

MIF *Monthly*
2008 Legal Supplement



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From its humble origin as a sole practitioner, the firm has grown into one of the top three largest and oldest law firms in Malaysia today. From a litigation-oriented practice, it has evolved into a leading full service firm that offers a comprehensive range of legal services to clients spanning the globe.

The firm has distinguished itself in its commitment to the highest standards of professionalism and integrity over nine decades. It has built on that heritage and continues to invest in the development of its human resources, team of legal practitioners and infrastructural resources, including the latest technological systems, for the benefit of its clients. The latest in online legal research facilities enhances and complements one of the most comprehensive traditional library facilities in the country, enabling the firm to deliver on its mission of service with effectiveness and efficiency.

The firm has 12 departments representing major, though not exclusive, practice areas, which combine in a complementary and multidisciplinary practice to serve the needs of clients.

Practice Areas

*Banking & Finance

The firm provides comprehensive services across all areas of transactions and products in Islamic finance. Our team has experience in the negotiation, preparation and structuring of various documentation relating to Islamic finance, including the following:

- Islamic private debt securities;
- Ijarah for project financing;
- Musharakah notes issuance programs;
- Istisnah project financing;
- Murabahah notes issuance program;
- Limited recourse project financing.

* Corporate

* Property & Conveyancing

* Insurance, Shipping & Aviation

* Banking & Finance Litigation

* International & Domestic Arbitration

* General & Civil Litigation

* Intellectual Property, Information Technology & Licensing

* Probate & Administration

* Employment & Labour

* Tax Advisory & Compliance

* Company Secretarial Services

Note from the Editor

Islamic banks and capital market players do not operate in a vacuum. They are bound by the regulatory framework governing their turf. While Shariah compliance is the essence of Islamic banking and finance, the parties need to ensure their contracts are enforceable in the respective market in order to protect their interests under the law.

The *MIF Legal Supplement* aims to provide readers with recent updates and issues on the Malaysian regulatory framework. It kicks off with an overview of the legislation that governs the operation of Islamic banking in the country. Starting with a review of the jurisdiction that oversees disputes in Islamic banking cases, the Bar Council highlights a few ambiguities in the Islamic Banking Act (IBA) 2003, including the absence of a clear definition of Islamic banking business and the religion of Islam in the Act.

One reason for this may be due to the nature of the IBA — it is a regulatory charter meant to facilitate the provision of license to Islamic banks. The Act, therefore, does not provide substantive law for Islamic banking or any reference for the courts to decide in cases of dispute. Nonetheless, the Central Bank Act 1958 was amended in 2003 to provide that any court or arbitration proceedings involving Shariah issues may refer to Bank Negara Malaysia's directive or refer to the Shariah Advisory Council (SAC) for a ruling.

The Bar Council also sheds light on a few recent developments including the Islamic Hire Purchase bill to be endorsed by Parliament and the central bank's efforts to identify and remove legal impediments to the operation of Islamic banking by commissioning a committee to review various Acts of Parliament such as the Companies Act 1965, the National Land Code 1965 and the Contracts Act 1950.

Besides regulatory updates, it is also essential to understand the implications of decided cases. Mohd Herwan Sukri Mohammad Hussin of AmIslamic shares his analysis of *Beximco Pharmaceuticals Ltd v Shamil Bank of Bahrain EC* and reviews the Malaysian courts' approach to Islamic banking cases.

And last but not least, Dato' Noorashikin Tan Sri Abdul Rahim, director of the Kuala Lumpur Regional Centre for Arbitration, outlines the center's role and how the industry could benefit from its services.

For more interesting views and updates, turn to our interviews with law firms, ARSA and Azmi & Associates.

One thing's for sure: Malaysia is sailing resolutely towards her vision to become the center for Islamic finance and the regulatory bodies need to constantly adapt to facilitate and complement market developments.

Happy reading!



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Legal and Regulatory Framework of Islamic Banking and Finance in Malaysia

By The Malaysian Bar

The main statute that sets out the jurisdiction of the courts in Malaysia is the Federal Constitution 1957 (FC). Article 121 of the FC establishes the jurisdictions of courts in Malaysia, and dictates that the civil court has no jurisdiction over matters within the jurisdiction of the Shariah Court.

The jurisdiction of the civil courts covers all matters conferred by federal and state law, except for the personal law of Muslims.

The civil court's jurisdiction is specifically laid down in List I — Federal List, Ninth Schedule of the FC. This includes matters on civil and criminal procedure and the administration of justice, contracts, mercantile laws, arbitration and so on. This will obviously include banking and financial laws.

On the other hand, the Shariah court's jurisdiction is laid down in Para 1 of List II — State List of the Ninth Schedule. However, the jurisdiction of the Shariah court is limited to matters in Para 1 only, and it has no jurisdiction over any criminal offenses, except as provided by federal law.

In essence, Para 1 includes matters pertaining to Islamic law, and personal and family law of persons professing the religion of Islam, including divorce, wakaf, succession, and offenses against the religion of Islam (except which is in the federal law).

Based on the above provisions in the FC, it can be concluded that the jurisdiction over Islamic banking and finance matters rests with the civil court, as it is within List I of the Ninth Schedule on mercantile law.

Although the term "Islamic law" in Para 1 of List II is wide, its application is limited to persons professing the religion of Islam. Thus, it has no general application to other persons and legal persons, such as banks and financial institutions, which

cannot be construed to be professing the religion of Islam.

Furthermore, the legislations on Islamic banking and finance are all federal legislations that are subject to the civil courts' jurisdiction. There has not been any state legislation on Islamic banking and finance matters.

This conclusion is further supported by the decided cases in Malaysia, where the civil courts have heard and decided on Islamic banking and finance matters.

Examples are *Tinta Press v Bank Islam Malaysia Berhad* [1986] 1 MLJ 474; *Bank Islam Malaysia Berhad v Adnan bin Omar* [1994] 3 CLJ 735; and *Dato Hi Nik Mahmud bin Daud v BIMB* [1996] 1 CLJ 576 (High Court); [1998] 3 MLJ 396 (Supreme Court).

In all these cases, the civil courts had used the civil law and procedures in reaching their decisions. Apparently, the civil courts did not consider whether the application of the existing law and would have contradicted the Shariah or affect the validity of the documents.

