

LEGAL RISKS AND LEGAL RISK MANAGEMENT IN
WAKALAH SUKUK IN MALAYSIA

BY

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ABSTRACT

The default of *Dana Gas sukuk* has raised concerns regarding some legal issues prevalent in *sukuk*, e.g., the unenforceability of the purchase undertakings as a result of Shariah non-compliance declaration by the *sukuk* issuer and unenforceability of foreign court's decision. Even though the *sukuks* were eventually restructured, the investors' rights were compromised, and the legal issues remained untested. In Malaysia, *wakalah sukuk* has been the preferred structure. This structure embeds purchase undertakings and entails a unique relationship between the issuer and the investor, i.e., an agent-principal relationship. Given the perspectives of previous *sukuk* default, this structure may entail more legal issues and hence, legal risks. Besides, the literature on legal risk management in *sukuk* are very few in number. While there have been studies conducted on legal risk and legal risk management in *sukuk*, they did not offer empirical evidence, causing questions around these two focal points to remain unanswered. Therefore, this study was conducted to identify legal risks, determine the legal risk management in *wakalah sukuk*, and propose best practices for managing legal risks in the *sukuk*. This study is an exploratory form of research that employs doctrinal legal analysis and document analysis. The data were collected from 24 selected *wakalah sukuk* documents comprising the Information Memorandum, Trust Deed, Principal Terms and Conditions, as well as interviews. Content analysis and thematic analysis techniques have been employed for analysis of these documents. For the interview, seven participants representing various parties in *sukuk* were selected using a purposive sampling technique. Data obtained from the interviews were analyzed using thematic analysis. This study's findings have revealed five types of general legal risks in *sukuk*, four legal risks specific to *wakalah sukuk*, and 22 specific legal risks in *wakalah sukuk* documents. Regarding legal risk management, there are different approaches to legal risk management among the participants. However, review of *sukuk* documents was found to be the primary legal risk management strategy, besides seven other main strategies. Eight legal risk management general techniques and 18 risk-specific techniques were employed in the *wakalah sukuk* to manage the 22 legal risks. Among them are the use of Disclaimer, Assurance, Transfer of Risk to Investors (TOR), Shariah Waiver (SW), and Dissolution Event Clause (DEC). Other than these, the participants employed seven other techniques and seven legal risk management tools. The use of these strategies, techniques, and tools was found to be associated with several factors. While differences in the use of the strategies, techniques, and tools are plausible, differing views regarding the uses of several techniques are unexpected. Each view is also associated with solid justification. With these, several gaps in *wakalah sukuk's* legal risk management of *wakalah sukuk* have been identified and several improvements have been recommended. In sum, this study has provided insightful information and empirical evidence on legal risks and legal risk management, particularly for *wakalah sukuk* in Malaysia, as well as some of the best practices of legal

risk management. Moreover, future studies are recommended to further research on the legality of existing legal risk management techniques and possible regulatory changes to improve the existing legal risk management in *sukuk*. The aim is to position the Malaysian *sukuk* market as the preferred issuing jurisdiction and to ensure its sustainability.



خلاصة البحث

أثارت قضية التخلف عن السداد لصكوك دانة غاز مخاوف بشأن بعض المسائل القانونية السائدة في الصكوك، على سبيل المثال، عدم قابلية إنفاذ تعهدات الشراء نتيجة لإعلان عدم الامتثال للشريعة الإسلامية من قبل مصدر الصكوك وعدم قابلية إنفاذ قرار المحكمة الأجنبية. وعلى الرغم من إعادة هيكلة الصكوك في نهاية المطاف، إلا أن حقوق المستثمرين تعرضت للخطر، وظلت المسائل القانونية دون اختبار. وفي ماليزيا، كانت صكوك الوكالة هي الهيكل المفضل. يتضمن هذا الهيكل تعهدات الشراء ويستلزم علاقة فريدة بين المصدر والمستثمر، أي العلاقة بين الوكيل والأصل. وبالنظر إلى وجهات نظر التخلف عن السداد في الصكوك السابقة، فإن هذا الهيكل قد ينطوي على المزيد من القضايا القانونية وبالتالي المخاطر القانونية. علاوة على ذلك، فإن الأدبيات المتعلقة بإدارة المخاطر القانونية في الصكوك قليلة جداً. وفي حين تم إجراء دراسات حول المخاطر القانونية وإدارة المخاطر القانونية في الصكوك، إلا أنها لم تقدم أدلة تجريبية، مما تسبب في بقاء الأسئلة حول هاتين النقطتين المحوريين دون إجابة. ولذلك فقد أجريت هذه الدراسة للتعرف على المخاطر القانونية، وتحديد إدارة المخاطر القانونية في صكوك الوكالة، واقتراح أفضل الممارسات لإدارة المخاطر القانونية في الصكوك. هذه الدراسة هي شكل استكشافي من البحث الذي يستخدم التحليل القانوني الفقهي وتحليل الوثائق. تم جمع البيانات من 24 وثيقة مختارة لصكوك الوكالة تشمل مذكرة المعلومات، وسند الثقة، والشروط والأحكام الرئيسية، بالإضافة إلى المقابلات. وقد تم استخدام تقنيات تحليل المحتوى والتحليل الموضوعي لتحليل هذه الوثائق. ولإجراء المقابلة، تم اختيار سبعة مشاركين يمثلون مختلف الأطراف في الصكوك باستخدام تقنية أخذ العينات الهادفة. وقد تم تحليل البيانات التي تم الحصول عليها من المقابلات باستخدام التحليل الموضوعي. كشفت نتائج هذه الدراسة عن خمسة أنواع من المخاطر القانونية العامة في الصكوك، وأربعة مخاطر قانونية خاصة بصكوك الوكالة، و22 خطراً قانونياً محدداً في وثائق صكوك الوكالة. فيما يتعلق بإدارة المخاطر القانونية، هناك أساليب مختلفة لإدارة المخاطر القانونية بين المشاركين. ومع ذلك، تبين أن مراجعة وثائق الصكوك هي الإستراتيجية الأساسية لإدارة المخاطر القانونية، إلى جانب سبع استراتيجيات رئيسية أخرى. تم استخدام ثمانية تقنيات عامة لإدارة المخاطر القانونية و18 تقنية خاصة بالمخاطر في

صكوك الوكالة لإدارة المخاطر القانونية البالغ عددها 22. من بينها استخدام إخلاء المسؤولية، والضمان، ونقل المخاطر إلى المستثمرين (TOR)، والتنازل عن الشريعة (SW)، وبند حدث الحل (DEC). وبخلاف ذلك، استخدم المشاركون سبع تقنيات أخرى وسبع أدوات لإدارة المخاطر القانونية. وقد وجد أن استخدام هذه الاستراتيجيات والتقنيات والأدوات يرتبط بعدة عوامل. في حين أن الاختلافات في استخدام الاستراتيجيات والتقنيات والأدوات معقولة، إلا أن وجهات النظر المختلفة بشأن استخدامات العديد من التقنيات غير متوقعة. يرتبط كل رأي أيضاً بتبرير قوي. وبهذا، تم تحديد العديد من الثغرات في إدارة المخاطر القانونية لصكوك الوكالة وتمت التوصية بالعديد من التحسينات. باختصار، قدمت هذه الدراسة معلومات ثاقبة وأدلة تجريبية حول المخاطر القانونية وإدارة المخاطر القانونية، وخاصة بالنسبة لصكوك الوكالة في ماليزيا، بالإضافة إلى بعض أفضل الممارسات لإدارة المخاطر القانونية. علاوة على ذلك، يوصى بإجراء دراسات مستقبلية لإجراء مزيد من الأبحاث حول شرعية تقنيات إدارة المخاطر القانونية الحالية والتغييرات التنظيمية المحتملة لتحسين إدارة المخاطر القانونية الحالية في الصكوك. والهدف من ذلك هو وضع سوق الصكوك الماليزية باعتبارها جهة الإصدار المفضلة وضمان استدامتها.

APPROVAL PAGE

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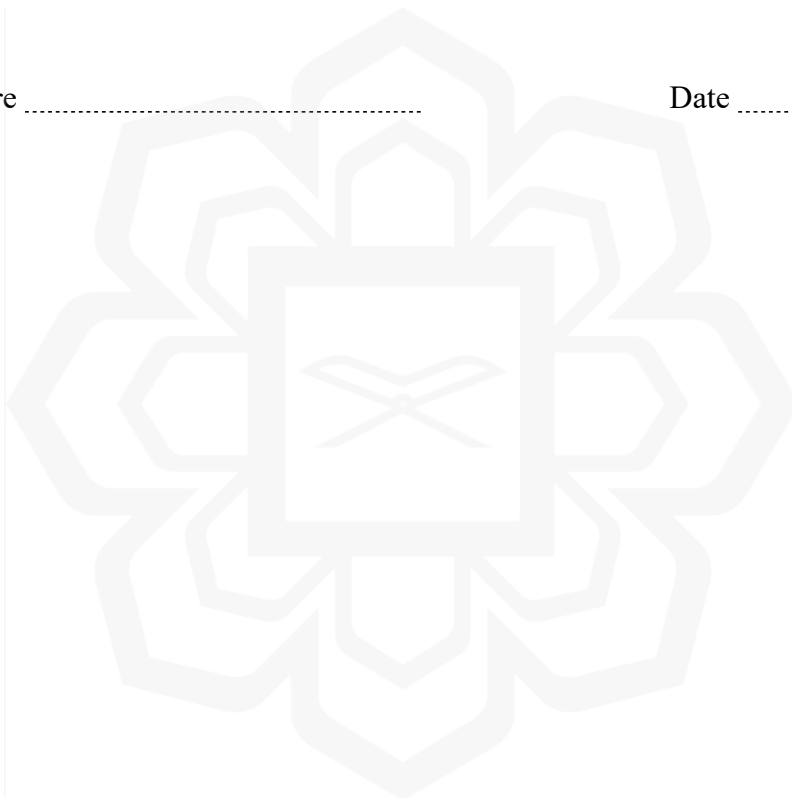
DECLARATION

I hereby declare that this dissertation is the result of my own investigations, except where otherwise stated. I also declare that it has not been previously or concurrently submitted as a whole for any other degrees at IIUM or other institutions.

Noor Fadhana Mohd Noor

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Firstly, it is my utmost pleasure to dedicate this work to my dear parents, Mohd Noor Yaacob and Zainon Hashim, my husband, Noor Affendi Ismail, my dearest sons, Noor Hairs and Noor Yusuf, and daughters, Noor Fateema, Noor Sarah and Noor Safiya, and my family, who granted me the gift of their unwavering faith in my ability to accomplish this goal: thank you so much for your persistent support and patience. For my husband, thank you for paying my tuition fee. May Allah grant all of you His Jannah for all the good deeds that you have committed yourselves with.

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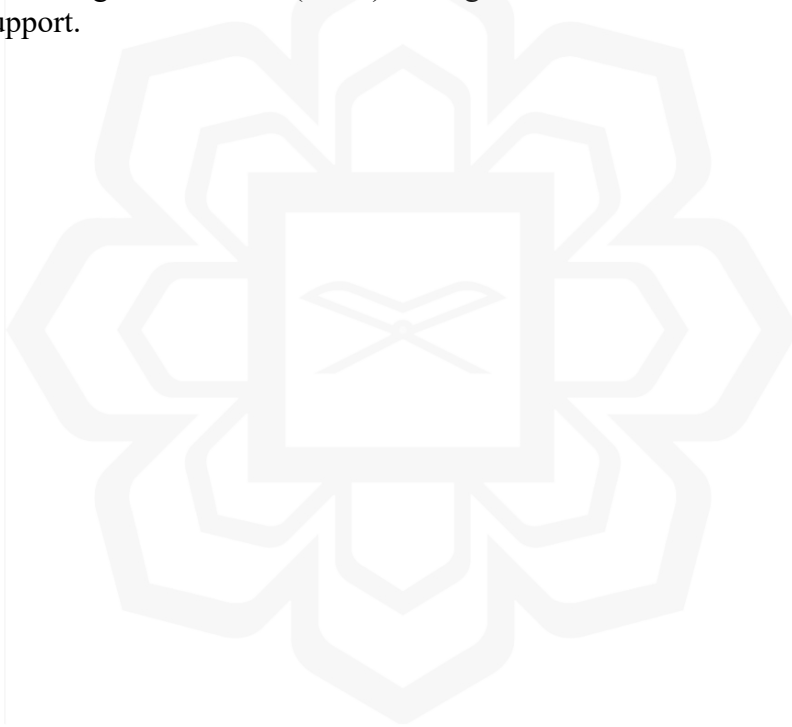


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CHAPTER ONE

INTRODUCTION

1.1 OVERVIEW

The Islamic capital market is a significantly emerging segment in the global financial universe. In the Malaysian context, the capital market was initiated in March 1960, when the Malaysian stock exchange was first established, followed by the commencement of public trading of stocks and shares in the mid-1960s. The year 1992 witnessed the introduction of Shariah-approved shares and equity in the Kuala Lumpur Stock Exchange (KLSE)¹, which comprised Islamic unit trusts and Islamic indices by the Securities Commission of Malaysia (SC) (Rosylin, 2008). To date, there are at least five critical instruments of the Islamic capital market, namely Islamic indices, Shariah-compliant real estate investment trusts (i-Reits), Islamic mutual funds, Halal/Shariah-compliant stocks, and most prominently, Islamic securities or better known as *sukuk* (Farooq, 2022).

