



Herbert Smith

Islamic finance guide

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Herbert Smith in association with
Gleiss Lutz and Stibbe

Contents

Foreword	1
Introduction	2
Islamic Finance	2
Sources of Shari'ah	2
Islamic Finance Industry	2
Shari'ah Prohibitions	3
Interest (riba)	3
Uncertainty (gharar)	3
Speculation (maisir)	3
Unjust Enrichment/Unfair Exploitation	3
Unethical Investments	4
Hoarding Money	4
Compliance Issues	5
Shari'ah Supervisory Committees	5
Fatwa	6
AAOIFI	6
Governing Law	6
Islamic Finance Products	7
Asset based structures	8
Risk sharing structures	15
Sukuk	18
Product Application: Innovative Transactions	19
Villamar@theHarbour – the first non-recourse sukuk issuance	19
The first series of Shari'ah compliant LBO financings in the UK	20
BNP Paribas/Al Qatrana Cement – Islamic ECA-covered financing in Jordan	21
Hedging Products	22
General	22
Profit Rate Swap	22
Shari'ah Compliant Investment Funds	23
Overview	23
Fund Structure	23
Investment Objectives and Investments of the Fund	24
Terms of Investment and Treatment of Investors	24
Debt and Financial Ratios	24
Current Developments	24
Herbert Smith Global Islamic Finance Group	26

| Foreword

We are delighted to present this, the first edition of our guide to Islamic finance. The lawyers in our Global Islamic Finance Group are experts in advising on Islamic finance transactions and their wealth of knowledge has been essential in producing this guide.

The purpose of this guide is to inform you about some of the key products and financing techniques utilised in the modern day Islamic financial services sector. The Islamic finance industry has grown at a rapid pace in recent years and Islamic finance undoubtedly has an important role to play in the global financial services market. It has, in particular, played a key role in enabling sponsors, governments, corporates, financiers and the like to tap into the liquidity pool in the MENA region and beyond as a source of funding. As the industry has evolved and moved further into the mainstream market place, the products on offer have developed and become ever more structured and sophisticated. This guide seeks to highlight the main basic products available to Islamic financiers upon which many of these more complex structures are based.

We hope that this guide offers you a useful introduction to the Islamic financial services sector. Please feel free to contact me or any member of the Global Islamic Finance Group (contact details for whom are set out at the back of this publication) if you would like to discuss with us anything in this guide.



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“Nadim Khan, most highly nominated individual in Islamic Finance”

Who's Who Legal UAE 2008

“Nadim Khan is a ‘top Islamic finance lawyer’”

Chambers 2008

Introduction

Islamic finance

There is no single definition of Islamic finance, but the term is now widely understood to mean commercial financial activity that complies with the principles of Islamic jurisprudence, or the Shari'ah as it is often referred to, and as such it enables parties to invest in and avail of resources in a manner which conforms with Islamic religious principles. Generally speaking, Islamic financial products and instruments seek to offer viable alternative methods of participating in financial services transactions to that offered by conventional products and instruments in order to achieve similar business goals.

Sources of Shari'ah

The Arabic word "Shari'ah" in its literal sense means "the way". Shari'ah gives guidance as to what is, and what is not, acceptable behaviour in all areas of a Muslim's life. It governs the moral, ethical, spiritual and social dimensions of a Muslim's private and public life, as well as the practical matters of day-to-day life, including commercial and economic activity.

Shari'ah refers to the uncodified body of Islamic law. It is an ethics-based legal system capable of interpretation and development. Shari'ah has two principal sources: the Qur'an (the sacred text of Islam that records the word of God as revealed to the Prophet Mohammed *pbuh*) and the Hadith (the body of documents that records the Sunnah, the sayings, teachings and actions of the Prophet Mohammed *pbuh*).

These two primary sources form the basis of determining compliance with Shari'ah. A key role played by Shari'ah scholars is to extrapolate principles that can be applied to modern financing techniques but which remain faithful to those primary sources. In order to achieve this, scholars will undertake a process of continuous jurisprudential analysis (or *Ijtihad* as it is known) in which they may exercise the accepted principle of *Qiyas* (or drawing legal analogies derived from the primary sources) in order to arrive at a widely accepted consensus (*Ijma*) on the principles relevant to such technique.

Islamic finance industry

The Islamic finance industry has grown rapidly in the last few years. Estimates as to the size of the industry vary and quickly become out of date, but the astonishing rise of the industry and the influence it now exerts in the wider financial services context is widely acknowledged.

The growth of the industry has also been evidenced by the volume of new Islamic financial institutions which are being established the world over, as well as the number of conventional institutions that now offer Islamically compliant financial solutions.

Shari'ah prohibitions

Islam teaches that money must be utilised in a manner which can produce a return. Such returns should be derived from profit-and-loss and risk-reward sharing arrangements. As such, Islamic finance promotes the trading of real assets and encourages stakeholder participation in the underlying business opportunity.

Islamic finance arrangements must seek to avoid those matters that are fundamentally prohibited under Shari'ah. Products or principles that are deemed to be permitted are commonly referred to as *halal*, while those that are prohibited are commonly referred to as *haram*.

It is not uncommon for large fundraisings to use a combination of Shari'ah compliant and conventional financing sources. However, this approach requires careful structuring in order not to "taint" the Shari'ah compliant elements with that which is considered *haram*, such as interest (*riba*) for example.

A view held by a number of eminent Shari'ah scholars is that under Shari'ah the doctrine of necessity may be applied to a person's business circumstances such that it would permit a Muslim as a last resort to break with traditional Islamic principles and obtain conventional products where no Shari'ah compliant alternative is available. It is felt that Shari'ah takes a pragmatic view so that in certain circumstances it may be acceptable to use a conventional financing product or technique, for example to meet a short term financing need.

The main Shari'ah prohibitions include:

Interest (*riba*)

The prohibition on *riba* is a fundamental tenet of Islam. Shari'ah regards money as simply a means of exchange. In itself, money cannot be used to make money and therefore one should not charge for its use. The charging and receipt of interest is therefore strictly prohibited under Shari'ah and any obligation to pay interest is considered void.

Uncertainty (*gharar*)

The existence of uncertainty in a contract is prohibited under the principles of Shari'ah and such contracts are treated as void. The test for certainty under Shari'ah is a strict one: all the fundamental terms of a contract, such as price, relevant assets, the parties and time milestones must be clearly stipulated in the contract when it is entered into. As an example of how seriously the scholars view this principle, it is rare to see conditionality requirements set out within Shari'ah compliant financing documents and the scholars strongly encourage that all conditions precedent requirements be met prior to these documents being entered into.

Speculation (*maysir*)

Transactions that rely on pure speculation or chance to produce a return are *haram* and are therefore considered void. This prohibits the participation of an Islamic investor in speculative share trading as well as a large part of the derivative industry. There is a clear distinction, however, between what is a more pure form of speculation and what can be described as entrepreneurial speculation of the type involved in the establishment of a business or an investment therein which is clearly not intended to be caught by this prohibition.

Unjust enrichment/unfair exploitation

Contracts where one party is perceived to unfairly exploit another or gain unjustly at another's expense are also considered void. This is because a Muslim should only generate benefit from a venture in which he invests and shares the risk to avoid an assured profit. A common example of the operation of this principle is that it is not possible for a financier to gain financially by charging and retaining late payment fees when debtors are in default. It is permissible (and accepted by several Shari'ah scholars) that financiers may impose late payment charges as an incentive for receiving prompt payment. However, the financier is only entitled to deduct the amount of the actual costs incurred due to the late payment and any amount in excess of the actual costs must be donated to charity.

| Shari'ah prohibitions

Unethical investments

The purpose of any Islamic financing must be to invest in an opportunity that in itself is not prohibited by Shari'ah. Finance cannot, for example, be raised for haram products and activities. These include alcohol, armaments, pork, pornography and gambling. The screening of investments and loans to ensure that they are not for businesses or projects that operate in haram activities can be complex and, to an extent, subjective.

Hoarding money

Since Shari'ah regards money as merely a means of exchange with no intrinsic value, then hoarding money is improper and strongly condemned. A Muslim may accumulate wealth which is legitimately acquired, but should spend his wealth judiciously. Where an individual's annual wealth exceeds a minimum level, he is obliged to contribute a certain percentage of his wealth to specified categories in society under one of the five pillars of Islam, zakat.

Compliance issues

Each financial institution offering Islamic financial services will have its own processes and procedures for the determination of the Shari'ah compliance of an Islamic product. The Shari'ah approval process is, ultimately, a wholly internal procedural matter which is likely to vary from one institution to another.

Generally, to certify a product as Shari'ah compliant, the religious panel of Shari'ah scholars that comprise the Shari'ah supervisory committee or board of the financial institution will carry out a review of the products and documents and decide whether or not they are Shari'ah compliant. The institution will seek a fatwa, or religious ruling, from its Shari'ah board as to compliance with matters of Shari'ah in respect of such product. Ultimately, whether Shari'ah compliant financial products are created or not will come down to the decision of that particular financial institution's Shari'ah board. English qualified lawyers, or in fact lawyers qualified under the laws of any other jurisdiction, would not typically opine on matters of Shari'ah compliance.