The reported cases also indicate that the courts had always based their decisions on the current banking laws regime without making any reference to the underlying Shariah principles that apply to the Islamic banking and finance (IBF) facility in dispute.

The full extent and impact of the courts' decisions on Islamic banking and finance transactions will be considered later.

However, it is proposed that the Malaysian courts take into consideration the attitude of the English Court of Appeal in the recent case of *Shamil Bank of Bahrain v Beximco Pharmaceuticals Ltd and Others* [2004] EWCA CIV 19, [2004] All ER (D) 280 (Jan), where it indicated its willingness to consider Shariah principles and obtained evidence from the Shariah experts before making its decision.

Legal infrastructure in Malaysia

• Islamic Banking Act 1983 (IBA)

Introduced to govern the operations of Malaysian Islamic bank(s), it was the first legal infrastructure to facilitate Islamic banking in Malaysia. There was also an amendment to the Government Investment Act 1983 to facilitate both (Islamic) statutory reserves and liquidity reserve requirements, which were to be interest-free.

This was followed by the enactment of the Takaful Act 1984 (TA) to allow for the licensing and operation of Islamic insurance (Takaful) companies in Malaysia.

Then, there was the amendment in 1996 to section 124 of the Banking and Financial Institutions Act 1989 (BAFIA) to allow banks licensed under the Act to introduce Islamic banking business.

The IBA mainly provides for the licensing and regulation of Islamic banks and Islamic banking business in Malaysia. Subsequently, the IBA was amended in 2003, and became the Islamic Banking (Amendment) Act 2003.

An analysis of the provisions in the IBA shows that the Act is regulatory in nature and does not provide for the substantive law for Islamic banking. There have not been specific thoughts of meeting the requirements and expectation of the Shariah since the clauses used are mainly derived from the conventional banking practices and the existing banking laws.

Moreover, the main legislative framework for Islamic banking in Malaysia is actually based on civil laws and falls within the jurisdiction of the civil courts.

There are also ambiguities in the Islamic Banking Act 1983. For example, there is no definition of banking business in the IBA. By way of comparison, BAFIA provides a

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definition of banking business in section 2(1), which provides:

- “(a) the business of —
 (i) receiving deposits...;
 (ii) paying or collecting cheques;
 (iii) provision of finance...”

In addition, the term “Religion of Islam” has not been defined. This may give rise to ambiguity as to the position of the Islamic legal schools (*madhhab*) in the interpretation of the catch-all phrase “approved by the Religion of Islam” used in IBA.

This difficulty is somewhat mitigated by the existence of a Shariah advisory body (SAB) for the Islamic bank as required by the IBA, essentially to safeguard and ensure Shariah compliance. The general rule to be observed in IBF is ensuring that there is no contravention of any Shariah principles in the transactions; for example, all transactions must be free from the elements of usury, dubiousness and gambling.

A new section was also added to the IBA in the 2003 amendment. Section 13A provides:

“(1) An Islamic bank may seek the advice of the Syariah Advisory Council on Syariah matters relating to its banking business and the Islamic bank shall comply with the advice of the Syariah Advisory Council.

(2) In this section, “Syariah Advisory Council” means the Syariah Advisory Council established under subsection 16B(1) of the Central Bank of Malaysia Act 1958.”

This amendment enables Islamic banks to seek the advice of the Syariah Advisory Council (SAC) of Bank Negara Malaysia (BNM); and it is mandatory for the Islamic banks to comply with the advice given by the SAC pursuant to such request. This indicates that the SAC has advisory powers over the Islamic banks, where liaison and

common understanding between the SAB and SAC are expected. This will also ensure that Shariah compliance is always strictly observed and adhered to by the Islamic bank with the advice of the SAC. The liaison with the SAC can also facilitate a shorter timeframe in endorsing any new products in IBF.

Nonetheless, nothing in the IBA provides for a minimum qualification of lawyers who are involved in IBF documentation and litigation. There is no specific requirement that lawyers dealing with Islamic banking transactions should have the relevant qualifications in drafting the documents.

“There is no specific requirement that lawyers dealing with Islamic banking transactions should have the relevant qualifications in drafting the documents”

Generally, this lack of necessary knowledge of the Shariah and Islamic law could lead to mistakes in drafting and also risks on the legality of the documents, especially for non-compliance with the Shariah principles.

- Banking and Financial Institutions Act 1989 (BAFIA)

Conventional banks licensed under BAFIA are allowed to carry out IBF business in addition to their conventional banking business, provided that they consult BNM.

According to section 124 of BAFIA, a licensed institution may carry

on Islamic banking business or Islamic financial business, provided that BNM is consulted before Islamic banking and financial business is carried out.

Under BAFIA, Islamic banking business has the same meaning as that in the IBA, while Islamic financial business is defined in section 124(7)(c) as:

“... any financial business, the aims and operations of which do not involve any element which is not approved by the Religion of Islam”.

Section 124(3) and (4) of BAFIA further provide that any licensed institution carrying on Islamic banking business or Islamic financial business may refer to BNM’s SAC and shall comply with the directions on Islamic banking business or Islamic financial business issued by BNM in consultation with the SAC.

However, it should be noted that under section 124(5) of BAFIA, the licensed institutions under the Act are not Islamic banks but conventional banks offering IBF services. Previously, these IBF services were known as “Skim Perbankan Tanpa Faedah” (SPTF) windows. Now, they are known as Islamic banking divisions.

Other significant amendments

- Central Bank of Malaysia Act 1958
 The Central Bank of Malaysia Act 1958 (CBA) provides for the establishment of the National Shariah Advisory Council (SAC) at BNM. An amendment was made to the CBA in 2003 to enhance the power and integrity of the SAC.

The SAC is now the authority for ascertainment of Islamic law for the purposes of Islamic banking business, Islamic financial business, Takaful business, Islamic development financial business and any other business that is based on Shariah principles and is supervised and regulated by BNM.

The amended CBA also provides that no member of the SAC can be a member of any Shariah body,

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or act as a Shariah consultant or Shariah adviser with any banking institution or other financial institution.

Further, the CBA provides that any court or arbitration proceedings involving Shariah issues may refer to BNM's directive or refer to the SAC for a ruling. The ruling by the SAC may be considered by the court, and is binding on an arbitrator.

Under the CBA, Islamic banking business has the same meaning as that in the IBA whereas "Islamic financial business" has been defined in section 16B(12) to mean "financial business whose aims and operations do not involve any element which is not approved by Syariah".