In 2001, the Central Bank of Bahrain (CBB) issued the first sovereign *sukuk* for its domestic market (IIFM, 2010). Later, in December of the same year, Kumpulan Guthrie Bhd. issued the first international corporate *sukuk* with a volume of USD150 million (Wedderburn-Day, 2010), heralding the international penetration of *sukuk* by Malaysia. The first rated global sovereign *sukuk* was issued by the Government of Malaysia in the year 2002, and this marked a global milestone for *the sukuk* market (ISRA, 2017). By the end of March 2021, it was reported that Malaysia had accounted

¹ Now known as Bursa Malaysia.

for RM1,042.5 billion total *sukuk* outstanding volume², and RM67.3 billion *sukuk* volume issued³ for the year (RAM Ratings, 2021). Thus, Malaysia maintained its position as the most significant player in *the sukuk* market, followed by Saudi Arabia and Indonesia (RAM Ratings, 2021). Similarly, in 2022, Malaysia continued to spearhead the international *sukuk* market with a 40.3% market share and the global corporate *sukuk* with a 69.6% market share.

1.2 BACKGROUND AND RATIONALE OF THE STUDY

In 2023, Malaysia has dominated the *sukuk* market with a market share of 61.12% for domestic *sukuk* and 57.26% for short-term *sukuk* issuances. A similar trend was already seen in 2021 when Malaysia stood as the jurisdiction with the most significant market issuances, with a market share of 41.18% (IIFM, 2022). This position has been held by Malaysia for the past ten years, i.e., since the inception of the global *sukuk* market in January 2001 (IIFM, 2021). As reported in IIFM (2022), Malaysia has become a leader in international, domestic, and short-term *sukuk* issuances, both in terms of volume and value. In other words, *sukuk* issuances by Malaysia have led to the healthy growth of the *sukuk* market.

As the market continued to grow, evidently many studies on *sukuk* were carried out. These studies were mainly on *sukuk* market growth, *sukuk* and finance theories, and *sukuk* market behaviors (Paltinieri, Hassan, Bahoo, & Khan, 2023). Similarly, several studies related to socially responsible investment (SRI) were also evident (Delle Foglie & Keshminder, 2022; Rahman, Isa, Tu, Sarker, & Masud, 2020). Nonetheless, a

² Volume issued and outstanding until the financial year 2020.

³ Volume issued in the financial year 2020, at nominal value, inclusive of volume redeemed or not redeemed.

recent bibliometric review of Islamic capital market-related studies revealed that fundamental issues which are present in the Islamic capital market, e.g., differing interpretations of permissible transactions and lack of uniformity of rules/regulations governing the market, have not been adequately addressed (Mohamad Shafi & Tan, 2023). Similar findings were gathered upon reviewing studies which looked at the legal issues surrounding *sukuk* (Abdul Khaleq, Richardson, & F., 2007; Jobst, 2008; Kordvani, 2009; McMillen, 2015; Nazar, 2011; Zulkhibri, 2015).

The legal issues discussed in the literature were, among others, the unenforceability of *sukuk* contracts, legal uncertainties of *sukuk* cases, unenforceability of *sukuk* contract clauses, unenforceability of foreign judgment, unenforceability of choice of law, etc. (Al-Amine, 2012; Ali, 2009; Ali Said & Rihab Grassa, 2013; Djojosingito, 2008a; Jobst, 2008; McMillen, 2007; Mohammad, 2010; Nazar, 2011). These legal issues were discussed generally, and they were recognized as being either hypothetical or observed risks. Under the literature on risks (Arnott, 2004, 2006; Krohley, 2012; McCormick, 2013; Moorhead & Vaughn, 2015), these fall under the spectrum of legal risks. At the same time, some studies have discussed legal risks in *sukuk*. Although these studies are evident in the literature, they are few in number (Al-sayed, 2013; Haider & Azhar, 2010; Hasan, Ahmad, & Parveen, 2019; Najeeb, 2013; Nanaeva & Pandey, 2010; Nazar, 2011)⁴. In line with what was implied in Mohamad Shafi and Tan (2023), further analysis of these studies showed that legal risks in *sukuk* have been widely studied from the theoretical aspect. Within these studies, only a small number of them have presented empirical data based on interview findings or case

⁴ In the aspect of legal risk, these studies have discussed theoretical legal risks that may arise from lack of uniformity in *sukuk* regulations (Al-sayed, 2013; Haider & Azhar, 2010; Majid et al., 2011; Najeeb & Vejzagic, 2013), the 'legislative risk' that may arise from conflict between Islamic laws and conventional law, and the 'regulatory risk' that may arise from non-unified *sukuk* regulations (Nanaeva & Pandey, 2010)

studies (Oseni, 2014; Ab Majid, Shahimi, & Abdullah, 2011; Abdul Rauf & Ibrahim, 2014; Haider & Azhar, 2010; Oseni & Hassan, 2011; Oseni & Hassan, 2015; Salah, 2010; Sole, 2008; Ab Majid, Shahimi, & Abdullah, 2011; Haider & Azhar, 2010; Oseni & Hassan, 2011).

At the same time, a few cases of *sukuk* defaults worldwide have raised concerns over the viability of *sukuk*, particularly on how to protect the rights of the *sukuk* holders. The relatively recent default cases were the Dana Gas *sukuk* case and the Garuda Airlines *sukuk* case. Although the latter was more recent and legal issues surrounding its settlement were noted by few (Al-Natoor & Shawqi, 2021; Maulia, 2021), the *sukuk* was finally restructured and the legal intricacies were less apparent (Suhartono & Sipahutar, 2022; Suroyo, 2022), thus differentiating it from the Dana Gas *sukuk* case. It was observed that the *sukuks* were eventually redeemed on 31st October 2020 (Al-Natoor & Brown, 2020) after a long legal battle and restructuring attempts that began in June 2017. The value of the restructured *sukuk* was also reduced from USD700 million to 530 million as *ijarah sukuk*, with 4% profit per annum (IIFM, 2019). Although the dispute was eventually resolved, it was evident that the rights of the *sukuk* holders were compromised. More importantly, some legal uncertainties relating to the *sukuk* have remained. Among the uncertainties are the effects of Shariah non-compliance on purchase undertakings, the viability of multiple governing laws for different contracts, and the unenforceability of foreign court's decision (Al-Natoor & Brown, 2020; Busari, AbdulAziz, Zakariyah, & Amanullah, 2019; Zada, 2019).⁵ Given these, managing the risks has become another important aspect.

⁵ These were evident in *Dana Gas PJSC v. Dana Gas Sukuk Limited* and reviews of the case (Abdelhady, 2017; Al-Natoor & Brown, 2020; Busari et al., 2019; Convington & Burling LLP, 2017; Dey, Jin, & Eltumi, 2017; Haroon et al., 2019; Parker, 2017; Zada, 2019)

Taking relevant literature into consideration, it was found that these uncertainties form part of the legal risks. Although different terms were employed, the legal risks of *sukuk*, either hypothetical or observed, have been discussed in the literature (Al-Amine, 2012; Ali, 2009; Ali Said & Rihab Grassa, 2013; Djojogugito, 2008a; Jobst, 2008; McMillen, 2007; Mohammad, 2010; Nazar, 2011). In addition, the literature on legal risk management (LRM) of *sukuk* was found to be mainly theoretical (Al-Sayed, 2013; Haider & Azhar, 2010; Najeeb, 2013). Based on the discussion on *sukuk*'s legal risks, some of the literature contained suggested strategies and techniques to manage the risks (Bälz, 2008; Colon, 2011; McMillen, 2007; Oseni & Hassan, 2015; Salah, 2010; Sole, 2008). However, the suggestions were mainly theoretical, and in-depth discussions on how the strategies and techniques can or have been employed were lacking. Only a few studies were based on empirical data, i.e., case studies and interviews (Oseni, 2014; Oseni & Hassan, 2015; Salah, 2010; Sole, 2008).

These studies have highlighted some legal uncertainties around *sukuk* defaults that were perceived as legal risk (Oseni, 2014), legal uncertainties around the enforceability of governing law clauses, lack of post-default safeguards, lack of regulatory framework for *sukuk* (Oseni & Hassan, 2015), legal issues surrounding unsupportive legal environment for the *sukuk* structure (Salah, 2010); and some LRM issues, e.g., dispute resolution management for looming and real *sukuk* defaults, arbitration, and improvement of *sukuk* legal framework of the issuing jurisdiction (Oseni, 2016a; Oseni & Hassan, 2011; Salah, 2010). However, these were insufficient, considering the many types of legal risks mentioned in the literature as well as the different *sukuk* structures involved. Thus, the aim of this study is to provide empirical findings on legal risks and LRM of *sukuk*, with focus given to a particular type of *sukuk*.

The findings of this study will benefit the parties involved in *sukuk* LRM, i.e., the *sukuk* policymakers and the *sukuk* parties. LRM strategies, techniques, and tools identified in this study will be beneficial in improving the existing laws and practices related to *sukuk*, particularly on how *sukuk* documentation can serve as a method of LRM. It is also anticipated that this study will fill the existing gaps in *sukuk* literature, particularly those relating to legal risks and its management.

1.3 STATEMENT OF PROBLEM

In response to the *sukuk* defaults, particularly the Dana Gas *sukuk* default, Goud (2017) and Parker (2017) have highlighted the need for an adequate legal framework and governance of the capital market in ascertaining legal predictability. Similar calls were made when the Garuda Indonesia *sukuk* defaulted on its coupon payment in 2021 (Maulia, 2021). It was recommended that Shariah interpretation and legal documentation be standardized (Ambrose, 2017; Mcaughtry, 2017; Thomson Reuters, 2017). They also accentuated the critical roles played by the central Shariah advisory body (Boans & Loans, 2017), the due diligence working group (DDWG) (Abdelhady, 2017), the Shariah advisors (Busari et al., 2019; Oseni & Hassan, 2015) and the credit rating agencies, e.g., inclusion and quantification of compliance within the ratings accredited (Al-Natoor & Brown, 2020). Meanwhile, other scholars focused their recommendations on the *sukuk* documentation, i.e., due diligence in terms of the structuring, documenting, and reviewing of the *sukuk* documents (Dey, Jin, & Eltumi, 2017; Haroon, Meenai, & R. Rizvi, 2019), the importance of ascertaining the governing law and jurisdiction in case of future disputes (Abdelhady, 2017; Boans & Loans, 2017; Mcaughtry, 2017; Oseni & Hassan, 2015) as well as the use of enhanced warranties and waivers to prevent challenge *sukuk* enforceability on Shariah grounds (Al-Natoor

& Brown, 2020; Thomson Reuters, 2017). These implied that both macro- and micro-level solutions are needed to manage the legal risks. However, most of the recommendations have yet to be examined thoroughly, and empirical findings pursuant to these recommendations still need to be studied.

Legal risks are inherent in *sukuk*. There are at least three underlying reasons for this. Firstly, *sukuks* are innovative products created to give similar economic effects to conventional bonds but which are Shariah compliant (Saeed & Salah, 2014). With this, *sukuk* owes its existence to both the conventional securities laws and Shariah (Al-Sayed, 2013). Incompatibility between the two sets of law is a significant problem for *sukuk* (Nazar, 2011; Oseni & Hassan, 2015), which may trigger legal risks. Secondly, innovations engineered within *sukuk* structures have complicated their legal documentation, also triggering legal risks. This was implied by Arnott (2006). Thirdly, *sukuk* penetration into the global market may herald more legal risks. According to P. R. Wood (2013), legal risks had expanded massively due to a few challenges, such as unmanageable growth of law, intensified regulatory regimes, participation of countries in the international economy, volatility of laws, and diversification in terms of how the countries apply the laws. *Sukuk* is assumed to face these challenges because, among others, the operation of *sukuk* stretches from one jurisdiction to another. For instance, legal risks may arise in the context of the unenforceability of the governing law of choice and foreign judgments (El-Malki & Ryan, 2010; Nazar, 2011; Oseni & Hassan, 2015).

In general, legal risks pose detrimental effects on a contract and the contracting parties. For instance, the immediate effects of legal risks are legal claims and unenforceable contracts (McCormick, 2013). These expose the contracting parties to financial and reputational losses (McCormick, 2009). Additionally, legal risks also pose

threats to the global financial market. Confidence in the market may deteriorate, and legal risks may also cause a ‘domino effect’ that triggers systemic risk (McCormick, 2013). This is the case when a particular legal risk affecting one major player in the financial market may precipitate failures in other institutions. These effects can be anticipated even in the *sukuk* contract, the *sukuk* contracting parties, and the *sukuk* market.