There is an absence of consensus as to what constitutes Shari'ah compliance on many issues. Interpretations of Shari'ah law vary across jurisdictions and between individuals. Each Shari'ah scholar has the discretion to approve or reject transactions regardless of whether similar structures have been previously used. Scholars based in the Middle East and Europe are generally not obliged to conform their opinions to a market standard and, therefore, their opinions may differ. The position is different in Malaysia as the scholars there, under the supervision of Bank Negara (the national bank of Malaysia), have agreed a uniform set of principles for Shari'ah investments. Additionally, scholars in Malaysia and scholars in Europe and the Gulf may have different views on Shari'ah investments and structures. As a result, the market suffers from a lack of standardisation in terms of deal structures and documentation, with participants often using bespoke arrangements for each transaction.

That said, the high volume of transactions in the sector in the past few years has led to a rapid evolution of the key Islamic finance products, with the result that transaction structures have become increasingly standardised. The strength of Islamic finance borrowers, and the desire of banks (both Islamic and conventional) to tap into a busy market, has seen market participants begin to self-regulate in the interests of getting deals done. The continuation of that process is likely, with the result that documentation may settle in format and style, and further participants may enter the scene.

Shari'ah supervisory committees

Most Islamic financial institutions and a large number of those conventional institutions with Islamic financing units tend to have their own Shari'ah supervisory committee or board that sets out how its operations should be carried out in order to be consistent with Shari'ah rules and principles. The Shari'ah supervisory committee is a specific organ of governance in applying fatwa in practice and not just in having the products approved as Shari'ah compliant in principle.

The Shari'ah supervisory committee will typically be composed of three or more appropriately qualified Shari'ah scholars who are independent and have authority to reject any proposals deemed to be against Islamic law. Certain jurisdictions lay down specific mandatory qualifications for scholars. For example, in Malaysia, a scholar is required to have at least three years experience in Islamic financial transactions. Neither the Middle East nor Europe have similar minimum requirements although, in practice, scholars will have at least equivalent experience.

The Shari'ah supervisory committee will scrutinise in detail the structure and documentation of a proposed transaction to ensure Shari'ah compliance and supervise the development of Islamic finance products. In the case of banks, the Shari'ah supervisory committee will also annually review the overall activities of the bank and determine whether or not these have been carried out in accordance with Islamic law.

The Shari'ah scholars are eminent individuals who have made the study of the Qu'ran and the Hadith a key component of their life's work. In the current Islamic financial services industry, there are a limited number of eminent scholars whose experience in the industry is recognised throughout the sector and whose views are widely accepted which means that the same scholars often sit on the Shari'ah supervisory committee of a number of different Islamic institutions. In practice, this means that there tends to be a consensus regarding the interpretation of Shari'ah between those institutions which can lead to a greater consistency of approach to the key Shari'ah issues which, in turn, is helping to improve consistency within the Islamic finance industry.

There is undoubtedly a difference in approach between some Shari'ah supervisory committees and others: some require strict adherence to basic Shari'ah principles while others are more commercially aware and market-orientated in approach. Several commercial Shari'ah advisory services have been established recently to help plug the gap in the availability of experienced scholars.

Compliance issues

Fatwa

When the Shari'ah supervisory committee has completed its transaction review and is satisfied as to matters of compliance, it may, as part of the institution's approval process, issue a religious order or authoritative opinion. This is known as a fatwa. The issue of a fatwa can be a condition to the relevant institution's ability to participate in the transaction and it proceeding to completion.

A fatwa issued by a Shari'ah board to confirm something as Shari'ah compliant may not necessarily mean that other Islamic scholars or Shari'ah supervisory committees will agree. Although there is therefore a risk of difference in opinion, it should be noted that in practice it is very rare for a Shari'ah supervisory committee to have issued a fatwa and for this to be openly questioned by other scholars or Shari'ah supervisory committees. The fatwa itself is typically only issued where the Shari'ah supervisory committee is wholly satisfied as to matters of compliance and it will therefore carry substantial weight with other Shari'ah supervisory committees and scholars.

AAOIFI

The Accounting and Auditing Organisation for Islamic Finance Institutions (AAOIFI) is a non-profit organisation established to maintain and promote Shari'ah standards for Islamic financial institutions, participants and the overall industry. It prepares Shari'ah standards on areas such as accounting, auditing, governance and ethics for financial institutions that wish to gain access to the Islamic financial markets. In practice, it is hoped that AAOIFI's publications will assist in developing the standardisation of Islamic finance products and documentation since AAOIFI's pronouncements carry some weight in the Islamic finance market, as evidenced by their recent pronouncements on the compliance of certain types of sukuk.

Governing law

Many Muslim countries have parallel legal systems with Shari'ah generally applying to a Muslim's private life while commercial codes govern commercial activity. Some regional institutions and some Shari'ah scholars insist that Shari'ah should prevail as the chosen law of contracts. However, Islamic finance documents will typically be governed by an appropriate law of a specific jurisdiction, for example, English law. It is not necessary for Islamic finance documents to state that they are governed by Shari'ah as typically the financier will refer to a Shari'ah supervisory committee to procure the fatwa (as discussed above) as to matters of Shari'ah compliance.

In the past, some contracts have included a reference to Shari'ah as the governing law. This approach was called into doubt in the 2004 case of *Shamil Bank of Bahrain v Beximco Pharmaceuticals* in which the English courts held that there could not be two separate systems of law (English law and Shari'ah law) governing a contract (in this case a murabaha contract). The parties were not able to choose Shari'ah law as the governing law because it was not the law of a country and there was no provision for the application of a non-national system of law such as Shari'ah law. Further, it was considered highly improbable that the parties had intended that an English secular court should determine any dispute as to the nature or application of religious principles. A choice of law clause in a contract referring to Islamic principles is too vague or will be deemed by the Courts as a reference to religion rather than law. In practice, it is for the financier to satisfy itself that the transaction is Shari'ah compliant by reference to its Shari'ah supervisory committee and the fatwa it issues.



| Islamic finance products

In order to ensure Shari'ah compliance under an Islamic finance structure, it is essential that the financier assumes some commercial risk in relation to either the asset or the customer it is providing finance for. Islamic finance techniques therefore typically rely on either the transfer of underlying assets (asset based structures) or the assumption of some other commercial risk (risk sharing structures).

This focus on risk in Islamic finance products illustrates one of the key differences between Shari'ah compliant and conventional financing techniques. Under a conventional financing the financier will seek to ensure that, so far as possible, it minimises the assumption of commercial risk relating to the asset, customer or activity for which it is providing finance. By contrast, it is an essential tenet of Shari'ah compliant financing that the financier does assume some such risk. The challenge for the financier therefore lies in ensuring that it assumes only a strictly necessary amount of commercial risk in order to ensure Shari'ah compliance.

A further challenge for the Islamic financier is finding a way to structure its products in order that it gets a return on its capital investment which is comparable to the interest payable under a conventional financing technique, without actually tainting its offering with *riba*.

Outlined next are a number of common asset and risk based Islamic finance products which seek to find solutions to the above challenges. Whilst each structure can stand alone as a financing technique, it is quite common for transactions to combine a number of different structures / techniques in order to produce the desired financial outcome.

Islamic finance products

Asset based structures

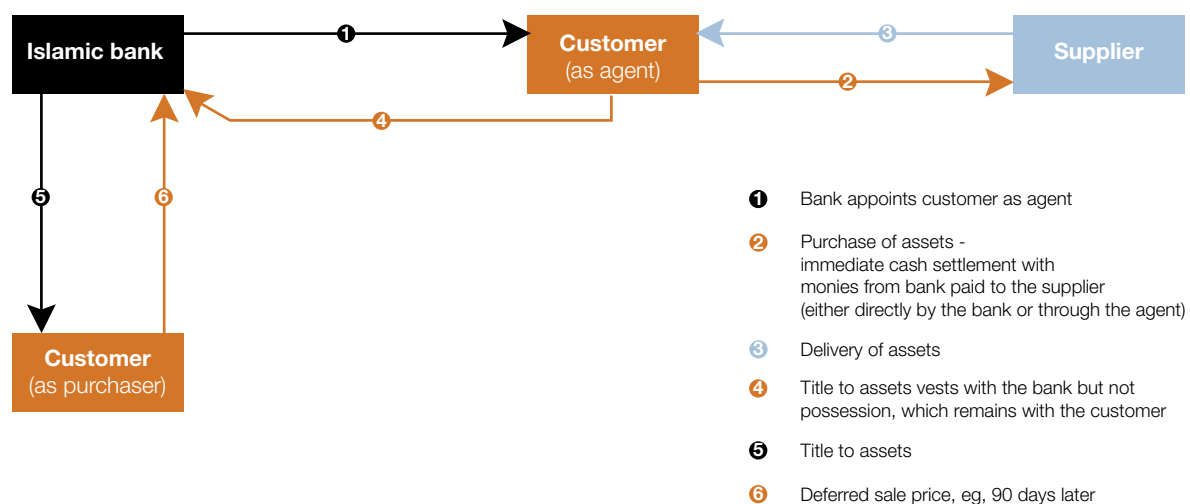
Asset based structures rely on the transfer of underlying assets. Typically the financier will acquire a physical asset, such as goods, machinery or commodities, and assume some commercial risk relating to that asset.

Pure Murabaha

Murabaha is essentially an asset based financing device in which a financier purchases an asset from the market and sells it to its customer at a marked-up price and on deferred payment terms typically payable in instalments. In return for providing financing for the asset, the financier will receive a deferred payment from the customer comprising of the cost price (the original amount paid for the asset) plus a premium. The premium can be (and generally is) based on LIBOR benchmarks plus an agreed profit rate. Under a classic asset financing the customer retains the asset, such as a piece of machinery, for use in its business.