The CBA also deems all advice by the previous SAC as valid.

- **Stamping and taxation**

An amendment was made in 1989 to section 14A of the Stamp Act 1949 to avoid double stamp duty for Islamic financing documents.

Further orders were issued to give equal status to Islamic financing documents in terms of stamp duties — Stamp Duty (Exemption) Order 1996; the Stamp Duty (Remission) (No 4) Order 1996; the Stamp Duty (Exemption) (No 6) Order 2003; the Stamp Duty (Exemption) (No 2) Order 2004; the Stamp Duty (Exemption) (No 3) Order 2004; and the Stamp Duty (Remission) Order 2004.

An amendment was also made in 1985 to the Real Property Gains Tax Act 1979 to avoid double taxation on IBF transactions. In another recent development, the tax chargeable on all Islamic leasing or Ijarah financing will be at par with conventional leasing.

New developments

Recently, a bill on Islamic hire purchase was drafted in order to provide an Islamic alternative to the existing Hire Purchase Act 1967 to govern Islamic hire purchase transactions. Nevertheless, it is not certain as to when the bill will be passed by the Malaysian Parliament.

There have also been efforts to establish an Islamic tribunal panel to solve disputes pertaining to Islamic banking outside the court, following the procedures of the Code of Arbitration.

In addition, efforts have been made to solve problems pertaining to some provisions in BAFIA regarding the acquisition of shares and immovable property, towards facilitating Islamic banks or Islamic banking divisions to carry out Islamic banking transactions, especially in offering Musharakah and Mudarabah types of financing.

BNM has also established legal working committees to identify and look into the possibilities of removing other legal impediments to the development of IBF. These include a review of various Acts of Parliament, such as the Companies Act 1965, the National Land Code 1965 and the Contracts Act 1950.

For example, the central bank is looking into substantial value transaction under section 132C of the Companies Act, which requires the approval of shareholders for such transactions. This may cause problems to the practice of immediate sale and repurchase of assets under Islamic financing transactions which may amount to substantial value transactions under the Act.

Also, if the Islamic banking transaction involves the use of shares as underlying assets, it may be hindered by the requirements in section 69E to G of the Companies Act for notification of interests to the company in all transfers and retransfers of substantial interest in shares.

There is also a need to remove the "interest" or *riba* element from some of the sections in the Companies Act. Examples are:

- Section 69, which provides that where share capital is raised to defray expenses of construction of any works or buildings which cannot be made profitable in the long period, the company may pay interest on

such share capital and charge such interest as part of construction cost.

- Section 285(1), which provides for investment or placing of deposit at interest with any bank of surplus funds of a company in liquidation.
- Section 286(3), which provides that interest arising from the investments of unclaimed moneys of companies in liquidation be paid into the companies' liquidation account.

While significant advances have been made in the legal and regulatory framework relating to IBF since its introduction in Malaysia in 1983, it is also true that such advances have failed to keep pace with phenomenal development both in Malaysia and elsewhere.

Globalization and the frequent interface and collaboration between conventional bankers and Islamic financiers have given rise to not only a proliferation of new players but also the rapid introduction of novel and intricate forms of Islamic products and services.

There is, therefore, a need for the legal system of Malaysia to be not just responsive to these challenges but also to be proactive in anticipating and dealing with such issues as may surface from time to time if Malaysia is to realize its ambition of becoming a global leader in the industry. ☺



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Consolidating Growth through M&As

Senior partner of Azmi & Associates keen for the firm to climb the ranks from No 12 in the country into Tier 2

By Nazneen Halim



Located in Kuala Lumpur's Golden Triangle, smack in the middle of the cacophony of mid-day traffic, with pedestrians made up of the Suits and tourists against the backdrop of an ever-changing skyline, law firm Azmi & Associates seems to embody the essence of the city.

Embracing change and riding the wave of the evolving financial scene is what separates Azmi & Associates from the pack. Darwin's theory of natural selection has always applied to the economy, and the firm is well aware of this. After all, there is only room for global players in the global economy.

This month, **MIF Monthly** spoke to Azmi Mohd Ali, senior partner of Azmi & Associates. Yes, now we know who's the boss. From the time he walks into the room, it's clear the man means business — also because only the boss would have three cell phones on the table, ringing simultaneously. However, despite his serious and straightforward

demeanor, Azmi's sense of humor and candor conquer all. We trust this man, and so should you.

Azmi is all for consolidation of resources, and very proud of the fact that the firm is the sole member from Malaysia of TerraLex — the Worldwide Network of Independent Law Firms. TerraLex currently constitutes more than 158 top independent law firms and 15,000 attorneys in nearly 100 countries and more than 40 states in the US.

Could you share some of Azmi & Associates' and your own experience in handling Islamic finance documentation and advisory?

There are three things that you need to have in order to promote Islamic banking. First, someone who understands Islamic banking practices and concepts. And the mastery of both would not be enough. What is needed is actually the passion and desire to create new instruments. Which means you need to undertake research and development, you need to be creative to assume the drafting responsibilities.

For Islamic banking to develop, you must have practitioners who are not only senior enough but are also prepared to invest time to create new documents.

I was involved in one document of its kind 12 years ago — the drafting of the documents for the first ever Islamic bonds issue structures on Bai Bithamin Ajil with warrants; the first two maiden issues of the Murabahah revolving underwritten notes issuance facilities (acting for the issuer) under the Rentas Secondary Trading System initiated by Bank Negara Malaysia (BNM).

In a way, I have left Islamic banking because I'm giving the space to younger practitioners (such as partner and renowned Islamic finance lawyer

Ahmad Lutfi Abdull Mutalip) and I'm doing more strategic planning for the firm.

I'm trying to get this firm into Tier 2, and later on Tier 1, through mergers and acquisitions. I am also not involved (directly) in the drafting process. However, if you had talked about these instruments a few years ago, few firms were involved.

You don't find many senior Islamic banking practitioners who are prepared to take up the challenge of drafting documents... because the process of drafting documents is challenging. You need to think, you need to structure it basically.

There are many practitioners in the market but they are not the ones creating the documents. They copy documents crafted by others.

What are the latest developments at the firm?

Last year, our revenue from cross-border work was almost 30%. And when you get fees from overseas, there are double tax exemptions because the government is trying to encourage Malaysian law firms to export our services.