Similar examples can be depicted from the commentary on contemporary applications of *sukuk* by Usmani (2008) (Merzaban, 2009), particularly on the issue of purchase undertaking of an asset at its nominal price (Shamsiah & Nor Fahimah, 2013). The commentary was believed to have partially caused a downturn in *sukuk* issuance and size (Maurer, 2010). Likewise, the Dana Gas *sukuk* default in the UAE exhibited the potential for the reputation of the *sukuk* market to be tarnished when Dana Gas initiated a Shariah non-compliance issue in regards to its USD700 million *mudarabah sukuk* (Dey et al., 2017). Should the *sukuk* holders have rejected the final restructuring which took place in 2017 (Mcaughtry, 2017), and if the court’s decision on the Shariah non-compliance issue had favoured Dana Gas, such a decision may have been damaging for another seven ongoing *mudarabah sukuk* in the country (Sharif, 2017). At this point, it is clear that the effects of legal risks of *sukuk* can be very damaging. Thus, there is a need to study the legal risks inherent in *sukuk*.

The study of legal risks in *sukuk* is more relevant if done upon a specific *sukuk* structure rather than upon the general *sukuk*. How the *sukuk* is structured determines the inherent legal risks. This was made evident in past literature, which asserted that each *sukuk* structure holds a different risk profile (Alswaidan, 2017; Shazly & Tripathy, 2013; Tariq, 2004; Tariq & Dar, 2007). In other words, each *sukuk* structure contains unique legal issues that pose unique legal risks, e.g., ownership of the underlying asset

and parties involved in the *sukuk*. In 2017, *wakalah sukuk* was among the most issued *sukuk* structures in the market (ISRA, 2017a). This trend continued until 2021 when the *wakalah sukuk* remained as the dominant structure that stood at USD 20,420 billion in terms of value and constituted 41% of the international *sukuk* issuance (IIFM, 2022). Thus, a thorough examination of legal risks in *sukuk* based on *wakalah* structure or contract will be carried out in this study.

Although examining legal risks in *sukuk* is inevitable, the more significant matter is how the legal risks are managed. As discussed earlier, the effects of legal risk can damage the *sukuk*. Several claims have been made in past literature on the strength of Malaysia's legal and regulatory framework to promote the development of *the sukuk* market and Malaysia's position in the global market⁶ (Hashim, 2018; Majid, Shahimi, & Abdullah, 2011). Even in cases of *sukuk* defaults or near defaults in Malaysia, these cases were not exaggerated as compared to other near defaults or defaults in other jurisdictions, e.g., Nakheel *sukuk* and Dana Gas *sukuk* of UAE, Investment Dar *sukuk* of Kuwait, Golden Belt 1 *sukuk* of Saudi Arabia, etc.⁷

It was claimed that the defaulters of Malaysian *sukuk* were overwhelmed by the comprehensiveness of the Malaysian legal and regulatory regimes that confer ample protection to both *sukuk* issuers and investors⁸. Nonetheless, these claims have remained inconclusive due to lack of empirical analysis. At the same time, even though past literature on *sukuk* legal risk or legal risk management was quite significant, the

⁶ For the past 10 years up to end of September 2018, Malaysian *sukuks* were able to produce decent absolute returns with evidently low volatility (Hashim, 2018, p.4).

⁷ In 2009, there were 21 Malaysian *sukuk* defaults (Khniifer, 2010). Nevertheless, the defaults were not accentuated. Normally, when a *sukuk* nearly defaults or defaults, there would be numerous legal issues raised. These are all the materialized legal risks. For instance, the enforceability of choice of law, Shariah compliance of the *sukuk* contract, etc. Nonetheless, it was claimed that tight regulations and laws that bind the *sukuk* market have subdued the defaults (Ab. Majid, Hafizi, Shahimi, Shahida, Abdullah, 2011, p.17).

⁸ <https://www.thestar.com.my/business/business-news/2009/10/03/sukuk-investors-position-amid-defaults>. Retrieved on 23rd August 2019.

approach taken was mainly theoretical (Abdul Khaleq et al., 2007; Al-sayed, 2013; Balz, 2012; Colon, 2011; Haider & Azhar, 2010; M. K. Hassan & Oseni, 2014; McMillen, 2007; Naim, 2013; Najeeb, 2013) or at best, based on selected case studies and interviews (Oseni, 2014; Oseni & Hassan, 2015; Salah, 2010; Sole, 2008). Therefore, there is still a pressing need to empirically assess the legal risks and the risk management of *sukuk*.

1.4 RESEARCH OBJECTIVES

With the above discussion in mind, the objectives of this research are:

1. To identify legal risks of *wakalah sukuk* in Malaysia;
2. To determine the management of legal risks of *wakalah sukuk* in Malaysia;
and
3. To propose the best practice in managing legal risks of *wakalah sukuk* in Malaysia.

1.5 RESEARCH QUESTIONS

Q1: What are the legal risks of *wakalah sukuk* in Malaysia?

- a. What is a legal risk?
- b. What are the legal risks of *wakalah sukuk* in Malaysia?

Q2: How are the legal risks of *wakalah sukuk* in Malaysia managed?

- a. What are the strategies employed to manage the legal risks of *wakalah sukuk* in Malaysia?
- b. What are the techniques employed to manage the legal risks of *wakalah sukuk* in Malaysia?

- c. What are the tools employed, if any, to manage the legal risks of *wakalah sukuk* in Malaysia?

Q3: How can the management of legal risks of *wakalah sukuk* in Malaysia be improved?

- a. What are the gaps in the management of legal risks of *wakalah sukuk* in Malaysia?
- b. How can the management of legal risks of *wakalah sukuk* in Malaysia be improved?

1.6 SCOPE OF THE STUDY

This study seeks to determine the legal risks and the LRM of *wakalah sukuk* in Malaysia. Although legal risks in *sukuk* may be subjective, depending on the different types of *sukuk* structures and the jurisdictions in which they are issued, the scope of this study is confined to *wakalah sukuk* structures in the Malaysian jurisdiction. This is to enable an in-depth analysis of specific legal risks in *wakalah sukuk* contracts. It also supplements the existing literature that lacks studies on *sukuk* legal risks that focus on specific *sukuk* structures and how to manage them. The selection of *wakalah sukuk* structure is based on two reasons:

- 1) *Wakalah sukuk*, i.e., *wakalah bil al-istithmar sukuk*, has been among the structures preferred by the *sukuk* issuers in Malaysia since 2015 (IIFM, 2022). Considering this, the findings of this study with a focus on *wakalah sukuk* would benefit the *sukuk* players.
- 2) The unique characteristics of *wakalah sukuk* structure:
 - a. Unlike other *sukuk* structures, the *sukuk* issuer and *sukuk* investors are of agent-principal relationship which entails contractual and fiduciary

duties between them. Considering this, legal risks arising from this type of *sukuk* can be extensive and require more attention.

- b. *Wakalah sukuk* embeds purchase undertakings in its structure. As seen in the literature (Busari et al., 2019; Lahasna & Lin, 2012; Salah, 2010), purchase undertakings have been a significant issue of *sukuk* disputes, particularly for *sukuk* that have defaulted. Thus, it is imperative to identify legal risks associated with the purchase undertakings and determine the management of such risks.

In this study, the LRM of *sukuk* covers the aspects of risk management strategies, techniques, and tools. LRM strategies consist of all long-term plans, and LRM techniques are specific skills employed to manage the risks. The techniques form part of an immediate response to legal risks. These strategies and techniques are compiled from interviews and document analysis. It does not cover a broader dimension of risk management, e.g., operational risk management approaches, and in-depth analysis of specific risk analysis tools.

CHAPTER TWO

AN OVERVIEW OF LEGAL ISSUES IN SUKUK

2.1 INTRODUCTION

This chapter serves as a general review of literature on *sukuk*, *wakalah sukuk* and legal issues in *suku*. It is divided into four subtopics. It begins with reviews of *sukuk*, *wakalah sukuk* and subsequently, reviews on the legal issues in Islamic finance and *sukuk*.

2.2 LITERATURE REVIEW

2.2.1 Sukuk

The Islamic capital market has emerged as a promising avenue for corporate entities and the government to obtain alternative financial funding. One of the main markets in the Islamic capital market is the *sukuk* market. The total global issuance of *sukuk* in 2022 amounted to USD 182.715 billion has confirmed its leading position as the key financing instrument (IIFM, 2023). It was also noted in the report that the total value of Malaysian market contribution in the domestic *sukuk* issuances alone amounted to USD 67.20 billion, followed by Saudi Arabia with USD38.2 billion and Indonesia, USD 18.18 billion.

Sukuks are certificates produced from the process of securitization. Securitization itself can be understood as a process of transforming illiquid asset into liquidated form. The objective of the securitization process is to add more value to the illiquid asset so that they will become more favorable to the investors in terms of cash flow and risk segmentation (Engku Ali, 2007). To define *sukuk* in the modern financial

context, one has to depart from its original context as applied at the time of *Muawiyah*, where *sukuk* was the term used to represent access to food like a coupon, but with the coupon being tradable (Rohim, 2013).

In modern times, *sak*⁹ was described as a commercial note or financial certificate to represent ownership of a project or investment, structured to embed Islamic elements into the frame of established conventional bonds (Ayub, 2007). Superficially, they may be the same, but from the aspect of their underlying basis and behaviors, they are distinguished from each other (Cakir & Raei, 2007). The Accounting and Auditing Organization for Islamic Financial Institutions (AAIOFI) in Shariah Standard No. 17 defined *sukuk* as:

“certificates of equal value representing undivided shares in ownership of tangible assets, usufruct and services or (in the ownership of) the assets of particular projects or special investment activity.”

This definition is, however, confined to investment *sukuk*. It also allows for a combination of tangible asset and intangible asset as the *sukuk* underlying asset (ISRA, 2017). In the IFSB Guidelines, Standard IFSB-7 on Capital Adequacy Requirements for *Sukuk*, Securitisations and Real Estate Investment (2009), *sukuk* is defined as:

“certificates with each *sakk* representing a proportional undivided ownership right in tangible assets, or a pool of predominantly tangible assets, or a business venture (such as a *mudārabah*). These assets may be in a specific project or investment activity in accordance with Sharī`ah rules and principles.”

On the other hand, the SC offers another definition of *sukuk*. *Sukuk* is defined as:

⁹ *Sak*, also spelt as *sakk*, is the singular form for *sukuk*.

“certificates of equal value which evidence undivided ownership or investment in the assets using Shariah principles and concepts endorsed by the Shariah Advisory Council.”

This definition is broader than the previous definitions and it focuses on the role of the Shariah Advisory Council to endorse the permissibility of the *sukuk*.

There has been a lot of innovation applied to *sukuk* structures, e.g., innovation to permit the combination of tangible and intangible assets as *sukuk* underlying assets, financial assets such as receivables and debts from Shariah-compliant activities to constitute *sukuk* underlying assets and to allow trading of *sukuk* that are 100% receivables at par. These have caused the definition of *sukuk* to become more complex. Thus, another definition was offered to include various combinations of asset as the *sukuk* underlying asset (ISRA, 2015). The definition of *sukuk* is:

“any certificate evidencing an undivided ownership right or interest, wholly or partially, in a Shariah-compliant tangible asset, intangible asset, usufruct, commodity or business as a going concern or a participation right in any Shariah-compliant profit-sharing venture, or a Shariah-compliant financial asset or any combination thereof through a mixed portfolio of various assets, provided that the financial asset portion of the mixed portfolio of assets should not be exchanged except at par value”.

Sukuk can be classified into a few categories, i.e., asset-backed *sukuk*, asset-based *sukuk*, blended asset *sukuk*, and asset-light *sukuk*. Other than these, other categories underscored in the literature are debt-based *sukuk* and project-based *sukuk* (Rainey & Salah, 2011). The asset-backed *sukuk* involve the true sale or transfer of assets. In this structure, the investors are secured with an underlying asset. The secured asset will be liquidated, and the proceeds will be used to pay the investors in the event of default, if the issuer becomes insolvent (Adam & Thomas, 2004). However, there are a few challenges faced by the *sukuk* issuer in issuing this *sukuk*. The challenges include

the lack of suitable asset to back the *sukuk*, the insufficiency of the asset or encumbered asset, and taxation burden on the transfer of the asset (Haneef, 2009).

In 2002, the asset-based *sukuk* structure emerged. For Malaysia, the emergence was pursuant to the effect of negative pledge on the Government's proposed RM600 million asset-backed *sukuk* in 2002. The negative pledge has restrained the issuer from issuing any bonds/*sukuk* in the future that are not in *pari passu* with the existing unsecured bonds/*sukuk* (Haneef, 2009). In response to this, the issuer revised the *sukuk* structure that resulted in the holding of only beneficial ownership of the underlying assets (Haneef, 2009). Hence, the concepts of beneficial ownership and *sukuk* trustee have been recognized (Haneef, 2009). In asset-based *sukuk*, most challenges prevalent in asset-backed *sukuk* have been reduced. Nevertheless, other challenges have arisen, mostly originating from the underlying asset. This is because the transfer of beneficial ownership is not considered a true sale transaction (Hidayat, 2013). Although Shariah approves the concept of beneficial ownership, there are some problems from the perspective of the operation of *sukuk* where the investors do not have any interest in the underlying asset. In this *sukuk* structure, the investors are merely creditors. Thus, the transfer of the underlying asset to the investors will not be perfected (Dusuki & Mokhtar, 2010).