To avoid the appearance or characteristics of an interest bearing loan and to maintain the features of a contract for the sale of an asset, the financier must hold title to the asset and assume risk in relation to it, even if for only a very short period of time, until the asset is on-sold to the customer. The financier may appoint the customer as its agent for the purchase on its behalf and, once the customer effects the purchase as agent for the financier, the customer may retain possession of the asset on its own behalf.

The profit generated by the financier on the marked-up sale price is not prohibited as *riba* because it is a profit generated from the sale of an asset. This technique is used in a broad spectrum of transactions, including trade financing, vendor financing, project finance, acquisition finance and leveraged buyouts.

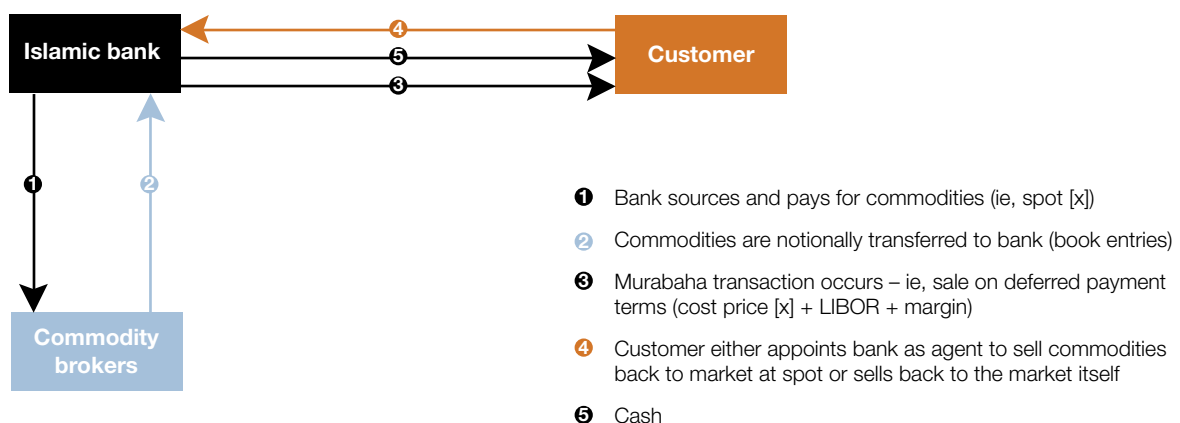


Commodity Murabaha

The commodity murabaha, which is also widely referred to as the tawarruq, is a technique used where the customer has a cash requirement (rather than a requirement for a particular asset). At its most simplistic, the financier buys an asset, directly or indirectly, and sells the same asset to the customer on deferred payment terms (as described above).

The customer, either itself or acting through the financier as its agent, then immediately sells the same asset at market value back to the market (either back to the original supplier or to a third party) to realise a cash sum in return for periodic instalment payments. In this scenario, a broker is typically used as an interface with the market, and the underlying asset will be a freely tradable Shari'ah compliant commodity, such as copper. Gold or silver cannot be used as Shari'ah regards these commodities as currency.

Murabahas can be effected on a syndicated basis by using additional contractual arrangements. They can also be adapted to replicate a revolving funding arrangement by instituting a series of back-to-back murabaha trades and a netting arrangement. Here, the customer takes receipt of the commodity at the outset of the deal, sells it to the market to realise cash and on the maturity date at which it is to pay the sale price, it enters into a new trade. The intended net result is that the sale price it pays on each payment maturity date is, either through the netting arrangements or through the funds flow it pays, an amount of the sale price that is greater than the cost price of the next trade only.

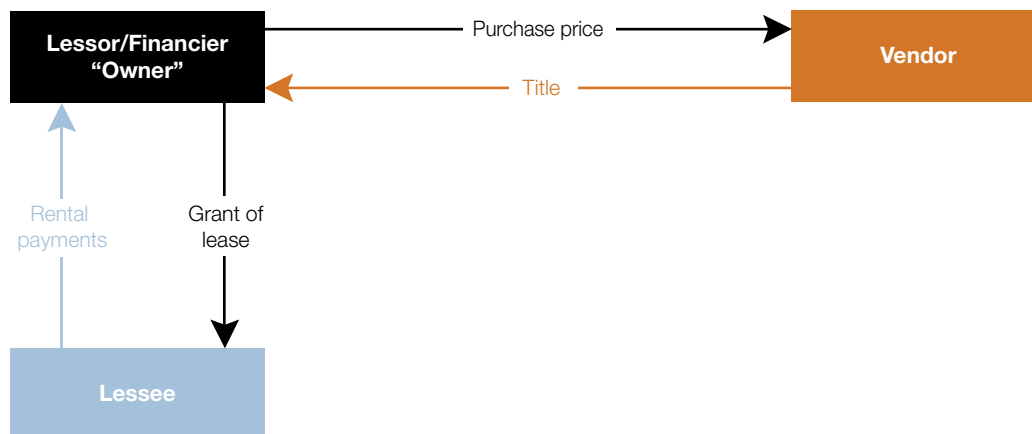


Islamic finance products

Ijara

Ijara is the Shari'ah compliant form of leasing and can be used to provide asset finance in respect of assets such as equipment, land, aircraft and ships, as well as longer term developmental or project financing. As with murabaha financings, the financier buys an asset from a supplier but, rather than selling it to the company, the financier leases it to the company for prescribed rental payments which can be structured to reflect the contemplated amortisation structure. An ijara structure can be used either by itself or combined with one or more other products to provide, for example, forward leasing structures (described below).

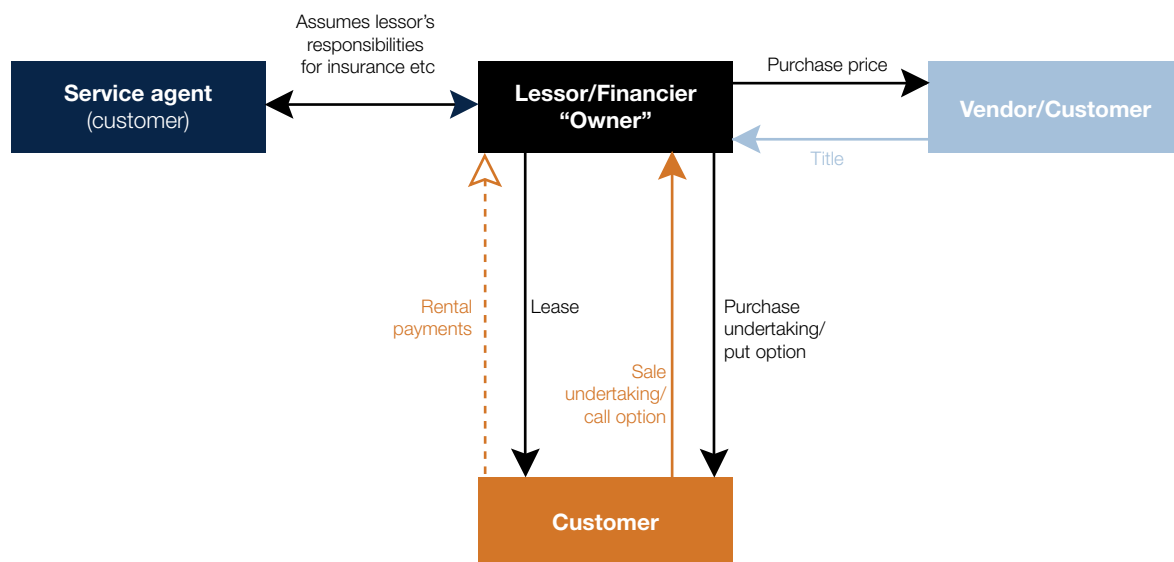
Unlike a conventional finance lease, under an ijara the financier must take on some of the commercial risks normally associated with an operating lease. For the life of the ijara the financier will therefore assume responsibility for insurance and ownership related taxes and undertake any major maintenance of the leased asset. It is fairly common to see service agency structures used to pass these obligations through to the financier's counterpart and costs associated with such a mechanic can be recovered as part of the rental calculation under the ijara.



Ijara Wa-Iktina'a

This technique is similar to the ijara structure described above, but will typically contemplate the lessee acquiring title to the asset at the end of the lease period. This structure is also commonly used to facilitate a sale and leaseback financing.