We believe that one day, the legal business will be so competitive you won't limit yourself to just doing business in Malaysia. You can say, Azmi & Associates, when its strength is combined with that of Terralex, is 100 times bigger than the biggest law firm in Malaysia. So, that's how we leverage ourselves.

We also intend to climb the rankings. We are ranked No 12 in the country. We want to move into Tier 2, which is among the Top 10 law firms and we are close to getting there. Following the merger with Illiayas & Co, we have roughly 34 lawyers now, and soon, there'll be 37. We have 15 trainee lawyers.

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We also plan to set up in Penang. We are finalizing our terms of engagement with the Penang-based lawyers with the view of absorbing them into our set-up so that we have a presence in the state.

We also intend to establish our branch office in Singapore. We have obtained quotations for the insurance cover and I think we are in the midst of finalizing our submission to set up there.

“So, what’s in store for us? I think eventually it will open up the eyes of the local law firms and force, encourage or stimulate them to create a bigger set-up so that they will be able to compete”

What do you think of the legal framework in Malaysia with respect to Islamic banking and the Islamic capital market?

The legal framework in Malaysia is quite good, quite comprehensive. It has positioned itself to be at a level where, in terms of legal framework, we are quite advanced compared to Dubai or Qatar. The Malaysian Islamic banking industry is said to be the pioneer in this. Because we started early, we have the legislation in place as well as adequate experience.



However, although our legal framework is advanced and we have many leading Islamic practitioners, but because the surrounding infrastructure supports Islamic banking per se, there is no infrastructure, there is no real congregation of top banking professionals. Therefore, in the long term, although we are pioneers, I think we will lose out if we do not open up the market.

And I think because of that reason, BNM is encouraging foreign law firms with expertise in Islamic banking to set up base in Kuala Lumpur.

The government is considering giving them tax incentives... Whatever revenue earned in Kuala Lumpur is to be exempted from tax in the first 10 years to encourage them to have a presence there. Otherwise, they will wonder why on earth should they open up in Malaysia when the borders of business are small.

The government is hoping there will be more international Islamic transactions done in Malaysia. And these people will be needing offices in Kuala Lumpur, people to be based in Kuala Lumpur... they might even employ Malaysian lawyers.

So, what’s in store for us? I think eventually it will open up the eyes of the local law firms and force, encourage or stimulate them to create a bigger set-up so that they will be able to compete.

If they can get local law firms to be their partners in these matters, it will not be necessary for them to fly in lawyers from London or Singapore to be based in Kuala Lumpur.

Because their lawyers are paid in US dollars or pound sterling, if they can get local lawyers to do the same work, and at a much cheaper rate, why not?

Do we need to improve on anything?

I think we need to open up our markets to financial professionals, Islamic banking professionals. We need to encourage, we need to attract more Islamic professional bankers, more international Islamic banking lawyers to have their operations in Kuala Lumpur. We need to attract Islamic fund managers to use Kuala Lumpur as a base.

How can we attract them to come to Kuala Lumpur?

That is something that our policymakers, our regulators need to address.

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We at Azmi & Associates support the notion of opening up the market to foreign lawyers. Are we not intimidated by the opening up of the market? No, not really. Although we anticipate that the market will be taken by or swallowed by the foreign law firms, we believe that our level of service is not that far off.

Bank Negara Malaysia is proposing full opening. Foreign law firms can come here and they will be granted a license to open up their own office in Kuala Lumpur to do international Islamic banking work. We encourage that. And we intend to strike a partnership with some of these international firms that are renowned for Islamic banking so that we can participate.

For example, we can participate with them in the operations of their Kuala Lumpur office, or we could have a joint venture with them, or have our lawyers seconded.

We need to consolidate, we need more people on board (and) we need to increase our size to 70, 100 lawyers. Sometimes, you can do it through internal organic growth; at other times, through mergers and acquisitions. This is just the beginning.

With TerraLex, we may be a small brother here but we've got bigger brothers. We therefore support the BNM initiative. This may be one way of forcing local practitioners to open up their eyes to embrace the forces of globalization. How are we going to be competitive when we are small, when we do not have friends outside of Malaysia? Would Malaysian law firms be able to render services to assist Malaysian companies overseas? Either you have offices overseas, or friends overseas.



“It makes sense for Malaysian Islamic banking firms to be further consolidated to create a much bigger establishment so that we can compete — if not on the global scale, then at least on a regional one”

Any plans to expand outside of Malaysia?

Outside of Malaysia, we hope to establish in Singapore and, later on, in the Asian region — in Thailand or Vietnam, perhaps. And two to three years from now, we hope to have a presence in the Middle East.

In light of the firm's recent merger with Illiayas, what are your thoughts on M&As on the Malaysian Islamic capital market scene, and is it really a do-or-die situation, seeing the rapid growth of Malaysia's Islamic capital market?

I think that there will be a lot more consolidation among Islamic banking sectors in Malaysia. So, I reckon that for Malaysian banks to compete on a regional and global basis, there has to be a higher level of capitalization.

For instance, the move made by CIMB was commendable. It acquired Southern Bank and they are a much bigger bank now. They have adopted changes, they have embraced transformation and they want to be more competitive. Recently, they also bought into a bank in China.

I was involved in a merger involving Sime Darby last year and I saw the necessity of the steps initiated by the government to encourage Malaysian institutions to create up a much bigger set-up in order to enhance the level of competitiveness, at least in the region.

I think there will be a lot more mergers among Islamic banking institutions to create a bigger Islamic financial institution in Malaysia. It makes sense for Malaysian Islamic banking firms to be further consolidated to create a much bigger establishment so that we can compete — if not on the global scale, then at least on a regional one. ☺



AZMI & ASSOCIATES
A member of TerraLex International **advocates & solicitors**

Arbitration for Islamic Financial Business Under the Auspices of the Kuala Lumpur Regional Centre for Arbitration

By Noorashikin Abdul Rahim

“To complement the court system, disputes may also be referred to the arbitration centre for resolution. In this regard, the Kuala Lumpur Regional Centre for Arbitration will be enhanced to serve as a platform to deal with cases involving Islamic banking and finance, and to extend these services beyond our borders”

[Dr Zeti Akhtar Aziz, Bank Negara of Malaysia governor as was quoted saying in StarBiz dated 26th August 2004]

The Kuala Lumpur Regional Centre for Arbitration (KLRCA) launched the Rules for Islamic Banking & Financial Services Arbitration (IBFS Arbitration Rules) in 2007. The initiative to produce the rules, however, would not have been possible without the innovation, guidance and support of Bank Negara Malaysia (BNM), as well as that of the Securities Commission of Malaysia.