For blended-asset *sukuk*, a mixture of physical asset and receivables are used as the *sukuk* underlying asset. A pool of commingled assets under the concept of *khultah* has been leniently utilized by the Islamic Development Bank (IDB) in 2003 to back the IDB *sukuk*. In 2005, *sukuk al-Musharakah* was issued by the Dubai Metals and Commodity Exchange *Sukuk* (DMCE) where another category of *sukuk* was born into the market. Since there were some newly expanding corporates that were unable to meet

the asset requirement, i.e., the physical asset or the receivables, this structure was likely preferable (Haneef, 2009).

Ghuri (2012) added on to this by classifying the *sukuk* into three categories, namely project-specific *sukuk*, asset-specific *sukuk*, and balance sheet-specific *sukuk*. Project-specific *sukuk* is issued to raise funds through a specific project, e.g., Qatar global *sukuk* to finance the construction of Hamad Medical City, while asset-specific *sukuks* are issued to mobilize resources by offering beneficial rights to the future investors. Meanwhile, balance sheet-specific *sukuk* is issued for balance sheet settlement, e.g., in the case of IDB in 2003.

Another category of *sukuk* is Sustainable and Responsible (SRI) *sukuk*. In the BNM SRI *Sukuk* Framework issued in 2014 and revised in 2019, *green sukuk* (GS) was identified as a type of SRI *sukuk*. SRI *sukuk* can be distinguished from other categories of *sukuk* as the *sukuk* proceeds in this case are used to exclusively fund any activities or transactions relating to the eligible SRI projects. There are 17 SRI projects outlined in the Framework and only 10 SRI projects are identified as green projects, *vis-à-vis* green *sukuk*. These include renewable energy, energy efficiency, and climate change adaptation, among others. These projects are aligned with the 17 SDGs set by the United Nations (UN). Malaysia has pioneered the issuance of green *sukuk* as early as 2017 (F. H. M. Liu & Lai, 2021; A. Rahman et al., 2023). Until 2020, the value of the *sukuk* amounted to approximately RM6 billion and they were distributed mainly among the renewable energy sector and real estate development program (A. Rahman et al., 2023). Being new, SRI and green *sukuk* are susceptible to various issues, e.g., ill-alignment with the 17 SDGs (A. Rahman et al., 2023), the lack of retail investors (Delle Foglie & Keshminder, 2022), greenwashing (Ulfah, Sukmana, & Laila, 2023), and ambiguous

compliance standards including unstandardized interpretations of ‘Shariah’ and ‘green’ in the *sukuk* (Delle Foglie & Keshminder, 2022; F. H. M. Liu & Lai, 2021).

Nasir, Farooq, Khan, and Khan (2022) conducted a segmented bibliometric analysis of *sukuk* literature based on *sukuk* structures. They found 89 that fit their sampling characteristics, i.e., literature discussing the *sukuk* based on the structures. They documented several structures that were least discussed in the literature, e.g., *salam* and *istisna’* *sukuk*. As much as the structures of *sukuk* have been discussed in previous studies, only a few elaborated on the significance of the structures and the implications (Rainey & Salah, 2011). In fact, the structures chosen can have some implications from the legal aspects, thus creating legal risks. The significant shift from asset-backed *sukuk* to asset-based *sukuk* can serve as an example (Dusuki & Mokhtar, 2010). The shift was to eliminate certain risks related to the laws governing foreign ownership of certain local asset. As underscored by Dusuki and Mokhtar (2010), the legal challenge was prevalent in asset-backed *sukuk*, particularly when issued in Gulf Cooperation Council (GCC) countries. In those countries, *sukuk*-related laws were yet to be developed. In addition, the shift also occurred due to the reality of investors in the market who were more interested in taking up the originator’s credit risk instead of the underlying asset risk (Dusuki & Mokhtar, 2010).

As *sukuk* issuances have become rampant, so have the *sukuk* structures. These structures were tailored to ensure that the demands of contracting parties are fulfilled as well as to ensure the Shariah compliance of the *sukuk*. Among the structures used in the market are *Mudarabah*, *Musyarakah*, *Ijarah*, *Istisna’*, *Salam*, *Wakalah* and hybrid type (IIFM, 2023). Further analysis on these structures is crucial because different *sukuk* structures may also hold different levels of profit rate (Abdul Jalil, 2012) and risk allocation (Maurer, 2010; Ab. Majid, 2011; A. Elhaj, 2015).

However, *sukuk* is still a newly emerging and preferred topic of research. The first detailed study on *sukuk* can be found in the classical *fiqh*, as analyzed by Engku Ali (2007). Tariq (2004) is another exemplary work on the structures as well as risks embedded in *sukuk*. Wilson (2008) later wrote at length on the innovative structures of *sukuk* when he elucidated on *murabahah*, *ijarah*, and the novel structure of *musyarakah sukuk*. Since then, studies on *sukuk* have been in wide-ranged topics, both qualitatively (Kordvani, 2009; Ab. Majid, 2011; Zakaria, 2012) and quantitatively (Ahmad, 2012; Azmat, 2013; Shafi, 2013; A. Elhaj, 2015). While some studies have explored the legal issues of *sukuk* (Djojosingito, 2008; Kordvani, 2009, Azahari, 2013; Grasa, 2014) not much focus was given to legal risks.

Zulhibri (2015) scrutinized the nature of prevalent studies on *sukuk* and concluded that past literature focused largely on qualitative approached studies, e.g., descriptive analysis of *sukuk* structures, Shariah compliance issues, and *sukuk* issuances. According to him, the underdeveloped research on *sukuk* compared to conventional bonds may be due to lack of accessible historical, consistent, and reliable data. Among the recommended fields to research on *sukuk*, according to him, are the corporate financial aspects and real economic effects of *sukuk*.

In the recent trends of bibliometric analysis, a few significant aspects of *sukuk* in the existing literature have been identified. Among them are: 1) *sukuk* growth and development; 2) *sukuk* and finance theories; and, 3) *sukuk* and stock market behavior (Paltinieri et al., 2023). In the field of SRI *sukuk*, M. Rahman, Isa, Tu, Sarker, and Masud (2020) identified three clusters of literature, and they are: 1) the distinctive features of SRI *sukuk*; 2) comparison between SRI and traditional *sukuk*; and 3) determinants of SRI *sukuk*. In another study, segmented bibliometrics revealed that there is a higher number of literature on *murabahah sukuk* compared to other structures,

and the least were *musyarakah sukuk*, *salam sukuk*, and *istisna' sukuk* (Nasir et al., 2022).

2.2.2 Wakalah Sukuk

According to IIFM (2020), *wakalah sukuk* has been the preferred structure since 2015. This was also evident in the more recent report issued by IIFM (2022). This *sukuk* structure stems from the original contract of *wakalah*, i.e., an arrangement contract. In 2019, the value of *wakalah sukuk* stood at USD 21.757 billion (56%) of the total international issuances. In practice, this *wakalah sukuk* structure employs *ijarah* and *murabahah* contracts (IIFM, 2022). In Malaysia, it was found that the *wakalah sukuk* structure generally employs *wakalah* and Commodity *murabahah* contracts as found in the list of *wakalah sukuk* issued through the SC website.

Similar to *ijarah*, this structure is preferred because it offers returns that mimic the returns of conventional bonds (ISRA Islamic Commercial Law Report, 2017). It was reported that the outlook for this structure is bright due to the Islamic financial institutions' need to comply with the Basel III requirements which can be met by using *wakalah* as the underlying contract (Thomson Reuters, 2016). This is because, under the *wakalah sukuk* structure, the underlying asset can be a pool of assets. The pool may consist of a mixture of tangible and intangible assets, shares, and receivables. Hence, this provides more flexibility (IIFM, 2022). This kind of underlying asset may allow the banks to convert the *sukuk* into common equity¹⁰.

¹⁰ According to Basel III, the financial institutions are required to hold higher quality capital and higher level of liquidity. According to IFSB-15, Revised Capital Adequacy Standard for Institutions Offering Islamic Financial Services (Excluding Islamic Insurance (*Takaful*) Institutions and Islamic Collective Investment Scheme, December 2013, Rule No. 28 and 29, *wakalah sukuk*, among others, can be used by the Islamic Financial Institutions to constitute their T2 Capital in order to fulfil the requirements set out in Basel III. The *wakalah sukuk* which are convertible to common equity can be utilized to absorb losses if the financial institutions become insolvent.

Other than that, the popularity of *wakalah sukuk* in Malaysia and among the GCC countries is also due to its tradability in the secondary market (Thomson Reuters, 2016). In the Malaysian context, this structure is preferred due to the tax reduction imposed by the Government (Islamic Commercial Law Report, 2017). This preference, however, changed in 2017. It was reported that the *wakalah sukuk* is preferred by the GCC countries, while Malaysia has shown a preference for *murabahah sukuk*. Nevertheless, due to the international market demand, Malaysia still adopted the *wakalah sukuk* structure for its sovereign *sukuk* to allow international investors of other Shariah opinions to participate (IFSB, 2017).

In the case of *wakalah bi al-istithmar sukuk*, it was preferred by both investors and issuers of *wakalah sukuk* due to the profit and fee being agreed upfront (ISRA, 2017). As a result, both the investors and the issuer would be able to avoid future disputes on the returns. If the *sukuk* defaults, both the investors and the issuer would already know the amount due to them. In the Guidelines on Issuance of Private Debt Securities and Sukuk to Retail Investors (Retail PDS and *Sukuk* Guidelines), *Wakalah bi al-istithmar sukuk* was defined as “certificates of equal value evidencing the certificate holder’s undivided ownership in the investment assets pursuant to their investment through the investment agent”. In November 2017, this Guidelines was renamed Guidelines on Issuance of Corporate Bonds and *Sukuk* to Retail Investors (CBSR 2017). As of 2022, it was reported that *wakalah sukuk* constituted a dominant percentage of global short-term *sukuk* issuance at 29% in the year 2021 and 51% of the global fixed rate *sukuk* issuance in the year 2020 (IIFM, 2022).

CHART 2F (C): GLOBAL SHORT TERM SUKUK ISSUANCES ≤ 12 MONTHS, STRUCTURE BREAK-UP FOR THE YEAR 2021, AMOUNT IN USD MILLIONS

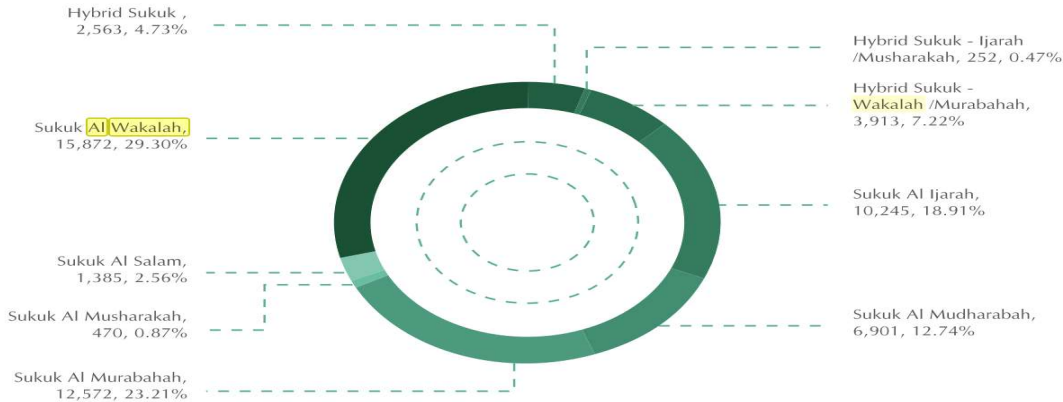


Figure 2.1 Short-term Sukuk Issuances by Sukuk Structures (Source: IIFM, 2022)

INTERNATIONAL SUKUK ISSUANCES FOR THE YEAR 2020

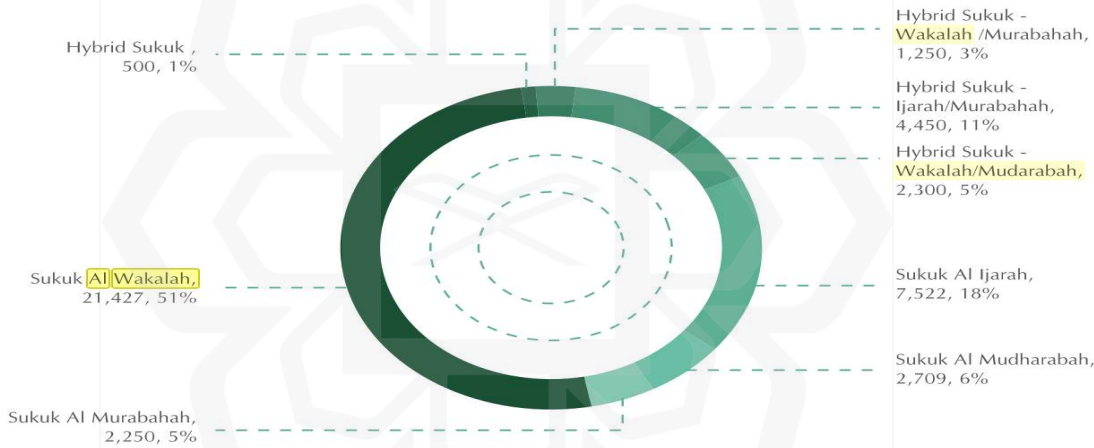


Figure 2.2 International Sukuk Issuances by Sukuk Structures (Source: IIFM, 2022)