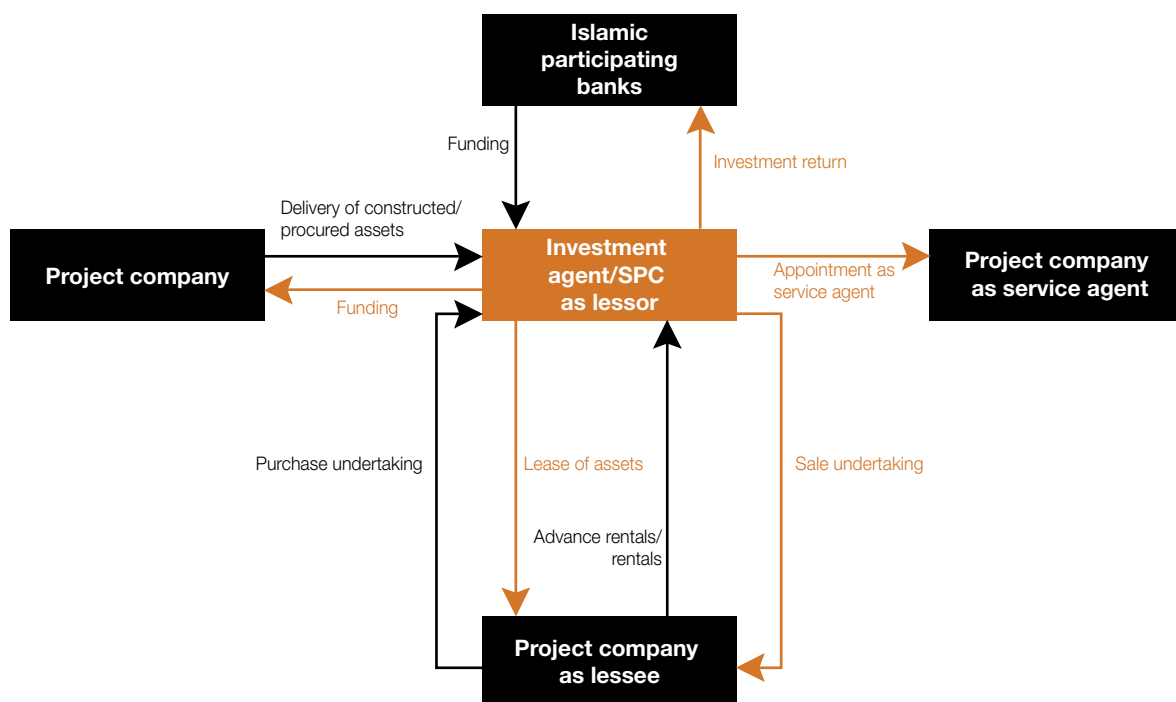
The right to acquire the asset is structured through a series of option arrangements. The option is a crucial element of the Islamic lease structure. The Islamic lease cannot be structured in such a way that the lessee is contractually obliged to acquire the asset at the outset – this would remove the risk element and make the financing look like a loan. The sale undertaking (similar to a call option) is discretionary but the amortisation profile will be such that the lessee will have the economic incentive to acquire the asset. From the financier's perspective, a purchase undertaking (similar to a put option) provides an exit route – the right to exercise the purchase undertaking arises in lessee default situations and, in effect, still gives the lessee the right to rectify his non-performance and acquire the asset; it is only if the lessee fails to comply with the put option that the lessee can then recover possession and enforce against the asset.



Islamic finance products

Ijara Mawsufah Fi Al Dhimmah

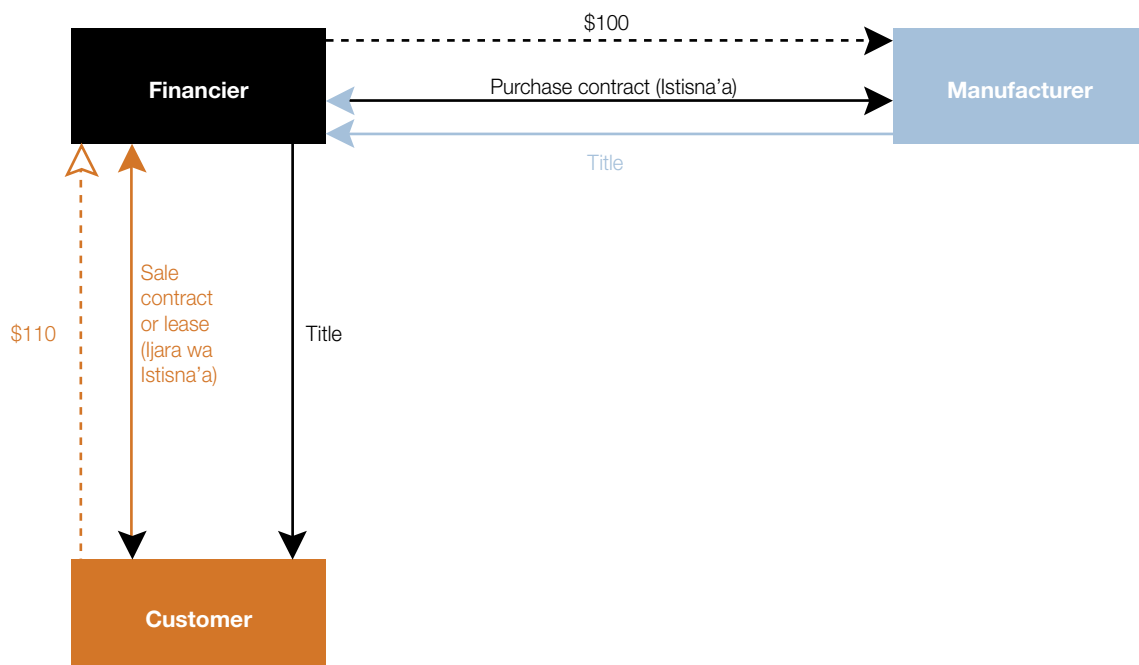
Forward leasing structures may be used where, at the outset, there are very little or no existing assets that may be used for lease based financing. The key advantage of the forward leasing structure from a financing perspective is that it is permissible for the financiers to earn a return (by way of payment of advance rentals) prior to any asset being available for leasing. These forward leasing structures make it possible therefore for Islamic financiers to participate in developmental or project financing transactions where they are able to earn a return during the construction period even though there may be no asset in existence at such time. Advance rentals are typically characterised as 'earnest money' payments on the part of the lessee, such that when the actual leasing of the asset begins the payments will be taken into account. Technically these payments are returnable if the lessor fails to provide the assets for leasing on the completion date although the exposure to the financier is dealt with as part of the structuring.



Istisna'a

This technique can be used for the advance funding of construction and development projects or large assets. The financier directly funds the supplier and takes title to the asset on completion. Unlike bai al salam (discussed below), the purchase price need not be paid in full nor the delivery date fixed at the outset. Typically the financier immediately sells the asset to the company seeking the finance or leases it back to the developer under an ijara. The combination of the istisna'a and ijara can enable financial institutions to provide construction period financing, with the payment of advance rentals during the construction period.

This technique represents an exception to one of the fundamental rules of Islamic finance. Contractual certainty usually requires the subject matter of an Islamic contract to be in existence at the time the contract relating to it is entered into. The istisna'a, however, allows a manufacturer to contract with another and undertake to manufacture a product for future delivery.

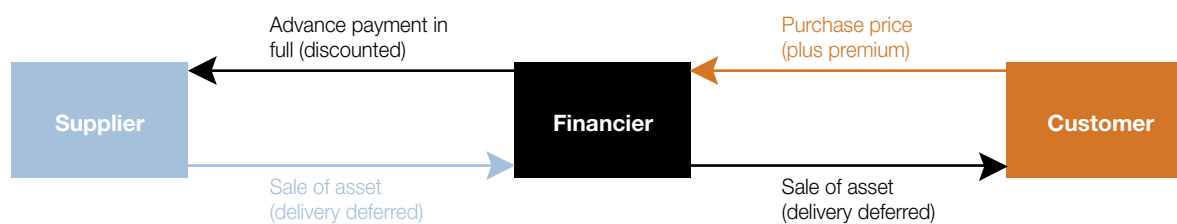


Islamic finance products

Bai al Salam

This technique is essentially a forward purchase of specified goods for full forward payment. It can be used to provide working capital. The financier pays in full for the specified asset in advance for delivery on a pre-agreed future date. In order for this technique to be Shari'ah compliant, full payment for the asset at the outset must be made, and the date for delivery must be fixed.

The financier will usually acquire the asset at a discount in return for advance payment in full. This is typically calculated by reference to a benchmark, such as a LIBOR (which it is generally permissible to use for this purpose), plus a margin. The financier may simply sell the asset on delivery for an increased price, or alternatively it may enter into a parallel but separate bai al salam contract with a third party to resell the asset for an increased price.

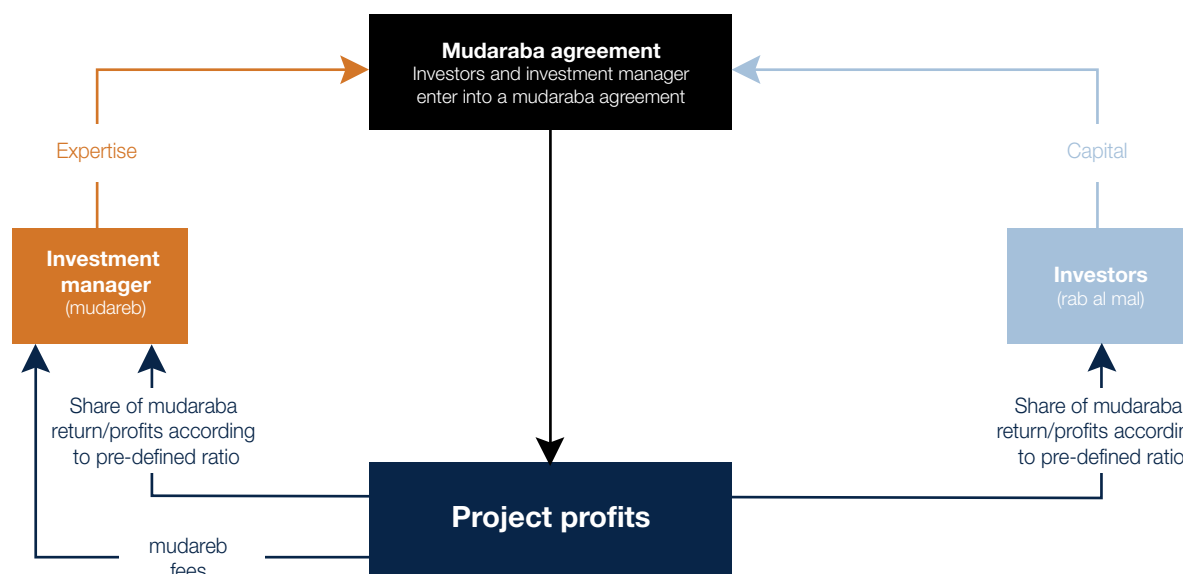


Risk sharing structures

Risk sharing structures rely on the assumption of some commercial risk by the financier. Typically, the financier and customer enter into some kind of enterprise together and share in the profits and losses arising from that enterprise.