Although located in Malaysia, KLRCA is a neutral and autonomous organization independent of the government of Malaysia. KLRCA was established in 1978 under the auspices of the Asian-African Legal Consultative Organization (AALCO), which is an intergovernmental legal organization comprising 48 member states.

The government of Malaysia and AALCO entered into an agreement, wherein the former agreed to provide the necessary infrastructure and facilities for the operation of AALCO's Regional Arbitration Centre in Kuala Lumpur.

Non-Malaysian arbitrators who arbitrate under the auspices of KLRCA are not subjected to any withholding of fees for tax purposes in Malaysia. Taxes that are payable by the arbitrators are only those for which they are liable as their personal income taxes in their respective countries.

The autonomous feature of KLRCA enables non-Malaysian arbitrators who arbitrate under the auspices of

KLRCA to arbitrate in Malaysia without having to obtain a work permit. Similarly, non-Malaysian legal practitioners who wish to represent their clients at arbitration proceedings conducted under the auspices of KLRCA do not need a work permit and/or practicing certificate from the Malaysian Bar Council.

Although a majority of the arbitration cases registered with KLRCA pertain to commercial matters (especially contracts, banking, insurance and construction), KLRCA has been mentioned alongside the International Centre for Settlement of Investment Disputes in an important Asean agreement for the promotion and protection of investments.

KLRCA and UNCITRAL Rules

The KLRCA Rules of Arbitration are essentially the UNCITRAL Rules of Arbitration. This stems from the commendation of UNCITRAL by AALCO, for the successful conclusion of UNCITRAL Working Group on the UNCITRAL Rules for Arbitration and the recommendation by AALCO of the use of the UNCITRAL Rules of Arbitration in the settlement of disputes arising in the context of international commercial relations.

Arbitration is a dispute resolution process that works beautifully only when both parties agree to resolve their disputes through this mechanism. The agreement for such reference is written in an arbitration clause, incorporated

in the contract entered into by the parties. One such clause is the KLRCA Model Arbitration Clause.

KLRCA Model Arbitration Clause is a simple yet effective clause, adapted from the UNCITRAL Model Arbitration Clause. It is recommended to those entering into an international commercial transaction:

Any dispute, controversy or claim arising out of or relating to this contract, or the breach, termination or invalidity thereof, shall be decided by arbitration in accordance with the Rules for Arbitration of the Kuala Lumpur Regional Centre for Arbitration.

The KLRCA Model Arbitration Clause for the IBFS Arbitration Rules is similarly adapted with the appropriate modifications:

Any dispute, controversy or claim arising from Islamic banking business, Takaful business, Islamic financial business, Islamic development financial business, Islamic capital market product or services or any other transaction business which is based on Shariah principles out of this agreement/contract shall be decided by arbitration in accordance with the Rules for Arbitration of Kuala Lumpur Regional Centre for Arbitration (Islamic Banking and Financial Services).

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Arbitration under the KLRCA Rules for Arbitration is that of an “institutionalized arbitration”. An institutionalized arbitration is an internationally favored mode of arbitration service, as opposed to ad hoc arbitration.

In an institutionalized arbitration, the arbitral institution administers and monitors the arbitration proceedings. Advantages include, but are not limited to, the following:

- The institution is neutral and impartial;
- Any challenge against the arbitrator is made before the person in charge of the institution, instead of the arbitral tribunal, which would inevitably create discomfort to the party who made the challenge, in the event that the challenge is dismissed by the tribunal;
- The institution monitors the arbitration proceeding by checking on all copies of communication and pleadings which arbitrators and parties are required to send to the institution. In the event of delay, the institution is able to “move” the arbitral tribunal and/or representatives of the parties.

Commencement of arbitration proceedings under the KLRCA Rules for Arbitration is relatively straightforward, easy and expedient. All the claimant has to do is just to write to the director, enclosing a copy of the notice of arbitration.

Role of KLRCA under the Arbitration Act 2005

Malaysia joined the family of UNCITRAL Model Law countries when the UNCITRAL Model Law was adopted in the Malaysian Arbitration Act of 2005 (the Act). The Act came into force on the 15th March 2006.

With the principle of *pacta sunt servanda* very much in mind as well as in heart, Malaysia continues to honor the agreement with AALCO in maintaining and supporting KLRCA.

The director of KLRCA has been made the statutory appointing authority under the Act. The Act continues to recognize the independence of the KLRCA against court interference wherein it has been provided that the decision of the director of KLRCA in appointing the arbitrator is not subject to appeal. The Act further gives cognizance to the independence of the director of KLRCA by granting immunity in carrying out the statutory functions.

The Act allows any party to challenge the arbitrator on the grounds of the existence of justifiable doubt as to the arbitrator’s impartiality or independence or where the arbitrator does not possess qualifications agreed to by the parties. However, the challenge has to be addressed to the arbitral tribunal and where it is unsuccessful, recourse to the High Court of Malaysia is provided. It would not be conducive for the arbitral tribunal to hear a challenge against itself or against one of its member, as this would effectively amount to the arbitrator being the judge and witness of his own appointment. Any application to courts, for instance, the challenge against the arbitral tribunal, tantamount to increment in the number of court cases and contributes to additional backlog of cases.

Arbitrations conducted under the KLRCA Rules for Arbitration empower the director of KLRCA to hear applications to challenge the arbitrator. As the director is not a member of the arbitral tribunal, she/he is able to make a neutral decision.

KLRCA consequently assists the courts in reducing the number of referrals to the courts. The procedure for challenging the appointment of arbitrator is provided under Rule 12 of the IBFS Arbitration Rules.

Support from the courts

The Malaysian government’s assurance to parties of non-interference in an arbitration conducted under the KLRCA Rules for Arbitration can be seen through the national legislation.

Equally supportive of arbitrations under the auspices of KLRCA are the Malaysian courts. In *Sarawak Shell Bhd v PPES Oil & Gas Sdn Bhd & Ors* [1998] 2 MLJ 20, the Court of Appeal ruled that the KLRCA Rules of Arbitration constitute “... a comprehensive framework for the resolution of all disputes within their ambit”.

