving customers in Japan typically opens a Japanese subsidiary or branch and obtains a banking licence under the BA.

¹ Naoyuki Kabata is a partner and Satoshi Kato is an associate at Anderson Mōri & Tomotsune.

The BA and its subordinate rules and guidelines that are applicable to licensed banks clarify the types of Islamic finance products that may be provided by a licensed bank and its subsidiaries (including those outside of Japan). The following are identified as permissible Islamic finance products for licensed banks:

- a* a commodity sale and purchase transaction that is economically equivalent to lending, provided that (1) the commodities involved in the transaction are tradable in an exchange; and (2) the bank has removed all risks related to such commodities other than the purchaser's credit risk in paying the sale price, including the risk arising from the failure to sell or buy the commodities;
- b* an asset lease transaction that is economically equivalent to lending, provided that (1) the bank has removed all risks related to the asset involved in the transaction other than the lessee's credit risk in paying the rent; (2) the transaction must possess the characteristics of a financing lease transaction that the bank licensed under the BA is permitted to perform; and (3) the transaction does not involve any business or transaction that banks are prohibited from conducting, such as construction work;
- c* an acquisition of interest in a customer's business that is economically equivalent to lending, provided that (1) the cash flow generated by the interest is similar to that generated in a lending transaction; and (2) the bank has removed all risks related to the customer's business other than the customer's credit risk;
- d* a commodity sale and purchase transaction that is economically equivalent to a deposit, provided that the bank has removed all risks related to the commodities involved in the transaction; and
- e* a commodity sale and purchase transaction that is economically equivalent to an interest rate swap or currency swap, provided that the bank has removed all risks related to the commodities involved in the transaction.

Transactions referenced in items (*a*), (*d*) and (*e*) correspond to commodity *murabahah* transactions, while the transaction referenced in item (*b*) corresponds to *ijarah* and *istisna* transactions. The transaction described in item (*c*) corresponds to *musharakah* and *mudarabah* transactions. However, whether a particular Islamic finance product is permissible must be determined by analysing if the specific terms and conditions of that product meet the requirements of the BA and its subordinate rules and guidelines.

Further, the following are identified by the BA and its subordinate rules and guidelines as permissible Islamic finance products for a subsidiary of a licensed bank:

- a* those Islamic finance products that are deemed permissible for a licensed bank; and
- b* a transaction that does not involve cash lending, but that should be deemed to constitute the equivalent of cash lending, provided that (1) the customer of such transaction (i.e., deemed borrower) is in a jurisdiction where the receipt of interest is prohibited owing to religious restrictions; and (2) the transaction is conducted pursuant to a judgment authorising such transaction from a board that is constituted by members who have special knowledge (which effectively refers to a *shariah* board) confirming that the transaction does not fall within the category of cash lending from the perspective of the applicable religious discipline.

In addition to those described above, other types of Islamic finance products might be permissible if such products are substantially the same as or similar to a conventional finance product. For example, a *mudarabah* transaction might be regarded as being similar to the

acquisition of interests under a silent partnership agreement or partnership agreement. As a result, although certain filing requirements would apply, a licensed bank might be permitted to conduct such transaction depending on the specific characteristics of the products and the business conducted by the *mudarabah* business operator.

Capital markets

Japanese law also does not provide any special legal framework for Islamic finance in terms of capital markets products. Under the laws and regulations governing conventional finance, a securities brokerage business is subject to a registration requirement. More specifically, the Financial Instruments and Exchange Act of Japan (FIEA) requires a securities brokerage business to register as either a Type I financial instruments business operator or a Type II financial instruments business operator depending on the types of securities that the broker handles. Thus, if an Islamic finance product is classified as a type of security under Japanese law, the broker of such product must register as either a Type I or Type II financial instruments business operator as described above. While a foreign securities broker is also subject to the registration requirements when it has customers in Japan, certain exemptions are provided by the FIEA for the benefit of a foreign securities firm (i.e., a foreign entity that is licensed to conduct a securities brokerage business under its home country's law). For example, without registering under the FIEA, a foreign securities firm may promote securities from outside of Japan to certain limited categories of sophisticated investors such as banks, insurance companies, trust companies, broker-dealers and discretionary securities investment managers (all of which must be licensed in Japan).