Mudaraba

In a mudaraba arrangement the investors (rab al maal) place funds with an investment manager (mudareb) who provides the expertise and manages the funds in the way it thinks fit in return for a fee. The mudareb and the rab al maal agree to the terms of the mudareb's appointment by executing a mudaraba agreement. Effectively, under the mudaraba agreement, the mudareb becomes the partner of the rab al maal and manages the latter's investment on its behalf. The funds can be invested in Shari'ah compliant business ventures and any profit generated will be divided and distributed between the investors at pre-agreed proportions. This technique, under the guise of a "special" mudaraba contemplating a specific type of investment only, has also been used to syndicate other Shari'ah compliant financing arrangements.



Islamic finance products

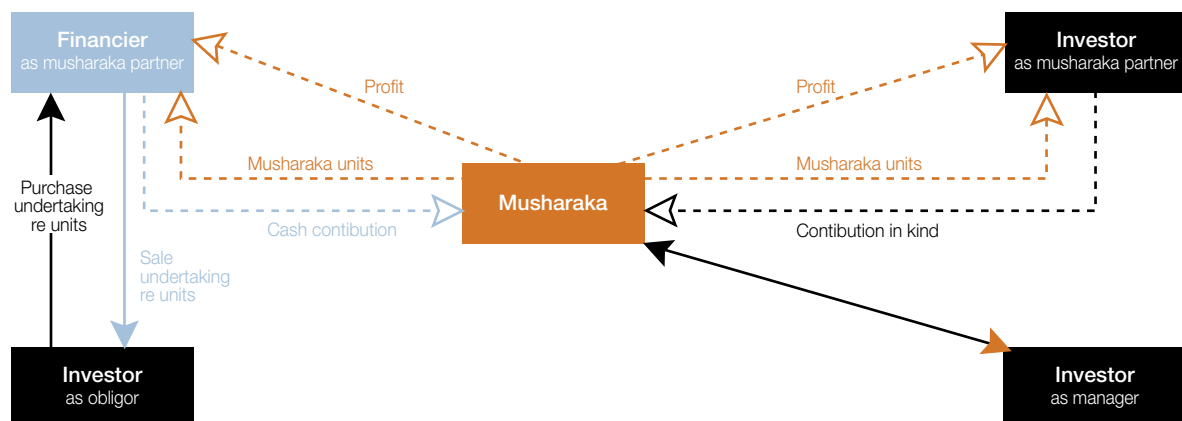
Musharaka

This product can be described as a partnership or joint venture arrangement depending on which type of musharaka technique is used. The financier and investor enter into business arrangements together (this being the musharaka) whereby they agree to make certain contributions to the musharaka in order to generate a return or develop a particular project for their mutual benefit. These contributions may be made in cash or in kind and one of the parties may be appointed to assume the role of the manager of the musharaka. The musharaka partners may agree the proportion in which they will share in the profits of the musharaka, but will share in any loss of the project or enterprise in proportion to their respective original contributions.

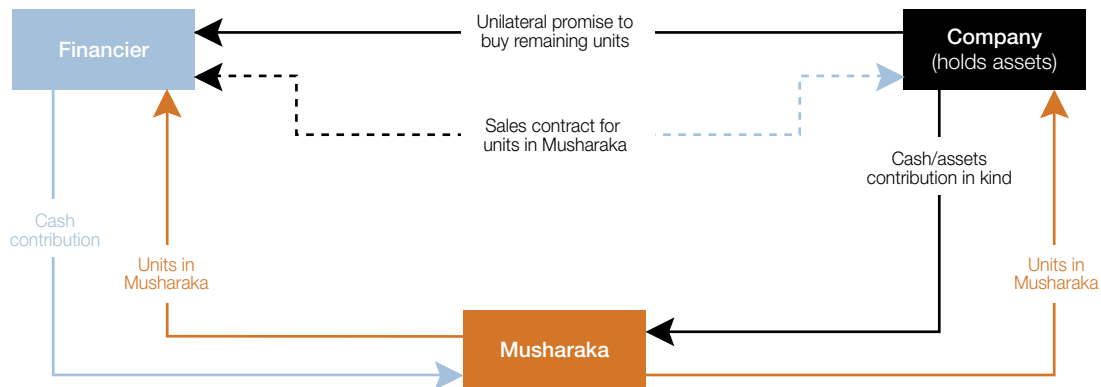
Musharaka arrangements may be structured in a number of ways, from using a so-called 'business plan' model, to one which contemplates the leasing of one musharaka partner's interest in the assets of the musharaka to the other.

Where the musharaka is being used as a fixed income product, the financier will expect that a purchase undertaking is granted in its favour enabling it, upon certain trigger events, to sell its share in the musharaka assets to an obligor for a price that provides it with a pay-out of its outstanding contribution. It was common up to the end of 2007 for the investor partner to assume the obligation of the obligor under a purchase undertaking under most, if not all, musharaka transactions up to such date. The permissibility of this under Shari'ah has been called into question such that it is increasingly rare for a musharaka transaction to utilise the purchase undertaking with investor partner as obligor model in the current market. For details of a viable alternative structure, see the section Product application: innovative transactions -Villamar@theHarbour.

Diminishing Musharaka



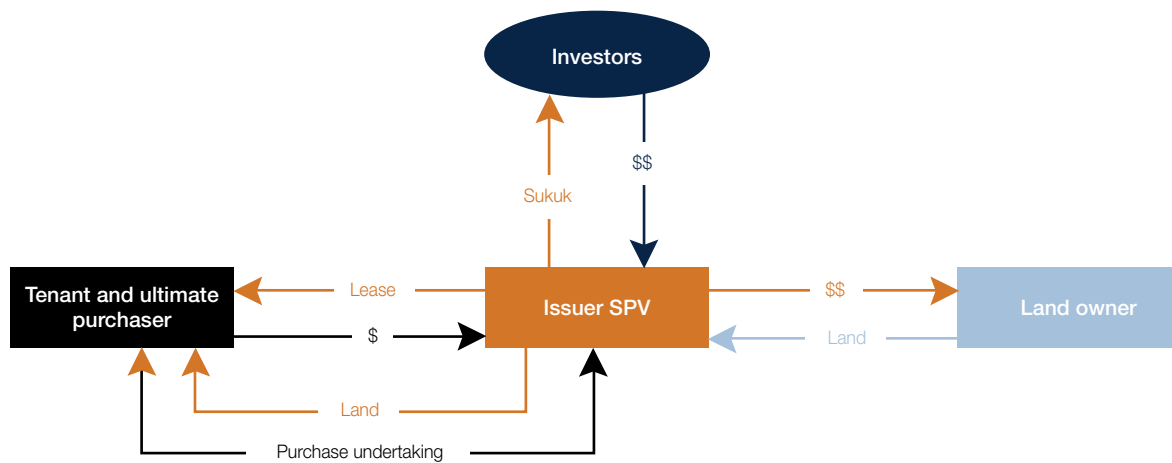
A variation of the musharaka is the diminishing musharaka, where the financier's investment participation, being its initial contribution to the musharaka, diminishes gradually over time as its ownership interest in the musharaka assets is transferred to the company and its initial investment is paid out along with its return.



Sukuk

Sukuk instruments can provide companies seeking Islamic finance access to the debt capital markets and are often described as the Shari'ah compliant equivalent of a conventional bond issue. Sukuk instruments are commonly constituted as trust certificates representing a proportionate interest in tangible underlying assets. These instruments are structured to be tradable instruments. In practice, they are used in conjunction with other Shari'ah compliant financing techniques, (such as ijara, musharaka or istisna'a) in order to create a Shari'ah compliant return on the underlying assets which are being financed. An example of a sukuk-al-ijara structure is set out below.

Although concerns have been raised by some market-leading Islamic finance scholars as to whether some existing sukuk issuances are truly Shari'ah compliant (these concerns being linked to some of the concerns raised with musharaka structures), sukuk continue to be used to finance deals, as well as refinance existing transactions.



Product application: innovative transactions

We have set out in three case studies examples of where the Herbert Smith Global Islamic Finance Group has utilised some of the financing techniques described above in creating several “first of their kind” Islamic financing solutions within the context of actual transactions.