Interim measures of protection can be granted by the national courts in Malaysia to support arbitrations conducted under the KLRCA Rules for Arbitration, notwithstanding the provision of section 34 of the old Malaysian Arbitration Act of 1952.

KLRCA is confident of the support of the Malaysian courts over arbitrations conducted under the auspices of KLRCA, as KLRCA uses the internationally accepted and standardized UNCITRAL Rules for Arbitration in this borderless arena of trade and commerce. KLRCA is the first arbitration institution in Asia Pacific to use the UNCITRAL Rules for Arbitration.

Rule 48 of the IBFS Arbitration Rules states that in the event that the IBFS Arbitration Rules are silent on any matter, the UNCITRAL Rules for Arbitration shall be applicable, provided they are consistent with the Shariah principles. ☺



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Taking a Top-Down Approach

Dr Abdul Raman Saad, managing partner of Abdul Raman Saad & Associates (ARSA Lawyers), tells *Shabnam Mokhtar* harmonization between the Arab and Malaysian models of Islamic finance is important, and that what's required is a convergence of the two



Heading a firm that he founded in 1979, Dr Abdul Raman Saad has tremendous experience in legal practice — he was a judge in the consumer court, has worked as a criminal litigator and later expanded his job scope in the world of finance.

Despite his busy schedule, the former magistrate, who had just returned from Los Angeles, where he presented a paper on Islamic finance, made time for *MIF Monthly*. In an hour-long chat, the managing partner of Abdul Raman Saad & Associates (ARSA Lawyers) shared his views on legal issues and ARSA's experience in Islamic banking and finance. Below are excerpts from the interview.

When did ARSA consider Islamic banking and finance as a viable business opportunity?

ARSA Lawyers has been around for more than 28 years. We started as, and continue to be, a full-service law firm. That means we handle all aspects of legal services except for criminal and matrimonial matters.

Initially, we served Muslim clients in Islamic banking consumer products (purchase of home) to cater to their beliefs. At the same time, we also gave them the option to consider Islamic modes of contract such as the sale and purchase agreement (SPA) for home ownership, where the contract is prepared in accordance with the Shariah.

You mean ARSA drafted the SPA between the developer and a house buyer that complied with the Shariah?

Yes, exactly. In fact, in one of our transactions, we advised a developer in Johor — the Johor Corporation (previously known as the Johor State Economic Development Corporation). In the early launches of its housing projects, we did an Islamic SPA, where there was no element of interest and it was Shariah compliant.

Our documents were also vetted by the attorney general. The features of Islamic banking products gradually became familiar to clients who, irrespective of religious beliefs, acknowledged the system's universal acceptance especially its inherent characteristics in providing equality, fairness and justice.

We realize that this is a product that has proven to be readily acceptable and its exponential growth is tremendous, more so in the past five years, when corporate and sovereign bonds were issued.

Does ARSA have a unit that focuses on Islamic finance?

We have three offices — KL, Melaka and Johor Baru. We have a team of lawyers from the three branches when it comes to Islamic finance deals, headed by Norliza Mohammed in Johor Baru.

All our lawyers are capable of doing banking and finance. So, the need and size of the deal will determine the composition of the practice group.

Can you share your firm's experience in handling Islamic banking and finance documentation and advisory?

We were entrusted by Bank Islam more than 20 years ago as one of the pioneer law firms to start the ball rolling. It began with the Bai Bithamin Ajil (BBA), but now with the controversy from the Arab world, the banks are moving into Musharakah Mutanaqisah.

When ARSA started, we were doing a lot of conventional corporate banking work including syndicated loans, private debt securities, commercial papers and MTNs (medium-term notes). Our experience in conventional corporate banking gave us an added advantage when we moved in on the Islamic finance industry. We became increasingly involved in Islamic private debt securities documentation from 2000.

Some of the projects we have worked on include advising the Pihak Berkuasa Tempatan Pasir Gudang (PBTPG, the Pasir Gudang Municipal) to raise an RM80 million (US\$25 million) Sukuk Mudarabah backed by property taxes (assessments). This was the first Islamic municipal bond and we are trying to promote this worldwide.

I received an invitation to speak at a knowledge city conference in Turkey. Knowledge city involves

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the development of a city within the municipality of local authorities.

So, I was thinking that Sukuk is one way in which municipalities can raise money for developments, just like Orange County in California.

What challenges did you face in advising on that Sukuk Mudarabah?

According to the Local Authorities Act 1976, the municipal/local authorities need the approval of the relevant state government for any external funding. We therefore had to conduct research on whether this exercise would go against the constitution, but we resolved the issues that arose.

In addition, the level of success of this Sukuk would depend on that of PBTPG collecting the assessment.

As Pasir Gudang is a big industrial estate, it had a stable and profitable assessment collection compared to other municipals that were administrating residential areas. Therefore, the same model could be applied to other municipalities with industrial land to raise funding.

The deal was rated 'AAA'. Although it was not a big and expensive deal, it was an interesting exercise because it involved the constitution and administrative law.

What other deals was ARSA spearheading?

We also advised a subsidiary of a utility company, namely SAJ Holdings Sdn Bhd with regard to its RM1.28 billion (US\$395 million) of BaIDS Issuance and the RM100 million (US\$31 million) Musharakah Mutanaqisah for Vastalux Capital.

We were also involved in the Al-Aqar KPJ REIT (real estate investment trust).

What was ARSA's role in the KPJ REIT issuance?

We basically advised the trustees and managers of Al-Aqar on land matters. The REIT involved land



and land matters always rest with the state. Some of these state lands have restrictions on interest to transfer, unless you have the state authority's approval.

So, in the Al-Aqar REIT structure, KPJ sold its hospital to the SPV (special purpose vehicle). Was it merely a transfer in beneficial title or was it a true sale?

It was a true sale. Then they issued the REITs and they get the funds. This is one way of obtaining liquidity. Operating a private hospital is very capital intensive due to the specialized and expensive equipment involved. Before REITs were approved by the SC (Securities Commission), one way of raising funds was through listing on the stock exchange. Returns were generated from the hospital fee; however, it is very slow as the revenue would have to be used towards servicing the capital repayment of the equipment.

This is similar to hotel management. Hotel owners and hotel management are two different parties. Hotel managers make money because they don't own the property. Hotel owners are different parties who are

exposed to the capital expenditure involved.