The following diagram illustrates the operation of *wakalah bi al-istithmar sukuk*:

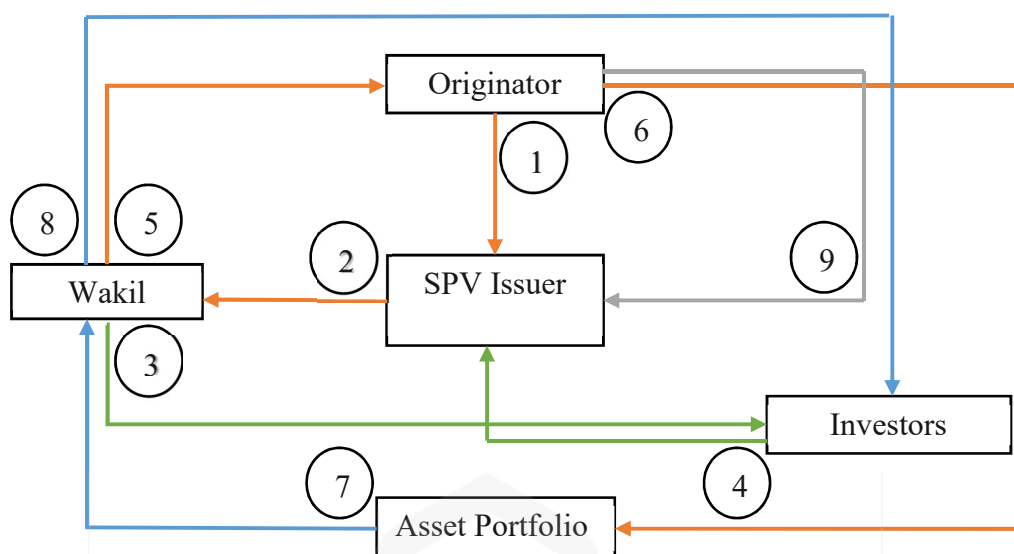


Figure 2.3 Operation of Wakalah Sukuk (Source: www.islamicbanker.com)

In this flow diagram, the originator will create an SPV (1). Subsequently, the SPV issuer will appoint a *wakil* (2). In the *wakalah* contract, the *wakil* will be appointed to act on behalf of the investors. The *sukuk* certificates will be issued by the *wakil* to the investors (3), and the investors will produce the *sukuk* proceeds to the SPV issuer (4). Later, the *wakil* will appoint the originator as the sub-*wakil* (5) who will be responsible to manage the asset portfolio (6). Profits generated from the portfolio will be channeled to the *wakil* (7), and the *wakil* will make the periodic distribution to the investors (8). Sale and purchase undertaking will be made by both the originator and the SPV issuer (9).

2.2.3 Legal Issues in Islamic Finance

Some legal issues in *sukuk* are related to the legal issues prevalent in Islamic finance. In Islamic finance, legal issues have been discussed in at least two aspects, i.e., legal issues relating to the law and legal issues relating to documentation/ contract. In the first

aspect, legal issues in Islamic finance were discussed in relation to the law. In Djojosingito (2008), the legal issues were referred to 'legal risks'. Although the legal risk was not defined, the risk was claimed to stem from four aspects, i.e., (1) uncertainty in laws; (2) legality of Islamic financial instruments; (3) legal capacity of parties to enter into a contract; and (4) contradiction between Shariah and post-colonial law regimes, i.e., common law regime or civil law regime. The fourth aspect was empirically researched by Grassa (2014), who found significant differences between countries adopting pure Shariah law, mixed Common-Shariah law, and mixed Civil-Shariah law and the development of their Islamic financial systems.

The second aspect deals with legal issues that are linked to documentation and contractual elements. It was explained in the literature that legal issues in Islamic financial transactions can be attributed to the complexity of documentation involved in Islamic finance, innovative product crafting, poor drafting on the part of document drafters, and lack of Shariah sensitivity when executing the documents (Abdullah & Hakimah, 2012). Legal issues also link to the enforceability of choice of governing law in a contract (Abdullah & Hakimah, 2012; Al-Amine, 2012; Colon, 2011; Junius, 2007; McMillen, 2007) and unenforceability of Islamic financial documents (Fiennes, 2012) or instruments (Djojosingito, 2008). Regarding the enforceability of choice of governing law, a few studies were reviewed.

With regards to the choice of governing law by the parties, there have been some significant insights on non-*sukuk* cases. The approach preferred by the UK courts can be seen in the case of *Shamil Bank of Bahrain v Beximco Pharmaceuticals Ltd* [2004] EWCA Civ 19. In this case, the parties have chosen a combination of Shariah law and English law as the governing law for their contracts. However, the governing law of choice was rejected by the UK court. The court ruled that the chosen governing law

must be a law of a country and not a non-national one, like the Shariah (Colon, 2011; McMillen, 2007). In the MENA (North Africa and the Middle East) region, choice-of-court agreements conferring jurisdiction on foreign courts are often disregarded or declared null and void (Elbaiti, 2024). Some instances are in the case of No. 2/13276/2023/02 of 17 January 2024 (Bahrain) where the court has rejected the use of the choice of law which confers exclusive jurisdiction on the English courts over actions brought against Bahraini nationals (Elbaiti, 2024). Mills & Abdel-nabi (2012) made the same conclusion that the local courts in Gulf Cooperation Council (GCC) countries were reluctant to apply the choice of governing law that is a foreign law.

These were in contrast with the position taken by the US courts, as pointed out in the *National Group for Communication & Computers v Lucent Technologies International* 331 F. Supp. 2d 290, 292 (D.N.J 2004). In this case, the parties agreed to follow Saudi Arabian laws in the respective contract. When the issue of expectation damages arises, the court acted upon the precepts of Shariah on the issue of ambiguity (*gharar*) and decided in favor of the defendant. As opined by Colon (2011), ‘having two sets of law governing a contract’ as claimed by the UK court in the case of *Shamil Bank of Bahrain v Beximco Pharmaceuticals Ltd* [2004] EWCA Civ 19, was spurious and hasty. Thus, he proposed a concept of combined-laws contract where instead of purporting Shariah as the second choice of law¹¹, it should be directed as a combined or cumulative law by making the state law subject to Shariah. In other words, disputes on the contract may be governed by the state law, but in case of any conflict between Shariah and the state law, the former shall prevail (Colon, 2011). In addition, Colon (2011) also concluded that the choice of law in a Shariah-based contract may fall into

¹¹ As stated as “subject to the principles of Glorious Sharia, this agreement shall be governed by and construed in accordance with the laws of England” (Colon, 2011)

one of these circumstances: (1) the combined law clause may run afoul with the laws of the country; (2) the choice of Shariah law may be deemed as a non-national law; (3) English law is the most popular choice of law superseding Shariah; or (4) all the laws of choice are deemed permissible in the first instance until it contravenes Shariah.

Junius (2007) reviewed the same issue from the perspective of German law. He concluded that the choice of Islamic law as the governing law by the contracting parties will not be possible according to the German international private law (*internationales Privatrecht*), which is codified in the second chapter of the *EinJhrungsgesetz zum Bbirgerlichen GesetZbuch* (EGBGB) (hereafter referred to the Code), under two situations: (1) Islamic law will not be a valid choice of law because it is not a state law as required by the Code; (2) application of both Islamic law and German law in one contract will not be enforceable since the Code prohibits it. However, there may be a possibility of limited application of Islamic law by making reference to specific and determined rules and regulations into the agreement (Junius, 2007). These insights are very beneficial and will be made relevant in a later discussion on the enforceability of choice of governing law in *sukuk* contracts or cases, where applicable.

In sum, these two aspects of legal issues, as found in the literature on Islamic finance, have shown that they can be linked to the law and the documentation/contract. In addition, it was also found that the legal issues were linked to contract handling, i.e., poor drafting of the contract and lack of Shariah sensitivity when executing the documents (Abdullah & Hakimah, 2012). This was discussed in length from the perspective of choice of law or contract governing law.

2.2.4 Legal Issues in Sukuk

Review of past literature on legal issues in *sukuk* has shown that the terms used were ‘legal issues’ or ‘legal challenges’. Only a few of the literature employed the term ‘legal risks’ (Nazar, 2011). For the purpose of this literature review, the term ‘legal issues’ will be used.

2.2.4.1 Legal Issues Associated with Regulatory Framework/ Legal System/ Jurisdiction

Legal issues in *sukuk* are commonly associated with the regulatory framework¹². *Sukuk*, being an investment, gives rise to regulatory or legal risks. The risks arise when the involved parties’ rights and obligations are not enforceable, or become void due to the regulatory framework, either the investors refuse to assume or the law forbids the investors’ requirement¹³ (Ali, 2009). The regulatory issues associated with *sukuk* were confined to issues of enforceability of the *sukuk*¹⁴ (Nazar, 2011). Al-Amine (2012) further elaborated on legal issues in relation to enforcement and jurisdiction law, the non-recognition of judicial precedents in most countries that may create legal

¹² Regulatory framework is a general term to indicate a set of rules, processes, and relevant bodies that describe a marketplace within which an industry operates. The function of ascertaining a regulatory framework is to ensure certainty of the outcomes of the operation and acts as protection mechanism for the players (Jobst, 2008). As for *sukuk*, there are at least three authorities monitoring the market in Malaysia, and they are Bank of Malaysia and Bursa Malaysia, together with Labuan Offshore, and the Securities Commission (SC). Thus, various legislations and regulations are involved. Among the key legislations, which work side by side with the conventional bonds, are Capital Market and Services Act 2007, Securities Commission Act 1993, Islamic Financial Services Act 2013 and guidelines, such as Guidelines on the Offering of Islamic Securities, Guidelines on the Offering of Asset-Backed Securities, and Guidelines on the Offering of Structures Products.

¹³ Apart from that, legal risk arising from the regulatory framework was also considered to fall partly under country risk. Country risk is considered as risks due to the legal provisions and the regulatory problems of a country (D. Sanrego, Antonio & Wahyuningsih, 2013). Still, the use of this category will render legal risk to be too broad since country risk may also imply foreign currency risk, political risk, etc.

¹⁴ He pinpointed issues of conflict between two or more legal systems, the transfer of asset (true sale execution), the special purpose vehicle (SPV), and the bankruptcy laws. Although the study mixed up between the normal *sukuk* and project financing *sukuk*, it has given some insights on the legal risks in *sukuk*.

uncertainties, the inapplicability of trust law in a law regime, the unsupportive legal infrastructure, and legal risks in the law relating to ownership and taxation. He discussed changes in local laws that could severely impact the issuer's ability to make payment under *sukuk*. Other than that, there were issues of non-recognition of English court judgments in the local laws of issuing countries such as Dubai, non-recognition of trust law such as in UAE country, and rejection by a local court of the governing law chosen by the parties in a contract. These are among the situations or areas of uncertainty where legal risks may arise.

As indicated earlier, one important feature of legal risk is its distinct characteristics based on legal jurisdiction (McCormick, 2013). For instance, Islamic finance documents may be subject to legal issues since they are not well-tested in the English courts (Fiennes, 2007). Similar points were echoed by McMillen in relation to *sukuk* (2007). According to McMillen, among the primary matters to give effect to and realize the benefits of securitization for *sukuk*, is to examine the general structure of the legal system. He pointed out that the legal system would impact the enforceability of the contract. He said:

“As a systemic matter, a primary issue for the transactional participants (and for obtaining ratings from major international rating agencies) is whether and to what extent an agreement among the transactional participants will be enforced. That, in turn, is dependent upon other structural elements of the legal system, including: (a) whether the relevant legal system is based upon a system of binding precedents; (b) whether legal and arbitral decisions-and the rationale for those decisions-are published and widely available; (c) whether the judicial structure is responsive to continuity, consistency, and transparency in the application of judicial precedents; and (d) the time frame for enforcement of remedies within the system.”

It was claimed that similar legal issues will arise on the issue of unenforceability of a contract due to conflict between the laws of a country and Shariah principles. This

was evident in the prominent cases *Shamil Bank of Bahrain v Beximco Pharmaceuticals Ltd* [2004] EWCA Civ 19 and *The Investment Dar Co. KSCC v Blom Developments Bank SAL* [2009] EWCH 3545.