Villamar@theHarbour – the first non-recourse sukuk issuance

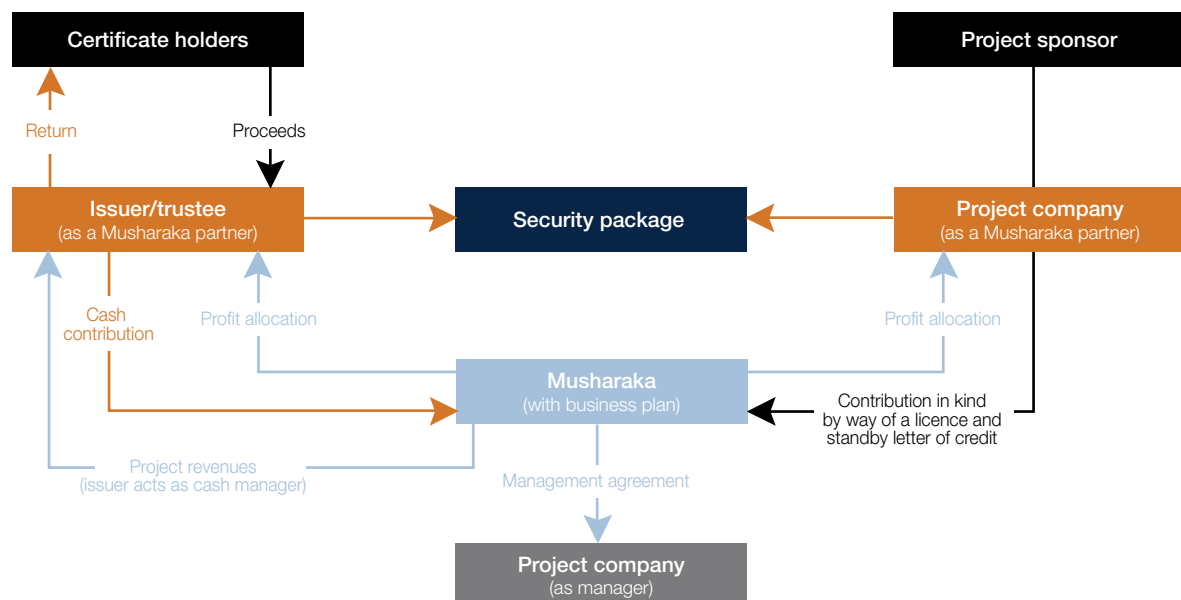
Herbert Smith’s Dubai office acted as international lead counsel on the first non-recourse Islamic real estate development sukuk financing to be completed in the MENA region and the first of its kind financing in the real estate development sector.

The US\$190 million sukuk-al-musharaka certificates issued by Villamar Sukuk Company Limited (a special purpose company incorporated in the Cayman Islands) were admitted to the Official List of Securities on the Dubai International Financial Exchange (now Nasdaq Dubai).

The offering, whilst based upon sukuk-al-musharaka principles, does not include a purchase undertaking and relies upon non-recourse project finance principles. The structure of the issuance represents an important milestone for the Islamic financial services sector, and is set to lead the way in the structuring of sukuk in asset-rich sectors such as real estate, infrastructure or energy.

With this issuance, the team successfully structured and closed a sukuk utilising musharaka principles in a manner which provides a direct structural solution to some of the key concerns raised by AAOIFI at the end of 2007. AAOIFI had expressed concern over the manner in which a number of earlier sukuk issuances had been structured using musharaka principles - identifying the use of purchase undertakings in such structures as being incompatible with the principles of Shari’ah. The structuring of the Villamar offering consequently involved complex financial engineering in order to incorporate non-recourse financing within a sukuk framework.

This transaction also demonstrates how the Islamic debt capital markets may be tapped to meet the demands for infrastructure development throughout the MENA region and further afield on a non-recourse basis. The Villamar structure provides an extremely useful template for a new era in sukuk development and utilisation.



Product application: innovative transactions

The first series of Shari'ah compliant LBO financings in the UK

Herbert Smith has recently acted on a series of first of their kind Shari'ah compliant leveraged buyouts.

Herbert Smith's Global Islamic Finance Group advised senior and mezzanine lenders in relation to the Shari'ah compliant leveraged acquisition of BWA Water Additives, a leading UK water treatment solution provider, by Seera Bank.

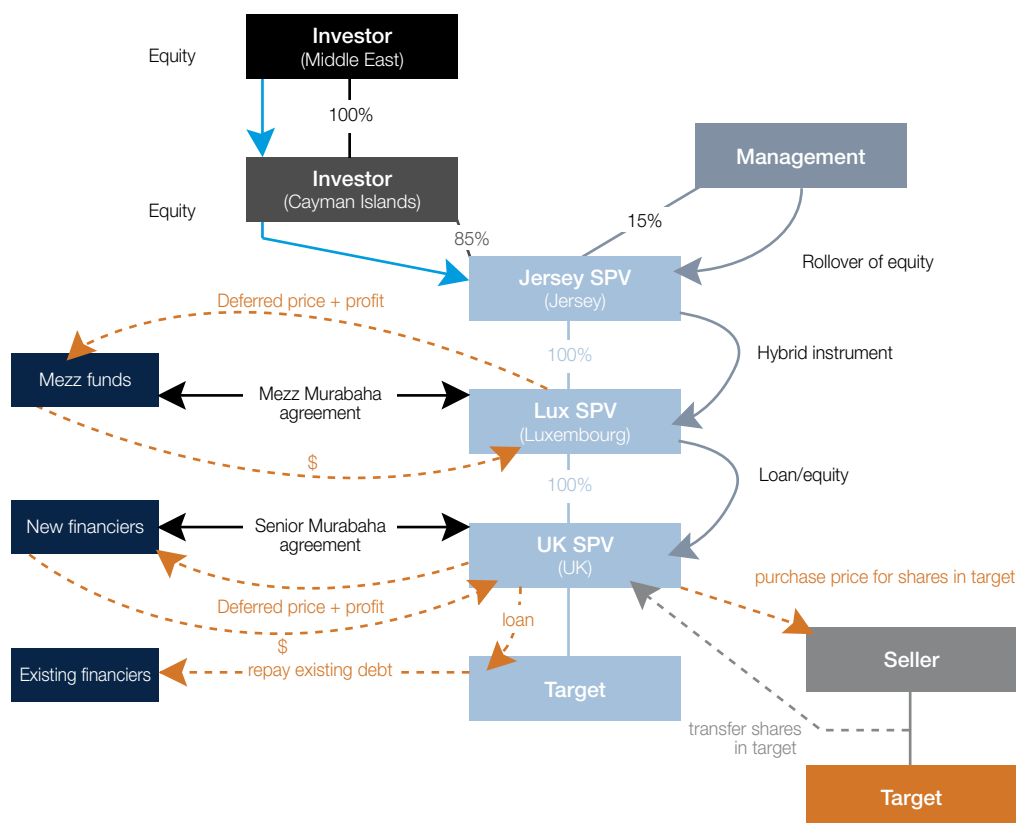
The deal involved senior and mezzanine financing provided under separate commodity murabaha facilities. The senior facilities comprised four tranches with the commercial characteristics of A, B and C notes and a working capital facility typical for a conventional European leveraged financing, but structured on a fully Shari'ah compliant basis.

The various interests of the senior, mezzanine and junior creditors were regulated by means of a common intercreditor agreement. The intercreditor raised a number of important Shari'ah issues that required innovative solutions, particularly in respect of the subordination of the mezzanine to the senior debt.

A similar murabaha-based structure was used for the leveraged buy-outs of Downhole Products by Arcapita, Inc. and Motherwell Bridge by Kuwait Finance House on which Herbert Smith's Global Islamic Finance Group also acted for senior lenders. Downhole Products and Motherwell Bridge are both international companies with head-quarters in Scotland, and the financing was provided exclusively by UK banks.

The use of murabaha facilities in the context of leveraged finance transactions is a new phenomenon in the UK. The three leveraged financings referred to above were particularly innovative in that they each involved Shari'ah compliant financing being provided directly by UK banks for the acquisition of UK target companies.

These transactions evidence that a number of Islamic sponsors are increasingly looking to acquire European assets and want to tap into local debt markets to do so. Western banks will no doubt also be keen to structure future deals in ways which are attractive for Islamic banks and sponsors, many of whom may have greater liquidity than their Western counterparts.



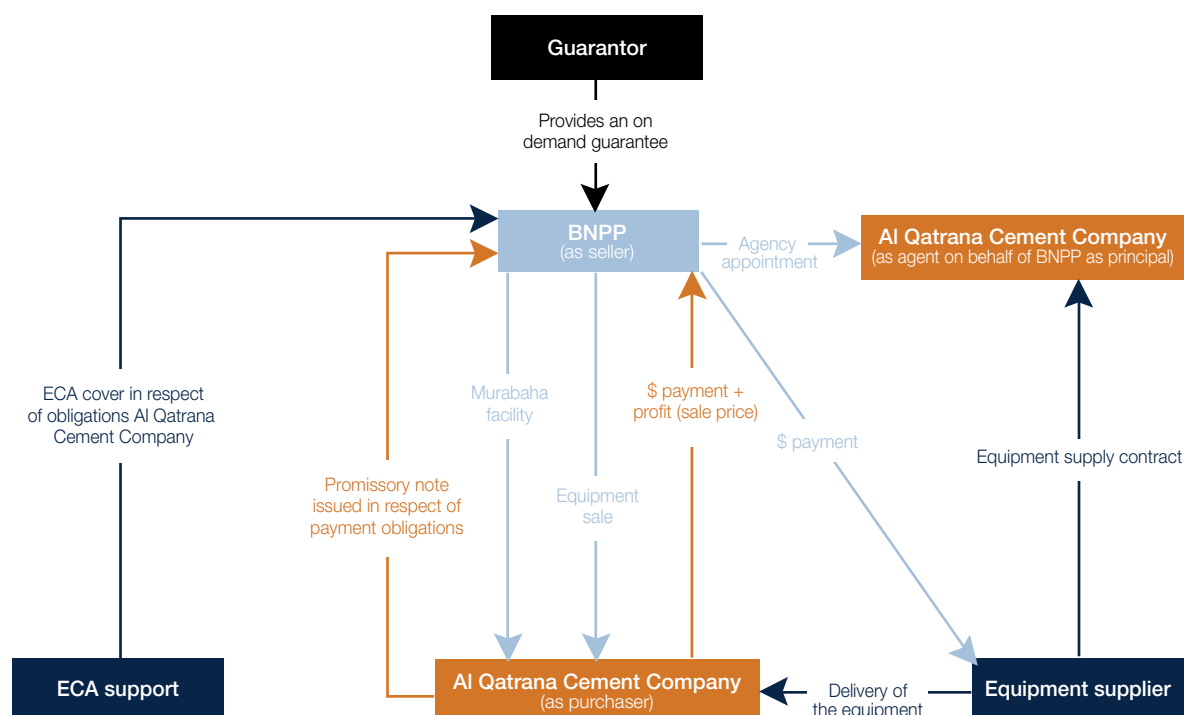
BNP Paribas/AI Qatrana Cement – Islamic ECA-covered financing in Jordan

In this transaction BNP Paribas made a series of murabaha facilities available to AI Qatrana Cement (AI Qatrana) to finance the acquisition by AI Qatrana of certain mechanical, electrical and automation cement line equipment for the construction of a cement plant in Jordan. This equipment was identified by the parties at the outset.