With respect to the origination of *sukuk* in Japan, amendments to tax legislation enabled the issuance of *sukuk* using a specified purpose trust created under the Act on Securitisation of Assets of Japan (ASA). Based on a typical *sukuk* scheme that uses a sale and leaseback arrangement (*sukuk al-ijarah*), the originator entrusts its asset (such as real property) to a specified purpose trust and, in exchange, obtains special beneficial interests (a quasi-bond beneficial interest), which are to be distributed to investors as *sukuk*. The amendments to tax legislation, for example, have caused distributions payable under such special beneficiary interests to be treated the same as interest payable under corporate bonds. They have also resulted in exemptions to the imposition of real property registration tax and acquisition tax on the buy-back of real property by the originator upon the redemption of *sukuk*. Such amendments to the tax legislation have provided a level playing field to *sukuk* issued through a specified purpose trust. See Section III, below, for details.

With respect to the distribution in the Japanese market of *sukuk* originated outside of Japan, the conventional regulatory framework that applies to the sale of bonds will apply. Consequently, assuming that the foreign *sukuk* is classified as a Type I security because of its high-liquidity, there are primarily two routes to distribute the *sukuk* that originated outside of Japan. If those who have been solicited to purchase the foreign *sukuk* include one or more qualified institutional investors and 49 or less non-qualified institutional investors (i.e., private placement or private sale), then the foreign *sukuk* may be sold via a relatively simple procedure that does not require the filing of a securities registration statement. However, if the foreign *sukuk* is distributed via a public offering or public sale, securities registration statements typically must be filed, which is a fairly cumbersome and costly process.

Insurance

There is no special legal framework for Islamic insurance (*takaful*) under Japanese law. Further, because the legal structures of conventional insurance and *takaful* insurance are different, a Japanese insurance company, which is licensed under the Insurance Business Act of Japan (IBA), is unlikely to be permitted to handle *takaful* insurance. However, Japanese law does not fully discuss whether a Japanese insurance company is permitted to handle *takaful* insurance.

Funds

There is no special legal framework for Islamic funds under Japanese law. However, under the laws and regulations governing conventional finance, there are several legal frameworks for funds in Japan. Consequently, it may be possible to establish Islamic funds by restructuring one such legal framework to satisfy the Islamic finance requirements, such as by (1) restricting the investment portfolio to *shariah*-compliant business or products; and (2) managing the funds through a *shariah* board. Note that using existing investment management companies as fund managers or existing trust companies as trustee might cause *shariah* issues since most of these companies in Japan are affiliates of a licensed bank and engage in a large number of conventional finance transactions.

Under the FIEA, a discretionary securities investment manager is required to register as an investment management business operator, while a non-discretionary securities investment adviser is required to register as an investment advisory business operator. Accordingly, the fund managers of Islamic funds established in Japan are likely to be required to register either as investment management business operators or investment advisory business operators, depending on the specific roles of each fund manager under the respective fund scheme.

ii Regulatory and supervisory authorities

The Financial Services Agency of Japan implements the BA, the FIEA, the MLBA and the IBA. The Ministry of Economy, Trade and Industry implements the ISA, which governs sale transactions involving instalment payments.

Islamic finance business is treated like any other finance business in Japan. Accordingly, it is subject to the supervision and authority of the regulatory authorities. The regulatory authorities monitor the activities of a finance business through a combination of on-site and off-site inspections. If any issue or failure respecting compliance is found, the regulatory authorities conduct additional examinations. If the issue or non-compliance is material, the regulatory authorities may impose administrative sanctions, such as an order for business improvement, an order for suspension of business or an order for revocation of the relevant licence. Moreover, if there is any breach of criminal law, criminal penalties may also be imposed.