Theoretically, *sukuk* issuance in a common law regime may not face insurmountable problems since it was originally adapted from the conventional system for investors to latch on and adaptation of English law is already embedded in the jurisdiction. In contrast, the civil law jurisdiction and other jurisdictions such as the Middle East and GCC countries may face severe problems (R. Ali, 2009). Al-Amine (2012) contended that Middle East and GCC countries, e.g. Kuwait, Bahrain and Dubai, are among the jurisdictions where legal uncertainty is more significant due to, among others, the inaccessibility of law and the non-application of principles from binding precedents. With this, decisions of past cases may not necessarily be followed by future judges, rendering the judicial reasoning unpredictable. This again gives rise to legal risks, as indicated earlier (Arnott, 2004; Pigott, 2004).

In addition to these, Abdulkareem & Mahmud (2024) have discussed the impact of legal system on the ownership of asset-based *sukuk* underlying asset. In general, the underlying asset must be owned by the investors before any transaction can be made. Nonetheless, when the assets are public property, government's asset or Malay reserve land, the ownership cannot be fully transferred to the investors. In common law regime, the court recognizes legal and beneficial ownerships. Thus, beneficial ownership of the assets by the investors in the regime does not pose legal issues. In contrast, in the civil law regime, in Middle East countries other than Saudi Arabia and Oman, the ownership of the asset are not differentiated between legal and beneficial (Abdulkareem, Sadad, Elsayed, Elbishr, & Hassan, 2022).

The legal issues in *sukuk* that are associated with regulatory framework have been studied either comparatively or based on individual jurisdiction. For example, Ahmad (2015) presented a comparison of *sukuk* legal infrastructures in Indonesia, Malaysia, United Kingdom, United States of America, Kuwait, Turkey, and UAE countries. The legal systems of Bahrain, Kuwait, and Dubai in relation to default *sukuk* cases were also studied comparatively by Al-Amine (2012). The impact of the regulatory framework in UAE and Saudi Arabia on *sukuk* default cases were studied by Zaheer and Wijnbergen (2013).

In a study by Ghezal, Hassan, & Lahsasna (2022), the legal and regulatory frameworks governing *sukuk* issuances in Malaysia, Indonesia and United Kingdom (UK) have been analysed. They noted, among others, that the regulatory framework applied in the UK does not require pre-requisite approval from Shariah adviser. The establishment of Shariah supervisory board to oversee the *sukuk* issuance is also not required. As a result, the *sukuk* investors are left to decide the *sukuk* compliance on their own (Balibek, 2017). In view of these, Ghezal et al. (2022) noted from commentaries on the UK legislative framework for the regulation of alternative finance investment bonds (*Sukuk*), that Shariah risk may arise due to the evolving nature of Islamic transactions which need disclaimers of appropriate clauses into contractual documentations of *sukuk* issuance.

Regulatory risk in an individual country was also studied by Sole (2008) when he analyzed Kuwait's legal disincentives for foreign investors in terms of tax implications and extra legal requirements. Salah (2010), who studied the default of Nakheel *sukuk*, also focused on the UAE laws instead of the *sukuk* structure. The legal implications discussed were the rights of mortgage or security rights, where the rights perfection is subject to registration with the Dubai Land department, the enforceability

of foreign judgments in the UAE (where the UAE courts have jurisdiction on the said matters and non-recognition of parties' choices of law, i.e., English law) and the issue of sovereign immunity. To complicate the situation, cross border default and insolvency also trigger more legal issues. This includes, among others, access to the underlying asset in foreign locality, the priority of sukuk holders over other creditors, and the recognition as well as enforceability of pledges, mortgages, or security (Chew, 2010).

Similarly, some legal issues in *sukuk* were discussed from the perspective of defaulted or nearly defaulted *sukuk*. Default of *sukuk* can theoretically be predicted through certain indicators, such as ratings, financial ratios (particularly liquidity and leverage ratios), firm size, and board size, among others (Osmanzadah, 2015). Although the relevant credit rating agencies place emphasis on the originator's creditworthiness to fulfil the financial obligations prescribed and the credit quality of the underlying asset (Chew, 2010), these do not exempt the *sukuk* from exposure to multilevel legal issues, particularly the enforceability of contract, trust, and even the applicability of insolvency law. However, studies on *sukuk* defaults have associated the defaults with the law. For instance, Ab Majid, Shahimi and Abdullah (2011) who studied Malaysian *sukuk* defaulters descriptively admitted that strict regulations in Malaysia is among the factors of less media attention being made on the defaulters. Zaheer and Wijnbergen (2013) who studied international *sukuk* defaults also highlighted the issue of governing laws for similar contracts in *sukuk* due to the different legal systems in default cases. These imply that legal risk arising from defaults is also subject to the legal system or jurisdiction.

Another example of default case highlighted in the study (Zaheer and Wijnbergen, 2013) is the Golden Belt (Saad) *Ijarah Sukuk* which was adjudicated in Saudi Arabia. According to them at the time when the proceedings were still ongoing,

the default of the *sukuk* may not secure the investors' position as they may have limited recourse on the originator's assets since most of the underlying assets are located in Saudi Arabia, a jurisdiction that has no recognition of trust law or any English court decision.

Another legal issue in *sukuk* that is associated with regulatory framework is the enforceability of foreign judgments. The operation of *sukuk* that stretch from one jurisdiction to another may give rise to this (El-Malki & Ryan, 2010; Nazar, 2011; Oseni & Hassan, 2015). This issue was also highlighted in the case of *Nakheel sukuk* should the *sukuk* was not bailed out by the UAE government. Although most *sukuk* is governed by English law due to its established position (Alexander, 2011; Bälz, 2008; Colon, 2011; Graham, 2011; McMillen, 2007; U. Oseni & Hassan, 2015; Salah, 2010), some issues prevail. For instance, the practicality of the use of other laws as a separate governing law for different contracts (Abdul Khaleq, Richardson, & F., 2007; Colon, 2011), the inapplicability of English law in some jurisdictions (Oseni & Hassan, 2015; Salah, 2010), parties bringing *sukuk* cases to jurisdictions other than the English court (Oseni & Hassan, 2015), and lack of reciprocity in the enforcement of foreign jurisdictions (al-Amine, 2012; Colon, 2011; Graham, 2011; Oseni & Hassan, 2015). These incompatibility-related issues yield uncertainties in the outcome of *sukuk* cases, especially *sukuk* that opted for local laws and intended to serve as litmus test for other laws aside from English law (Oseni & Hassan, 2015). One such example of *sukuk* is the Saudi Electricity Company *Sukuk*.

Sukuk issued in offshore jurisdiction is also another important aspect that may give rise to legal risks. Offshore Financial Centres (OFCs), currently also referred to as International Business Centre (IBCs), are among the popular places for *sukuk* issuance due to the low transaction and regulatory costs (Sairally, Muhammad & Hasan, 2012).

The reason originators or issuers establish SPVs in offshore jurisdictions is mainly due to the low or no tax imposed. So far, not so many countries have provided tax exemption, particularly through legislation, e.g., the Turkey government in April 2010 (Yucel, 2012). Being favored due to these, the establishment of Special Purpose Vehicle (SPV) in asset backed *sukuk* does entail regulatory challenges in terms of structure. For instance, it was highlighted that there are substantial problems in executing decisions of the English court for *sukuk* issued in the offshore jurisdiction (al-Amine, 2012). This leads to legal uncertainties, particularly in jurisdictions which do not have bilateral treaties for reciprocal enforcement of judgments (Nazar, 2011).

The issuer of *sukuk* inevitably plays a central role in the *sukuk* issuance and operation. Among the significant factors which cause investors to choose to invest is credibility of the issuer or the SPV. Hooft and Muller (2011) listed down the criteria desired in *sukuk* issuers, i.e., flexibility to accommodate investors' needs, cost efficient, bankruptcy proof, 'orphan vehicle', secured legal rights to hold asset and to issue *sukuk*-like instruments, including for listing if required. They pointed out that the location of the jurisdiction where the issuer, or the originator, of the underlying asset is registered is of major important concern (Kusuma & Silva, 2014).

In default and insolvency proceedings, these aspects will emerge. Thus, it was highlighted that there is a need to strategize for the *sukuk* issuance by studying the nature of the jurisdictions; the UK and Netherlands are considered creditor friendly while US and France are claimed to be the contrary (Hooft & Muller, 2011). Similar concerns were raised in terms of the underlying asset. This concerns the aspect of property law and the category of the underlying asset (Hooft & Muller, 2011). If it involves real asset, then it is *lex rei sitae*, where the jurisdiction of the immovable asset will be adopted in related procedures and proceedings. Some jurisdictions may not give recognition to the

underlying asset, such as Netherlands that limits it to rights of pledge and mortgages only. In view of this, some legal aspects of the *sukuk* are important to avoid risks associated with them. Although Hooft and Muller (2011) did not focus on legal risks, legal issues pinpointed may signal the possibility of legal risks arising from the regulatory framework or the legal system governing the *sukuk*.

In Itam, Noordin, & Mansor (2023), the impacts of the new tangibility ratio requirements set by the AAOIFI in Shari'ah Standard No. 59 on the sale of debt have been discussed. For countries adopting AAOIFI, the requirement has become mandatory since the 1st January 2021. Prior to the new requirement, the tangibility ratio was only 30%, and the highest was 51% without specifically requiring the ratios to be maintained throughout the *sukuk* tenor. With the new requirement, the tangibility ratio shall exceed 50% and need to be maintained throughout the *sukuk* tenor. This has posed several challenges for global hybrid *sukuk* issuance. Some of these challenges are operational that can have legal implications. For instance, the study noted that the new requirement can pose challenges in the *sukuk* issuance process, in term of identification the suitable assets and maintaining the tangible asstes at 51%. These also involve changing the *sukuk* documentation clauses. As observed by Al-Natoor, Shawqi, & Brown (2022), new clauses and revised terms began to appear in the *sukuk* documentation that include stricter tangibility ratio requirements with new dissolution triggers, and clauses on tangibility events, delisting events, indemnity payments and partial-loss events.

Based on the above, it can be concluded that legal issues in the literature on *sukuk* were linked to the legal environment governing the *sukuk*. However, past literature on this were mainly pure legal studies, where references were made mainly to relevant laws. It was also found that only a few studies analyzed legal issues in *sukuk* in specific

legal environments. This includes the quite recent Dana Gas *sukuk* dispute, where analysis was made on UAE law and conflict of laws (Haroon, Meenai, & R. Rizvi, 2019; Oseni & Hassan, 2015; Salah, 2010; Sole, 2008; Zada, 2019). Several studies also employed empirical data, either in the form of case studies or interviews.

2.2.4.2 Legal Issues Associated with Sukuk Documentation/Contract

Past literature also revealed that legal issues in *sukuk* were associated with *sukuk* documentation/ contract. This was presented in the aspect of contractual enforceability (McMillen, 2007). However, the legal issues discussed were linked to the legal system or jurisdiction governing the *sukuk* contract. According to McMillen (2007), the enforceability issue may arise in two main types of jurisdictions, namely the purely secular jurisdiction and Shariah incorporated jurisdiction. In a similar vein, R. Ali (2009) stated that scrutiny of *sukuk* legal documentation is important to identify legal risks that can be triggered by the split legal framework on trust law and agency law, legal ownership and beneficial ownership in both the common law and civil law regimes¹⁵. In other words, the legal issues that may arise from the legal framework is subject to the *sukuk* documentation.

Several studies analyzed the position of choice of law in *sukuk* documentation/ contract. It was highlighted that the choice of law by parties was deemed as recognized practice by the US court. This was shown in the case of *musyarakah sukuk* arrangement (Yaacob, 2011) in *Re East Cameron Partners L.P.* [2008] LEXIS 3918. However, in the case of the Dana Gas *sukuk*, the multiple governing laws documented in the *sukuk*

¹⁵ Ali (2009) stressed on the importance of choosing the best jurisdiction to adhere to that support trust concept and legal or beneficial ownership. These two aspects are important since they may ascertain the consequences of indemnities and warranties claimed by investors. They also explained the specific transfer modes used in the *sukuk* that have financial impact due to taxation.

contracts (i.e. English law for purchase undertaking and UAE law for *mudarahah* contract) has given rise to several legal challenges. In other words, the governing clause in the *sukuk* contracts has caused two ongoing court proceedings to resolve the purchase undertaking rights of the *sukuk* holders¹⁶.

In addition, Al-Amine (2012) has emphasized the importance of legal documentation to ensure the security of investors. This is because in The Investment Dar (TID) *sukuk*, asset backed *sukuk* has legally rejected the right of recourse to the *sukuk* holders because of the clauses in the documentation. It was stated:

“ .. although the investors in TID *sukuk* invested in an asset-backed *sukuk*, they are legally classified as unsecured creditors. The offering circular provides them with a return of principal upon default, but it does not provide them with recourse to the underlying asset held by the *Musyarakah*”.

As summarized by Zaheer and Wijnbergen (2013), the TID *sukuk* and East Cameron Partners *sukuk* were both based on *Musyarakah* structures but they are still different due to ‘distinctive business nature of originators and clauses embedded in the *sukuk* contracts’.