The first step in each murabaha trade was an acquisition of a pre-identified set of equipment by BNP Paribas from the relevant equipment supplier. In order to achieve this AI Qatrana was appointed as agent of BNP Paribas to acquire the equipment under the equipment supply contract with the relevant equipment supplier. The disbursement under the murabaha facilities would be a direct transfer of the drawdown proceeds from BNP Paribas direct to the equipment supplier in order to meet the payment obligations of AI Qatrana under the equipment supply contract. Immediately upon the acquisition taking place, BNP Paribas sold the relevant equipment to AI Qatrana with an immediate transfer of title and risk in the equipment to AI Qatrana. The price was payable by AI Qatrana on future dates and by way of instalments in amounts agreed between BNP Paribas and AI Qatrana.

The financing arrangements also involved the financing by BNP Paribas to AI Qatrana of services associated with the equipment. For Shari'ah compliance purposes, these services were funded by a series of commodity murabahas which sat alongside the other murabaha facilities. The commodity murabahas involved the acquisition of commodities by BNP Paribas and their on-sale to AI Qatrana on deferred payment terms, with the added component of “encashment” of the commodities by AI Qatrana selling the commodities to a third party in order to generate a cash amount.

Certain murabaha facilities were designed so that that they benefitted from Export Credit Agency support. These murabaha facilities had to be structured in a way that took into account key issues from the perspective of the Export Credit Agencies concerned, both in the context of their general requirements in multi-jurisdictional financings but also specific Islamic finance related aspects. The support of the Export Credit Agencies directly to cover the murabaha facilities themselves is a strong demonstration of the wide acceptance of forms of Islamically compliant structures as well as the versatility of Islamic finance in specialised areas of finance.



Hedging products

General

Conventional hedging products and other derivative transactions raise a number of issues for Shari'ah, especially in relation to the prohibitions against uncertainty and speculation (gharar and maisir). The interpretation and application of Shari'ah remains varied in this area but there is a growing acceptance that, where the purpose of the transaction is prudential risk management rather than speculation, then it is possible to structure the transaction in a way which is compatible with Shari'ah principles.

Increasing demand and continued innovation has led to the development of Shari'ah compliant profit rate swaps, total return swaps and currency swaps. The International Islamic Financial Market (IIFM) and the International Swaps and Derivatives Association (ISDA) are currently working together on the publication of a standard form Master Agreement for Islamic hedging products. This Master Agreement is intended to operate as a framework agreement under which parties can carry out a number of different hedging transactions, similar in purpose to the widely used ISDA Master Agreement which governs conventional derivative transactions. A first version is expected in the near future.

Profit rate swap

In a conventional interest rate swap the counterparties exchange a series of cashflows calculated by reference to a notional amount (eg, an amount which is equal to the principal outstanding under a loan). One party pays a fixed rate and the other party pays a floating rate (eg, LIBOR) and hence the fixed rate payer is able mitigate the risk that the interest rate will rise.

The structure and documentation of Shari'ah compliant profit rate swaps vary widely in the current market, but an example swap involves the counterparties exchanging a series of cashflows generated by fully funded asset based transactions. The fixed rate payments can be generated by a standard commodity murahaba transaction and the floating rate payments can be generated by a revolving commodity murahaba transaction. The payments represent profit rather than interest; the purpose of the transaction is risk management rather than speculation; and the series of back-to-back trades carried out under the revolving commodity murahaba provide contractual certainty as to the payment amounts at the time of each trade. The payments due from each party on each payment date are netted against each other in a similar manner to a conventional swap.

Shari'ah compliant investment funds

This section seeks to address the key characteristics of Shari'ah compliant investment funds, the factors which differentiate them from conventional funds and matters to consider when establishing such funds.

Overview

In order to establish a Shari'ah compliant investment fund, the investment fund structure is required to be Shari'ah compliant. This will mean ensuring the Shari'ah compliance of its investment objectives, criteria for investment and underlying investments, along with its terms of investment, and the treatment of its investors. Each of these matters is considered below.

Fund structure

Subject to its structure, management and investment criteria, an investment fund may be set up to be Shari'ah compliant. A Shari'ah compliant investment fund is required to be managed on the basis of either a mudaraba (as described above) or wakala arrangement (as described below).

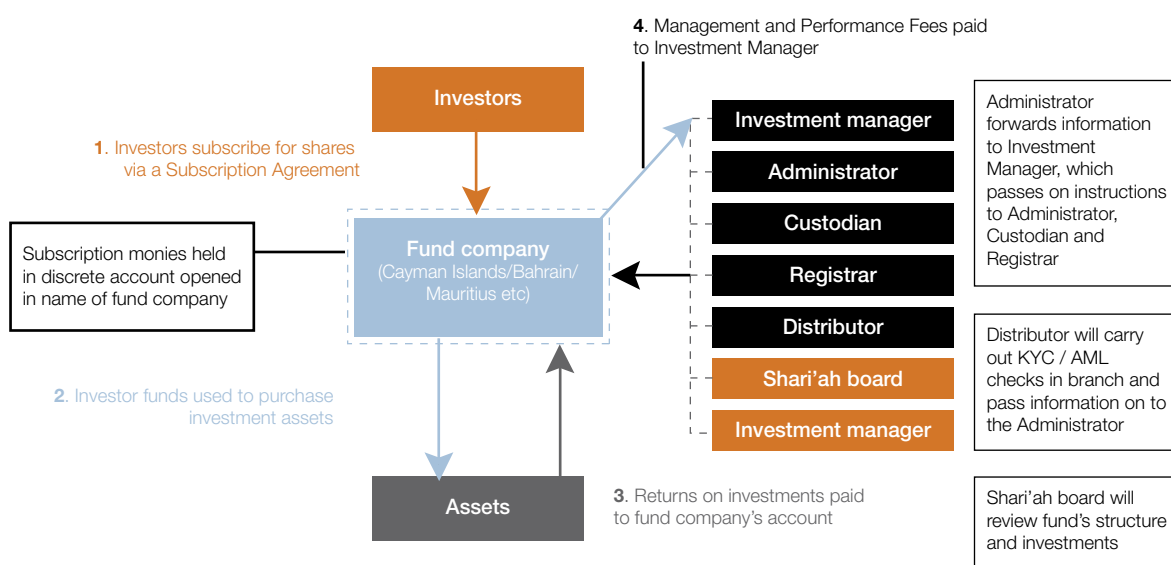
A wakala arrangement is an agency arrangement whereby an investment manager (a wakil) acts as the agent for the fund company and, indirectly, for the investors. As with a mudaraba, the wakil will invest the investor's money on its behalf. The wakil is either paid for its services by way of fixed fee or by reference to the performance of the money invested, or both.

The investment management agreement, whether structured as a wakala or a mudaraba, will typically include representations from the investment manager that it will carry out its duties using commercial reasonable care and skill and will, at all times, act in the best interests of the fund.

As part of the organisational structure of a Shari'ah compliant investment fund, a Shari'ah supervisory committee is normally appointed by the investment fund. The reputation of individual scholars is an important factor in deciding which scholars are to be appointed to an investment fund's Shari'ah supervisory committee. For example, investors in a particular region may look to invest in a fund where the scholars on that fund's Shari'ah supervisory committee are known to them. Also, on the basis that the opinions of scholars may differ at a regional and, in some cases, global level, it is not unusual for a fund's Shari'ah supervisory committee deliberately to include scholars who have known views in respect of the target investment or asset classes in target markets.

The scope of work of the Shari'ah supervisory committee will typically include reviewing the structure of the fund, reviewing the role of the investment manager, reviewing fund documents and the terms of the offering, determining appropriate investment criteria, issuing a fatwa, advising on purification of the haram profits of the fund and advice as to their payment, screening the investments and drafting and settling an annual Shari'ah review and preparation of reports (annual/semi-annual/quarterly/investment-by-investment, as the case may be) to investors.

Investment objectives and investments of the fund



As indicated above, the Shari'ah supervisory committee is typically responsible for setting the investment criteria in respect

| Shari'ah compliant investment funds

of an investment fund's investments. Generally, companies which undertake business in haram business sectors will not be acceptable investments for the fund. However, the Shari'ah supervisory committee of each investment fund will have its own views as to acceptable investment criteria.