When KPJ built all the hospitals, it wanted to expand very fast. So, it needed additional capital. Nonetheless, all its money was tied up in capital investment: buildings, hospital beds, operation theaters, equipment, and heart cardiac and cancer oncology equipment.

Prior to the introduction of REITs, KPJ wanted to sell the hospitals to other owners, i.e. to the parties who were keen to buy the properties. KPJ just sought to manage the hospital.

We were helping them find buyers. Nevertheless, not many people wanted to buy hospitals, because hospital ownership does not carry an image, unlike hotels. As a consequence, we did not get much response during that stage.

When the SC approved REITs, instead of selling the hospitals to individuals, KPJ formed an SPV, pooled all its assets, listed it on the stock exchange and issued the REITs. So, KPJ obtained the cash upfront. That basically is the behind-the-scene shot of the first Islamic REIT.

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We also assisted with due diligence for the REIT and we are still doing it because KPJ is still injecting more hospitals, not only in Malaysia but also in other parts of the world.

What is your view of the legal framework in Malaysia with respect to Islamic banking and the Islamic capital market? Do we need to improve anything?

This is a very, very interesting question. You see, when Islamic finance first started in Malaysia, it was a mandate by the government; a top-down approach to start Bank Islam. As we know, our BBA (Bai al-Inah as the underlying contract) was criticized by the Shariah councils in other jurisdictions, more so by the Arab world. In terms of religious interpretation of Shariah, we are too lax. In the course of trying to promote Islamic finance, the Arab world says we are rushing to grow by cutting corners.

This nevertheless reflects the different models in Islamic finance; one by the Arab world and one by Malaysia. Our model is more consistent because the driver of Islamic finance in Malaysia is the government through Bank Negara Malaysia (BNM). The industry is regulated and centralized.

On the other hand, the Arab approach is haphazard. Some may interpret it in accordance with their own jurisprudence or Islamic school of thought (*mazhab*). So, even in the Arab world, there was a divergence of approach.

What is required now is a convergence of the models. There must be consistency and harmonization.

Moving on, now we can see there is a rationalization. Musharakah Mutanaqisah is one of the areas of convergence where we have abandoned BBA and we are going with Musharakah Mutanaqisah, which is recognized by the Arab world. It's more consistent now.

So, harmonization is imperative in our industry if we are to bring it forward. There should be a

guiding model that will drive towards harmonization of Shariah rulings worldwide. Eventually, an international Shariah body that regulates Shariah council rulings should be formed as binding precedents for Islamic finance practice worldwide.

I'm sure all the rulings can be codified. Just like the civil code countries, where the laws are codified, we can also codify the Shariah rulings. These can be reviewed by an international body of Shariah scholars. Then there will be consistency; just like binding precedents.

“With more than 20 years of exposure in Islamic finance, we are at a greater advantage over other global lawyers”

AAOIFI (the Accounting and Auditing Organization for Islamic Financial Institutions) has to some extent done that for the Shariah part, but it just doesn't have the mandate to enforce it. How can we overcome this problem?

Maybe they can put (it) under Basel II, as part of corporate governance. Industry players including the government should take charge of this. If they can do it for conventional banking, where there are binding precedents in the governing law, why not do it for Islamic finance as well? It should be top-down driven.

Is ARSA looking to expand its operations outside Malaysia?

We see great potential for Malaysian lawyers with expertise in

Islamic finance to expand overseas. With more than 20 years of exposure in Islamic finance, we are at a greater advantage over other global lawyers.

ARSA Lawyers sees great potential in exporting our skill in Islamic finance worldwide and we've taken the first step. We have an office in Riyadh, where, to our surprise, they don't have much experience in Islamic finance because Saudi banks operate as conventional banks. So, we're targeting Saudi as a high-potential market.

There are other countries we are targeting. Our next target will be Indonesia because of the Muslim population there and the fact that they have just passed the Sukuk law.

Why is the Sukuk law important in Indonesia?

In order to issue Sukuk, you need an SPV. An SPV is a trust. However, Dutch law (from which Indonesia derives its law) does not recognize the notion of trust. Likewise, in Indonesia, the issue of trust (beneficial ownership) is not applicable. It has to be direct ownership.

Since Indonesia is a civil code country, the administration would need to codify the law if they want to make changes. They have to pass legislation to recognize the SPV. That was the reason it took longer to start on Sukuk, while we have already started because (our legal system is) based on English law (i.e. common law) and English law recognizes the notion of trust.

What is your opinion of the liberalization of law practice in Malaysia — allowing foreign law firms to set up here?

In Malaysia, we have the Legal Profession Rules for Admission of Foreign Lawyers 2004 ruling. However, it has not been passed by Parliament and the attorney general.

In my opinion, the joint alliance of 70:30 is better because we do not want foreign lawyers to set up unilaterally. Not because we are afraid

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of competition; rather, we don't want to play the 'second feeder' role and we want this to be a mutually beneficial relationship.

Could you explain what you mean?

Normally, when international investment banks want to do funding projects, they will always use the 'big boys' from the UK and New York — Clifford Chance and Norton Rose, just to name a couple.

They will be the ones brought in to advise on the structuring of deals for funding. If these international law firms have a JV (joint venture) with us, not only would they be able to advise on deals in Malaysia and share their best practices, the Malaysian lawyers could also go global and give input on the international deals.

BNM proposed to bring in the foreign law firms and let them set up independently. By the end of the day, our people (the Malaysian lawyers) will

still be assistants to them and not be real players.

So, if you are serious about sharing knowledge and promoting this, then we should work joint venture. If you've got deals in elsewhere, then we can join the team and work together. And we can share some of our innovative products. Only then will we be able to play in the global scene.

How can Malaysia entice international issuers to utilize the MIFC platform?

I'm looking at this from a legal point of view. What we can promote is the recognized enforcement of Islamic finance in Malaysia because issuers and investors are comfortable when there is certainty of law and enforceability of their rights. We can propose a special court for Islamic finance as a center here, created by our courts.

In addition, our arbitration center charges a reasonable fee compared to London or even Singapore. We must

promote our Islamic arbitration center. This is another alternative for the parties in dispute to consider if they don't want to go to court.

Do you have any last words for our readers?