At the same time, legal issues arising from the very nature of *sukuk* structures also need to be examined. The importance of this was emphasized McCormick (2009) when he confirmed that ‘legal risk’ is a product of the selected structure, stating as follows:

¹⁶ Nevertheless, the court ruled in favour of the *sukuk* holders. The proceeding was also prolonged and there was absence of Dana Gas representative in the English Court. Decision by the Shariah Court was never obtained and the dispute was eventually settled through a restructuring plan that was finalised in 2018 (Haroon et al., 2019).

“... the institution needs to identify where it is most likely that legal risks will arise... It needs to be by reference to the products and services offered in each jurisdiction and the risk profile of those products and services.”.

The selected *sukuk* structure gives rise to Shariah non-compliance risk as well as default risk (Maurer, 2010; Ab. Majid, 2011; A. Elhaj, 2015). Shariah non-compliance risk is an inherent risk in *sukuk* (Tariq, 2004) as well as other Islamic financial transactions. This risk is partly due to the nature of the contract or structure, and it may also be due to external factors such as fatwa shopping and uncertainty in court’s decision pertaining to the Shariah scholars’ views. Tariq (2004) defined Shariah non-compliance risk as:

“loss of asset value as a result of issuer’s breach of its fiduciary responsibilities with respect to compliance with the Shariah”.

Naim (2013) conducted qualitative research on *sukuk* and found some Shariah non-compliance issues in his case studies. Nevertheless, he highlighted the indispensability of Shariah scholars’ roles in mitigating the issues. On the contrary, Azmat (2014) evidenced a higher possibility of Shariah non-compliance when there are additional costs linked to participation of profit maximization oriented companies, the practice of fatwa shopping especially when the Shariah scholars in that particular field are limited in number and can be appointed on a one-off basis. This study, on the other hand, was conducted quantitatively. The ratings provided by Malaysian Rating Corporation Berhad (MARC) and RAM Rating Services Berhad (RAM), also formerly known as Rating Agency Malaysia Berhad also took into consideration Shariah compliance as ‘additional criteria’ and ‘added assessment’, respectively (Chew, 2010).

However, the Shariah non-compliance risk is not itself a legal risk. It may be apprehended that only when this Shariah non-compliance is questioned legally or impacts the legality of the *sukuk* operation, legal risk will emerge. As indicated by Jobst (2008), it is the Shariah recognition of the *sukuk* that poses legal risk, particularly on the rights of investors. It is also noteworthy that the complexity of *sukuk* structures may give rise to legal risk, as stated by McCormick (2004). McCormick (2004) pointed out that sophisticated contractual arrangements might yield technical risk of breach simply because the fundamental requirements of the contract have not been appreciated in full.

To reduce the Shariah non-compliance risk or Shariah risk, some contracts have incorporated a waiver of Shariah defense. As pinpointed by Bälz (2008) and Colon (2011), the possibility of Shariah contract being challenged renders Shariah as a risk and the contract void. Thus, in many Islamic financing transactions, this waiver clause has been incorporated to serve as protection to the Islamic financial institutions (Bälz, 2008). This type of defense was also, unfortunately, sought by the originators in the case of *The Investment Dar Co. KSCC v Blom Developments Bank SAL* [2009] EWCH 3545.

2.2.4.3 Legal Issues Associated with Other Aspects of Sukuk

Legal issues may also arise from other aspects of *sukuk*, i.e., parties' legal capacity and legal claims. A party's capacity to enter into a *sukuk* contract may be subject to internal restriction or external control. For instance, the internal restriction (e.g., the parties' corporation constitution) and the external control over party legal capacity may be due to legal restrictions, although not in the case of *sukuk*, the unenforceability of collateral in the case of *Barclays v O'Brien* [1994] 1 AC 180. Also, external impediments like

human rights provisions that remain to be assessed (Arnott, 2004). Besides, a party's creditworthiness is also another component of its legal capacity.

The creditworthiness of the parties is mostly linked to default or credit risk. This was assumed to be part of legal risk (Rubock, 2010). Arnott (2006) identified the legal capacity of the party involved in cross border transactions as legal risk. The importance of parties' creditworthiness was nevertheless used to measure the credit/financial risk of *sukuk*, as applied by rating agencies such as MARC (Noor & Shahimi, 2013; Santoso, Widodo, Akbar, Ahmad, & Setianto, 2022). The concern is that when the *sukuk* parties lose their legal capacity due to bankruptcy or other legal issues originating from their countries, other than the country where the *sukuk* is issued, these can theoretically give rise to legal risks to the *sukuk*.

Another dimension where legal issues may arise in *sukuk* is through legal claims. It may form part of legal risk, as noted by McCormick (2013) that a legal risk may arise from legal claims made on an institution, or in the case of *sukuk*, on the issuer and the originator. Theoretically, legal claim would stem from events of near default, default, insolvency, or bankruptcy. Other than that, legal claim could also be due to breach of trust, negligence, or misconduct. The exclusion of criminal liability as a legal claim was, however, not justified by McCormick (2013). The very nature of default risk is theoretically driven by credit risk and market risk. However, when the issuer or the originator is made subject to legal claim, it can be said that they are facing a legal risk. In addition, legal claims can also be made by the contracting parties in *sukuk*, such as in the case of breach of contract, breach of trust, negligence, and other types of breach of duty. This was evident in the case of *Pesaka sukuk*, where the issuer, the trustee, and the lead arranger were all made the subjects of legal claim (Oseni & Faruq Ahmad, 2011).

In sum, the legal issues in *sukuk* in the existing literature were discussed in many aspects, i.e., those associated with regulatory framework, *sukuk* documentation/contract, and other aspects such as legal capacity of contracting parties and legal claims. It was also found that, in the literature on *sukuk*, there was lack of consensus on the definition and concept of ‘legal risk’ when it was employed in the studies. Nonetheless, the studies indicate that various terms and aspects were used to explain legal issues or legal challenges surrounding *sukuk*. In addition, it was found that the studies on the legal issues or challenges remain scanty and most were theoretical in nature.

2.3 CONCLUSION

Upon review of the existing literature, it was found that numerous studies were carried out in relation to *sukuk*, either by local scholars focusing on the Malaysian jurisdiction, or foreign scholars. It was noted that most of these studies focused on legal issues. From the review as set out in this chapter, a specific study devoted to research on legal risk in *sukuk* and its management was apparently not evident. This has left room for further studies on the nature of legal risks in *sukuk*, types of legal risks in *sukuk*, and the management of legal risks in *sukuk*.

CHAPTER THREE

LEGAL RISK

3.1 INTRODUCTION

This chapter focuses on reviewing the literature related to the term ‘legal risk’ and what it entails. It starts with the definition of risk, uncertainty and other relevant concepts related to risk, e.g. probability. Later, review is made on the literature of risk from an Islamic perspective. Subsequently, review on the literature is zoomed towards legal risk, definitions of legal risk, and types of legal risk. Such a review is imperative since it provides this study with a clear and strong fundamental concept of risk, before elaborating further on legal risk. Thus, it helps to provide a conceptual framework on legal risk.

3.2 DEFINITIONS OF RISK

Theorizing risk itself is a complex task because it entails other relevant concepts such as uncertainty and probability. In fact, to capture one definition of risk in multiple magnitudes of research is impossible. This is because there are different levels of risk that need to be considered. The degree of exposure to risk is perceived differently in different contexts, i.e., exposure to risks in an investment and risks in the environment are perceived to be different. Different people or groups understand the meaning of risk differently based on their own perceptions and experiences; the layman and the expert will not perceive the term in the same way (Vasvári, 2015). For instance, economic or weather predictions are perceived as risks by the experts but for the public, they are

perceived as uncertainty (Hansson, 1999). In addition, risk can be voluntarily and involuntarily incurred, e.g., risk voluntarily incurred by investors who decide to weigh the benefits over the cost of investment, and risks involuntarily incurred by a community over environmental pollution (Gough, 1988).

As a result, the term “risk” can attract a wide range of definitions. This chapter is arranged in four main sections. The following discussion is dedicated towards defining three interrelated concepts, namely risk, probability, and uncertainty. Afterwards, a few sub-sections will be focusing on the relationship between risk, probability, and uncertainty. After that, the discussion is directed towards the Islamic perspective of risk. Subsequently, in the final section, a specific discussion on legal risk is presented.

3.2.1 Risk

Risk is ubiquitous in every human activity and so far, there is no consensus on how to define it (Aven, 2011). The same applies to risk in finance. Among the earliest work in defining risk was carried out by Frank Knight in 1921 (Knight, 1921). In his study, risk and uncertainty were distinguished from each other, the former being measurable and the latter being immeasurable. Later, other definitions of risk were developed that embraced the aspects of risk versus probability, risk versus threat, and risk as all outcomes versus negative outcomes (Damodaran, 2008). Other definitions tend to treat risk as synonymous with terms such as probability, uncertainty, chance of loss or damage, or undesired outcome (Aven, 2011; Hansson, 1999; Holton, 2004; Krebs, 2011; Spjotvoll, 1987; Willet, 1951). Defining risk is thus more complicated than defining probability and uncertainty, because the elements of probability and uncertainty are embedded in risk (Willet, 1951).

The term risk is used to indicate danger, dread, and variability (Krebs, 2011).

Risk in common usage, as pointed out by Hansson (1999, p.1), may indicate:

“unwanted event¹⁷, cause of unwanted event, probability of unwanted event, expected valuation of unwanted event, and in decision-making, a decision made with known probabilities”.

In addition, risk is also defined as a chance, as it denotes the act of taking a chance from a subjective perspective, and it can also denote acts of the external world¹⁸ from an objective perspective (Willet, 1951). An example of risk in the subjective sense, is the probability that a person assumes will happen if he does something when he has inadequate knowledge about it (Willet, 1951). An example of risk in the objective sense is the chance of head or tail of a flipping coin where the probability is attainable (Willet, 1951). These three definitions of risk indicate that risk is associated with negative, unwanted events, and that taking risk is about taking a chance on something that is indefinite, either subjectively or objectively.

In contrast, a study by Schiffres (2005) associates risk with a positive event. This is the case in terms of an investment, where the undertaking of risk may potentially result in profit generation. From this perspective, Schiffres (2005) stated that there are two ways to define risk, one is by looking at risk as the possibility of losing money and the other is to equate it to the likelihood of returns generated from the risk taken. In

¹⁷ It was observed in the past literature that, terms like event and proposition have been widely used to describe the meanings of risk, uncertainty and probability. The term ‘event’ is usually used to a situation for which a probability is assigned (e.g., the tossing of a coin to give heads). The event can also be described by a proposition (the tossed coin will give heads). The conclusion of a probability for instance, can be the event either occurs or do not occur, or the proposition is either true or false (Baise, 2013, p.82).

¹⁸ The external world is a theory developed in philosophy on the facts of the world that are independent from one’s perceptions and imaginations. It is defined as “*the totality of those physical objects and events that we locate outside of our bodies and that almost everyone would say exist independently of our minds*” (Rosán, 1953, p.1). See also Descartes (1986) Neta (2007) and Russell (1914).

other words, the association of profit and risk can also be done, particularly in the context of financial management (Gough, 1988). In fact, it was mentioned that this type of definition of risk is inherent in the literature, where risk had been defined using two approaches, the negative risk approach and the neutral risk approach. The neutral approach defines risk as a deviation from the expectations of the decision makers on future events, where the deviation can be either negative or positive (Kasiewicz & Kurklinski, 2017).

Risk can be classified into four types. The first type is the real risk, i.e., a type of risk determined by future circumstances when they have developed eventually. The second type of risk is the statistical risk, i.e., a type of risk that is determined by currently available data, typically using actuarial measurement. The third type of risk is the predicted risk, i.e., a type of risk measured using systems models built from historical data¹⁹, and the fourth is the perceived risk, i.e., a type of risk that is determined intuitively by an individual (Gough, 1988).

Another classification of risk was explored by Renn (1992), who extensively analyzed the concept of risk and its classifications. He went further by acknowledging different classifications of risk due to different perspectives sought for each. According to him, risk is confined to:

1. technical perspective (risk is assessed through the probability of physical harm caused on humans using actuarial approach);

¹⁹ The difference between statistical risk and predicted risk is that the former is determined using observed frequencies which can be evaluated by normal statistical means. The latter, on the other hand, is based on a theoretical probability valid only to the extent that the model from which it has been derived is able to be validated. Both types of risk are based on objective estimates, unlike the perceived risk, which is based on subjective probabilities.

2. economic perspective (risk is assessed through subjective probabilistic utility²⁰);
3. psychological perspective (risk is assessed through extensive subjective probabilistic utility, i.e., individual's perceptions that are influenced by a few factors²¹);
4. sociological perspective (risk is assessed through social judgments, from individualistic or structural and objective or constructionist dimensions (Renn, 1992); and
5. cultural perspective (risk is assessed through cultural background embedded in social judgment²²) (Renn, 1992).

The risk from each perspective has its own niche. For instance, each risk classification has its own basic unit, i.e., expected value of the risk, methodological approach, as well as application. One example is the economic perspective of risk, where risk is perceived based on its expected utility as the underlying base unit. A methodological approach used for this risk is risk benefit analysis and its application is on economic decision-making and resources allocation (Renn, 1992). This perspective of risk is different from the actuarial perspective of risk. In the latter, the underlying base unit is the expected value (mostly insurance value) and its methodological approach is actuary, i.e., using average values of time, space, and context to yield a prediction. This kind of risk is also perceived differently due to its application in the insurance business and risk-sharing decision making (Renn, 1992).