Terms of investment and treatment of investors

Shari'ah principles prescribe equality of treatment for investors. Certain scholars consider that equal treatment of investors in an investment fund may only be achieved where each investor is offered the right to acquire the same class of shares (so that all shareholders have the same rights). However, this view is not universally accepted and certain scholars have indicated that it is Shari'ah compliant for a company to issue more than one class of shares with different rights. Each investor holding a particular class of share should, however, be treated equally.

Share class issues aside, each investor should be treated equally in relation to factors such as the right to dividend income and capital returns, subscription and redemption terms, issue and redemption prices and voting rights.


Debt and financial ratios

Shari'ah takes account of the financial resources from which a company generates its income in ascertaining whether a company is Shari'ah compliant. As mentioned in the section detailing Shari'ah prohibitions above, interest-based transactions are prohibited under Islamic law. However, on the basis that companies invariably have some form of debt, it is generally accepted that a proportion of debt to equity in a company may be acceptable in ascertaining whether the capital structure of the company is Shari'ah compliant. It is commonly accepted that a company's debt to equity ratio must not exceed one third and that the cash and receivables of a company must not exceed 50% of its market value.

As interest is considered haram, a company should not have any interest-bearing securities. Despite this, it is generally accepted that a company may invest up to one third of its market value in cash and interest-bearing securities. Furthermore, it is accepted that investments should not be made in derivatives (including futures and options) as these types of instruments involve uncertainty in their subject matter and are therefore gharar. Short-selling is also prohibited on the same basis.

Current developments

Various means of structuring Shari'ah compliant funds have developed, including use of different entities (companies and limited partnerships) and incorporation in a variety of on- and offshore jurisdictions. In many cases, Shari'ah compliant funds are established alongside parallel conventional funds which invest in a broad range of asset classes. This gives investment managers the flexibility to exploit opportunities in various sectors of the market. As investors continue to seek Shari'ah compliant investment opportunities, it is likely that structures will continue to develop in variety and sophistication.



“Widely recognised for Islamic Finance,
advising on sizeable sukuk issuances and
the Islamic finance elements of major
projects inside and outside of the region”

Legal 500 2008

| Herbert Smith global Islamic finance group

Our group

Herbert Smith LLP's Global Islamic Finance Group comprises of specialist lawyers from across the Herbert Smith's global network who work together to provide an integrated service for our clients who are active in the Islamic financial services industry.

The Herbert Smith Global Islamic Finance Group deals with high value and complex Islamic finance transactions anywhere in the world.

We are one of the leading international law firms in the Islamic financial services sector. Members of our Global Islamic Finance Group are located in each of our Abu Dhabi, Dubai, Hong Kong, Jeddah**, London, Moscow, Paris, Riyadh** and Singapore offices.

Our award-winning Global Islamic Finance Group continues to work closely with Islamic banks, financial institutions, sponsors, government entities and corporates in developing innovative products and service offerings that continue to contribute to the growth of Islamic finance, whilst always working in a way that retains the integrity of Shari'ah principles and the parameters set thereby.

Our services

- The Herbert Smith Global Islamic Finance Group has been involved in the structuring and development of a number of "first of their kind" financing structures using in particular sukuk and murabaha products.
- With the opening of our Abu Dhabi office in June 2008 and the establishment of a formal association with the Al Ghazzawi Professional Association, one of the leading firms in Saudi Arabia and Shari'ah law, our Islamic finance practice is playing a significant role in the internationalisation of Islamic finance.
- We advised in particular on the first Islamic structures used in financing projects in Hong Kong and are currently undertaking similar such work in Tunisia.
- We advised Islamic financiers on mezzanine real estate financing structures in France.
- We advised Royal Bank of Scotland on three LBO transactions including Islamic financings that are representative of the trend that Western banks are currently attracted by the prospect of structuring deals which appeal to Middle Eastern lenders, many of whom have greater liquidity than their western counterparts.
- We advised on the structuring of the Villamar sukuk, first non-recourse Islamic real estate development sukuk financing to be completed in the MENA region.
- The Herbert Smith Global Islamic Finance Group is also at the forefront of Shari'ah investment funds structuring. We advised on the structuring of the largest and most significant Shari'ah compliant investments funds in the Middle East for clients such as Millennium Finance Corporation, Investcorp and Global Investment House and in particular on the establishment of one of the first Shari'ah compliant hedge funds for Millennium Finance Corporation.

"Debt and Equity-linked Deal of the Year (Villamar Sukuk)"

IFLR Middle East Awards 2008

"The Herbert Smith team impresses with its ability to 'tackle complex financings in an exemplary commercial manner while respecting time frames and cost quotes'"

Chambers UK 2007

** Herbert Smith associated firm

Examples of recent work

- **Merrill Lynch** on the US\$190 million sukuk-al-musharaka issuance for funding the Villamar luxury residential development in Bahrain Financial Harbour District (the first non-recourse Islamic real estate sukuk financing to be completed in the MENA region)
- **BNP Paribas** (supported by BNP Paribas Najmah, its Islamic finance division) as mandated lead arranger of one of the first ECA-covered Islamic financing in Jordan. The ground breaking US\$120 million package was designed for the financing of the Al Qatrana project developed by Arabian Cement Company (a listed company in Saudi Arabia) and consist of multiple bilateral facilities utilising several murabaha structures
- **Qatar Islamic Bank** on a US\$300 million commodity-based murabaha facility for bridge financing purposes. The bridge facility was arranged by Standard Chartered Bank and ABN AMRO Bank and will be participated in by a number of regional banks and financial institutions
- **Multilateral financial institutions** on the financing of a chemical project in North Africa involving an Islamic tranche
- **RZB Bank/Al Salam Bank** in connection with the wholly Shari'ah compliant financing of a biodiesel plant in Hong Kong (the first Islamic development financing in Hong Kong)
- **Royal Bank of Scotland** on three Shari'ah compliant LBO financing transactions which are among the few transactions in the UK using a murabaha facilities in an LBO context
- **Shari'ah compliant funder** on a £31,500,000 Shari'ah compliant funding in the UK by way of a tawaruq structure involving five jurisdictions
- **Salam Bounian** sukuk issuance as counsel to the lead arrangers on the US\$137.5 million sukuk to finance the development of a commercial real estate venture in Qatar (adapted a unique hybrid structure which contemplated limited resource for part of the financing term)
- **Sumitomo Chemical** on the financing of the US\$9.8 billion Rabigh refining and petrochemicals project in Saudi Arabia, including a US\$600 million ijara finance tranche
- a **leading investment house** on the Shari'ah compliant LBO financing of a Saudi company
- a **Middle East financier** in relation to the mezzanine financing of property investments in France
- **Global Investment House** and **Millennium Capital** on the establishment of Islamic Buyout Fund, a Shari'ah compliant fund
- **Investcorp Bank BSC** on the structuring and establishment of Investcorp Gulf Opportunity Fund and Investcorp Islamic Opportunity Fund, seeking to raise in aggregate US\$1 billion

“Musharaka Deal of the Year 2008 (Villamar Sukuk)”

Islamic Finance News Awards 2009

“The team ‘excels at executing non-standard deals and creating new vehicles’”

Chambers 2007

“Ranked Number 1 for investment funds in the UAE”

The Practical Law Company (2008) and Who's Who Legal (2008)

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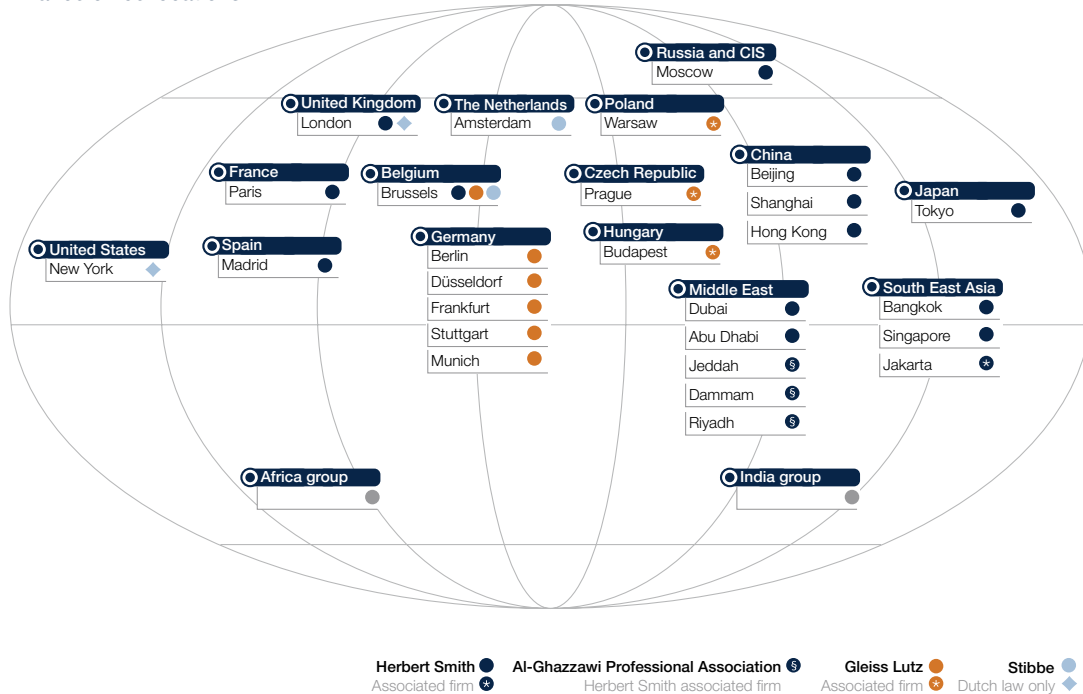
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