I would like to draw attention to the use of terminology in our industry. In Europe, especially in Germany, they do not use the term 'Islamic finance' or 'Islamic banking'. Instead, they use 'Shariah finance' and 'Shariah banking'.

Following the 11th September tragedy, the term 'Islam' sometimes gives people the wrong impression. The term 'Shariah', however, is more neutral and could appeal to a wider consumer base.

I recommend that we ponder on this and apply the term 'Shariah finance' instead of 'Islamic finance'.

Shariah has a more universal meaning and thus could embrace both Muslims and non-Muslims. ☺

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Interpretation of Shariah by the English Courts in *Beximco Pharmaceuticals Ltd v Shamil Bank of Bahrain EC*: An Analysis from the Malaysian Context

By Mohd Herwan Sukri Mohammad Hussin

In 2004, the English courts laid down a startling judgment in an Islamic banking case, *Beximco Pharmaceuticals Ltd v Shamil Bank of Bahrain EC* [2004] App LR 01/28.

The issue raised by the defendants on appeal in that case related to the construction and effect of the form of the governing law clause contained in the financing agreements. That clause read as follows:

“Subject to the principles of the Glorious Shariah, this Agreement shall be governed by and construed in accordance with the laws of England.”

The principal defense advanced by the defendants was that:

- (a) on a true construction of the governing law clause, the financing agreements were only enforceable in so far as they were valid and enforceable, both:
 - (i) in accordance with the principles of the Shariah (i.e. the rules or laws of Islam); and
 - (ii) in accordance with English law;
- (b) in fact, the financing agreements were unlawful, invalid and unenforceable under the principles of the Shariah in that, despite their form (which would be enforceable if they were a true reflection of the underlying transaction), the transactions were in truth disguised loans at interest.

As such, they amounted to unlawful agreements to pay *riba* and were thus void and/or unenforceable.

On appeal, the Court of Appeal commented that until their defenses had been filed, Beximco had never given the bank any indication that it was dissatisfied on religious grounds with the arrangements agreed between the parties or that they sought to challenge them on the grounds that they did not comply with the principles of Shariah law.

The court concluded that in interpreting the applicable law clause, the principles of Shariah law should not be taken into account.

The Court of Appeal agreed with that finding. First, it was held that there could not be two separate systems of law governing the contract. Reference to the 1980 Rome Convention indicated that there should be one law of a country chosen by the parties.

The judge noted that the principles of Shariah were not uniquely principles of law, but religious principles that applied to other aspects of life and behavior.

In consequence, he concluded, it was highly improbable that the parties to the agreements intended an English court to determine any dispute as to the nature or application of such religious principles.

The reference to the governing law being “subject to the principles of the Glorious Shariah” was no more than one to the fact that the bank purported to conduct all its affairs according to Shariah law.

In agreeing with these findings in the Court of Appeal, Potter LJ noted that in approaching its task, the court should lean against an interpretation of the contract which might defeat the commercial purpose

of the agreements. It was not possible to incorporate within the terms of the agreement any specific principles of Shariah law, such as the unlawful nature of charging interest upon a loan, as no specific reference to that provision of Shariah law had been made within the agreement itself. A general reference to Shariah law within the choice of law clause was insufficient.

“The court concluded that in interpreting the applicable law clause, the principles of Shariah law should not be taken into account”

The English court in the case of *Beximco Pharmaceuticals Ltd v Shamil Bank of Bahrain EC* did not recognize the application of Shariah in interpreting the financing agreements.

The court held that reference to the governing law being “subject to the principles of the Glorious Shariah” was just a mere reference to the fact that Shamil Bank of Bahrain purported to conduct all its affairs according to Shariah law.

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As far as the author is aware, the issue of conflict of laws between the Shariah and Malaysian law has never been raised in the Malaysian courts.

It is quite interesting to note that there is a statutory provision that can serve as guidance to the court when deciding on Islamic banking cases.

Section 16B(7), (8) and (9) of the Central Bank of Malaysia Act 1958 provides that:

(7) The Bank shall consult the Syariah Advisory Council on Syariah matters relating to Islamic banking business, takaful business, Islamic financial business, Islamic development financial business, or any other business which is based on Syariah principles and is supervised and regulated by the Bank, and may issue written directives in relation to those businesses in accordance with the advice of the Syariah Advisory Council.

(8) Where in any proceedings relating to Islamic banking business, Takaful business, Islamic financial business, Islamic development financial business, or any other business which is based on Syariah principles and is supervised and regulated by the Bank before any court or arbitrator any question arises concerning a Syariah matter, the court or arbitrator, as the case may be, may —

(a) take into consideration any written directives issued by the Bank pursuant to subsection (7); or

(b) refer such question to the Syariah Advisory Council for its ruling.

(9) Any ruling made by the Syariah Advisory Council pursuant to a reference made under paragraph (8)(b) shall, for the purposes of the

proceedings in respect of which the reference was made:

(a) if the reference was made by a court, be taken into consideration by the court in arriving at its decision; and

(b) if the reference was made by an arbitrator, be binding on the arbitrator.

What is more interesting to note is that as the word used in subsection (8) is “may”, the decision whether to follow the guidance laid down in that subsection is left to the discretion of the court.

“The issue of conflict of laws between the Shariah and Malaysian law has never been raised in the Malaysian courts”

In *Bank Kerjasama Rakyat Malaysia v Emcee Corporation* [2003] 1 CLJ 625 CA, Abdul Hamid Mohamed JCA, writing the judgment for the Court of Appeal, said:

“As was mentioned at the beginning of this judgment, the facility is an Islamic facility. But that does not mean that the law applicable in this application is different from the law that is applicable if the facility were given under conventional banking. The charge is a charge under the National Land Code.

The remedy available and sought is a remedy provided by the National Land Code. The procedure is provided by the Code and the Rules of the High Court 1980. The court adjudicating it is the High Court. So, it is the same law that is applicable, the same order that would be, if made, and the same principles that should be applied in deciding the application.”

Abdul Wahab Patail J in *Affin Bank Berhad v Zulkifli Abdullah* [2006] 1 CLJ 438 HC said:

“Since the question before the court is the interpretation and application of the terms of the contractual documents between the parties and of the decisions of the courts, reference of this case to another forum for a decision would be an indefensible abdication by this court of its function and duty to apply established principles to the question before it. It is not a question of Syariah law. It is the conclusion of this court, therefore, that there is no necessity to refer the question to another forum.” ☺



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