II COMMON STRUCTURES

To date, our understanding is that no Islamic finance product governed by Japanese law has been created. Nonetheless, Japanese financial institutions, such as Japanese banks and securities firms, engage in Islamic finance business in Malaysia and Middle Eastern countries through their subsidiaries or branches.

III TAXATION

Special tax treatment is applied to Japanese *sukuk*, which is structured using a specified purpose trust under the ASA. Although the Japanese *sukuk* is a trust beneficiary interest, as a result of a series of amendments to the tax legislation, the Japanese *sukuk* is now treated more like a bond than a trust beneficiary interest from the tax perspective. Under Japanese tax law, the dividends to be paid to the foreign holders of a trust beneficiary interest are subject to taxation. However, the foreign holders of a Japanese *sukuk* are exempted from such taxation when they register the Japanese *sukuk* with the Japanese depository system and receive the dividends of the Japanese *sukuk*.

In addition, special tax treatment that reduces the transactional costs of typical Japanese *sukuk* backed by real property has been introduced. When an originator buys real property back from the trustee upon redemption, such buy-back transaction is normally subject to the registration and licence tax and real property acquisition tax. However, if such transaction is conducted as part of a Japanese *sukuk* transaction, it is not subject to such taxation under certain conditions.

Other than the special tax treatment described above, no special tax treatment is given to Islamic finance. Islamic finance transactions are subject to general taxation rules under Japanese law. For example, a sale and purchase in a *murabahah* transaction will be subject to consumption tax, registration and licence tax and real property acquisition tax depending on the types of assets at issue.

IV INSOLVENCY

No special legal framework is provided for the treatment of Islamic finance under Japanese bankruptcy procedures. Further, no court precedent is available. Consequently, Islamic finance products may be subject to the rules that are applicable to conventional financial products that are similar to the relevant Islamic finance products.

V JUDICIAL FRAMEWORK

i Courts

Because no *shariah* court has been established in Japan, a conventional Japanese court will have jurisdiction over a dispute in relation to Islamic finance. Even if the parties agree to designate *shariah* as the governing law, it is unlikely that a Japanese court will apply *shariah* as the law governing the judgment in that case.

ii Case

There is no available case in which a Japanese court has handled a dispute in relation to Islamic finance.

VI OUTLOOK

The legal framework supporting and regulating Islamic finance is being gradually developed, primarily in the area of banking and *sukuk*. Because of the *de minimis* Muslim population in Japan, the Islamic finance retail business is unlikely to become prevalent in Japan. By contrast, the wholesale Islamic finance business, in particular for Muslim investors or

domestic companies engaging in business in Muslim countries, is likely to be the subject of increasing demand. Further development with respect to the legal, accounting and taxation framework in response to the demand from private sectors engaging in Islamic finance business is strongly expected to propel Islamic finance in Japan forward.

ABOUT THE AUTHORS

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Naoyuki Kabata has been involved with an extensive range of financial transactions at Anderson Mōri & Tomotsune, including securitisation, asset management and investment funds, project finance, private finance initiatives and leveraged buy-outs. He advised a fund affiliated with an Islamic bank in Kuwait on their acquisition of real properties in Japan involving the sale and leaseback structure to comply with *shariah* requirements, which is said to be the first transaction using Islamic finance techniques in Japan.

SATOSHI KATO

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Satoshi Kato is an associate at Anderson Mōri & Tomotsune, specialising in financial transactions and financial regulation. Utilising his expert knowledge and years of experience, he has advised on numerous structured finance deals, as well as financial regulatory issues in relation to banking, securities, money lending, trusts, leases, foreign exchange, anti-money laundering and Islamic finance. Additionally, during the year that he worked for a Malaysian subsidiary of a Japanese bank, Mr Kato was extensively focused on providing advice about Islamic finance.

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ISBN 978-1-912228-61-4