²⁰ Possible satisfaction or dissatisfaction attached to a specific action or transaction (Renn, 1992, p.62).

²¹ Among the factors that influence the perception of risk are the beliefs attached to the cause of risk, the qualitative risk characteristics, the catastrophic potential and the anticipated amount of fatalities or losses (Renn, 1992, p.65).

²² The cultural perspective assumes on the roles of cultural pattern to stricture the mind-set of individuals and social organizations to adopt certain values and reject others (Renn, 1992).

There are three basic elements of risk (Gough, 1988). The first element is the availability of choice of action or exposure to loss. The second element is the existence of possibly unwanted consequences and the third is the likelihood of the unwanted consequences to occur. In another study, risk is considered to comprise two elements, i.e., probabilities and consequences. Nonetheless, there are another four elements needed for risk to occur, namely the probability of occurrence of an event, the probability of an outcome of the event, the probability of exposure towards the outcome, and eventually, the probability of consequences (Spjotvoll, 1987). From another perspective, risk was claimed to consist of two elements, i.e., exposure and uncertainty (Holton, 2004).

Based on the definitions, classification, and elements of risk as provided above, risk is a chance that is typically associated with negative and unwanted consequences. A chance denotes probability (Willet, 1951). For a risk to materialize, there are concerns over issues of probabilities for the event that causes the negative consequences to occur and probabilities of the occurrence of the consequences. As a result, risk entails not only negative consequences, but also probabilities and at some points, uncertainty in regards to the event and the consequences.

3.2.2 Probability

Linguistically, probability has a synonymous meaning with “plausibility”. It is related to reasonableness of beliefs and expectations. If the term “logic” is understood broadly, probability can also be referred to as “logic”. Probability entails two senses, the physical probability that refers to “chances” and probability itself that refers to “logical probability” (Anscombe & Aumann, 1963).

The theory of probability can be traced back to Keynes (1921). He described “certain” and “probable” as being rational beliefs that a person has in various subjective degrees. Thus, the theory of probability is thus logical because it concerns the degree of belief which is rational to entertain in given situations. It does not merely concern the actual beliefs by an individual that may or may not be rational (Keynes, 1921). Simultaneously, the probability relations are determined by objective and logical beliefs. He stated:

“What particular propositions²³ we select as the premises of our argument naturally depends on subjective factors peculiar to ourselves; but the relations, in which other propositions stand to these, and which entitle us to probable beliefs, are objective and logical” (Keynes, 1921).

This proposition is different from that put forward by Knight (1921). Knight (1921) assigned probability to subjective perspectives, that is, a proposition has intrinsic probability, while Keynes assigned objective probability to a pair of propositions. In other words, a probability is the relationship between two propositions (Holton, 2004). According to Holton (2004), one proposition is not knowing the state of true or false, and the other proposition is the evidence of the first. For instance, a person believes that if he rides on a bicycle which he has never rode on before, he will fall. His propositions are, one that he is right or he is wrong, and the other is the proposition that he knows from his past experiences²⁴ that he will fall.

Hence, according to Keynes (1921), probability is the relationship between the two propositions. This is based on objective and logical factors as to the relationship

²³ Proposition denotes sensation, meaning, and perceptions (John Maynard Keynes, 1921, p.11).

²⁴ According to Keynes (1921), the propositions can be acquired through direct acquaintances, that are experience, understanding and perception. On the other hand, the proposition can also be built indirectly by way of argument (John Maynard Keynes, 1921, p.11). The argument is the corpus of knowledge of a person (John Maynard Keynes, 1921, p.4; Wilson, 2007, p.3).

between past experiences and actual events. In Holton's (2004) explanation of the views of Knight (1921), he asserted that probability is an intrinsic value embedded in one subjective belief. For example, when a person rides on a bicycle, the probability that he will fall has already been implanted in his subjective belief due to his past experiences. As a result, probability is embedded and not based on the relation between the two propositions. In the past literature, probability has been understood in two ways. The first way is, probability is a belief or knowledge and the second is, probability is a property of the external world (Lawson, 1988). Probability as a belief has been underscored by the subjectivists and Keynes. According to them, probability is the degree of belief in a given proposition or event held by a specific person at a specific time (Lawson, 1988). Keynes's theory of probability also falls in the same category, except that the relationship between the two propositions must be objective and the objectivity remains in the form of knowledge. In other words, probability is "a feature of how we think about the external world rather than a feature of any external material reality itself" (Lawson, 1988).

The second way to understand probability is through the work of the objectivists and of Knight (Knight, 1921; Lawson, 1988). Probability in this way is understood as the true probability of events that take place in the world. The events have probabilities that a person, or an agent, must learn and can be known (Lawson, 1988). The probability is when the subjective probability²⁵ of an agent coincides with the true probabilities of the real world. Furthermore, there are three probability situations. They are *a priori* probability, statistical probability, and *estimates* (Knight, 1921; Lawson, 1988). The *a priori* probability is a probability judgement that can be drawn from absolutely

²⁵ Subjective probability refers to probabilities in terms of a person's preferences as long as the preferences fulfil certain consistency assumptions (Anscombe & Aumann, 1963, p.199). The subjective probability theory was introduced by Frank P. Ramsey (1931) and Savage (1961).

homogenous classification of instances that are completely identical (as in the case of a dice), while statistical probability is probability drawn from empirical evidence. The difference between the two probabilities lies in the capability to classify the instances or the accuracy of classification of instances grouped together (Knight, 1921). Probability based on *estimates* is probability drawn from judgement or intuition. It is different from the other two types of probability because there is no valid basis of any kind for classifying instances (Knight, 1921).

In sum, probability is a degree of belief in a proposition or event. It may be perceived subjectively, i.e., probability is what a person believes or thinks, in which it may or may not be related with the external world, or it may be perceived objectively, i.e., probability is a true probability of events of the external world. When understood objectively, probability can be measured by *a priori*, statistics, and by *estimates*.

3.2.3 Uncertainty

Another concept related to risk is uncertainty. Uncertainty is a state of not knowing the truth or falsity of a proposition (Holton, 2004). It is linked to even chances (Willet, 1951). Knight (1921) had a twofold perception of uncertainty, one that is measurable, thus accounts as a risk, and another that is immeasurable, i.e., true uncertainty. On the other hand, uncertainty is also defined as something which is completely unknown.

Uncertainty thus:

“does not mean merely to distinguish what is known for certain from what is only probable. The game of roulette is not subject, in this sense, to uncertainty; nor is the prospect of a Victory bond being drawn. Or, again, the expectation of life is only slightly uncertain. Even the weather is only moderately uncertain. The sense in which I am using the term is that in which the prospect of a European war is uncertain, or the price of copper and the rate of interest twenty years hence, or the obsolescence of a new

invention, or the position of private wealth- owners in the social system in 1970. About these matters there is no scientific basis on which to form any calculable probability whatever. We simply do not know” (J. M. Keynes, 1937).

A similar point was highlighted on ‘true’ uncertainty, where the probability distributions are not considered to be a basis to comprehend real world behaviour under uncertainty (Davidson, 1991). In other words, analyzing the past and current market signals does not contribute reliable statistical or intuitive clues on the future prospect. As a result, true uncertainty occurs whenever one cannot specify a complete set of prospects about the future due to his inability to perceive all possible consequences, and not even to specify the probabilities of the consequences.

Another similar concept is ‘fundamental’ uncertainty. Fundamental uncertainty is defined as an event where some essential information about a future does not exist or cannot be retrieved from relevant data (Dequech, 1999). It asserts that the future cannot be predicted by a fully reliable probabilistic estimate because the future is yet to be created (Dequech, 2000). Nevertheless, it was concluded that fundamental uncertainty does not arise from complete ignorance since there are established practices, like laws and customs, even within the transmutable reality²⁶ (Dequech, 1999).

²⁶ Immutable referred to the external economic environment that was not susceptible to change induced by human action. For instance, the path of the economy is like the path of the planets under Newton's classical mechanics, was determined by timeless, immutable natural laws (Davidson, 1996, p.479). Transmutable reality as opposed to mutable reality was described as “a creative economic reality in the sense that the future can be permanently changed in nature and substance by actions of individuals, groups (e.g., unions, cartels), and/or governments, often in ways not completely foreseeable by the creators of change” (Davidson, 1996, p.482). In an economic perspective, the implications of uncertainty were drawn from two aspects, “... the fundamental differences among various economic theories involve (1) the analyst's conception of the external economic reality in which decision makers operate, and (2) the ability of agents to understand that reality” (Davidson, 1996, p.489). Thus, uncertainty is understood differently based on three economic external reality, (1) The reality is immutable, thus, (1) in both short and long run, the future is known or knowable, and (2) in the short run, the future is not completely known due to human’s incapability to manage the information, and (2) the reality is transmutable and creative, in a way that today’s decision may affect the future of the cosmos. From this view, uncertainty is linked to two aspects, (1) capability of human’s knowledge, and (2) the reality as perceived by the human.

In view of these definitions, uncertainty is a state of not knowing or even chances that is associated with the inability to specify possible consequences of the event. This may be because the essential information is completely out of human knowledge, or it is not possible to achieve. Nonetheless, detailed discussion on uncertainty in terms of how it relates to probability and risk will be provided.

3.3 COMPARATIVE ANALYSIS

3.3.1 Risk and Probability

Risk is associated with negative, unwanted events. Taking a risk is about taking a chance on something that is indefinite, either subjectively or objectively. For a person to take a risk, he is required to have certain knowledge on the risk, i.e., certain knowledge of the consequences of the risk he is taking and the possibilities of the consequences happening. The knowledge itself is the degree of belief that the person possesses.

According to Spjotvoll (1987), risk consists of two elements, which are probabilities and consequences. Probability is a notion in risk evaluation, and it is not similar to risk. There are four stages of evaluation before a risk can be materialized, and these are the probability of an occurrence of an event, the probability of an outcome of the event, the probability of exposure towards the outcome, and eventually, the probability of consequences (Spjotvoll, 1987). Either way, probability remains an element of risk. It is not risk itself but it creates risk.

3.3.2 Uncertainty and Probability

It was argued that although uncertainty is different from probabilistic risk, most of the uncertainty concepts imply the underlying theory of probability (Wilson, 2007). In fact, uncertainty concepts were believed by the post Keynesians to have been derived from the concept of probability, that became beneficial for an institutional approach (Wilson, 2007).

In past literature, there were different approaches towards probability, uncertainty, and the relationship between them. For instance, while uncertainty may be treated as similar to probabilistic risk (Davidson, 1991), another opinion considered probabilistic risk as a weak uncertainty (Dequech, 1999). In a study, probability and uncertainty is differentiated based on the ergodic²⁷ and non-ergodic²⁸ circumstances. It was asserted that, in ergodic circumstances of objective probability distributions, the belief developed on a certain event is a probability and not an uncertainty (Davidson, 1991). In the non-ergodic circumstances, true uncertainty arises since a probability is generalized beyond the relative frequency²⁹ approach by the subjectivists (Davidson,

²⁷ Ergodic circumstances involve the ergodic stochastic process, which means that averages calculated from past observations cannot be persistently different from the time average of future outcomes. For objectivists, probability distributions regarding historical phenomena was presumed to have existed and the same probabilities which determined past outcomes will continue to govern future events (Davidson, 1991, p.132). Ergodic was also referred to as a predetermined reality that permits one to assert that sampling from past and present market data is equal to obtaining a sample from the future. Ergodicity thus implies that “future outcomes are merely the statistical shadow of past and current market signals” (Davidson, 1996, p.480).

²⁸ Non-ergodic circumstances entail situations where an individual cannot specify a complete set of prospects about the future, because the individual cannot conceive of a complete list of consequences or cannot assign probabilities to all consequences that will occur in the future or the individual regards the inapplicability of today’s calculation for the future (Davidson, 1991, p.134).

²⁹ The subjectivists who held on the subjective probability distribution believe that probability can be interpreted either in terms of degree of conviction or as relative frequencies. When a probability is generalized beyond the relative frequencies, true uncertainty arises. The relative frequency is related to the theory of frequency as echoed by Frank P. Ramsey (1931), “I propose to begin by making some admissions in favour of the frequency theory. In the first place, this theory must be conceded to have a firm basis in ordinary language, which often uses 'probability' practically as a synonym for proportion; for example, if we say that the probability of recovery from smallpox is three-quarters, we mean, I think, simply that that is the proportion of smallpox cases which recover. Secondly, if we start with what is called the calculus of probabilities, regarding it first as a branch of pure mathematics, and then looking round for some interpretation of the formulae which shall show that our axioms are consistent

1991). In other words, when a belief is made beyond the relative frequencies, the probability becomes uncertainty. The differentiation was made in reference to Keynes' writings in 1921 and 1937 (Davidson, 1991; J. M. Keynes, 1921 & 1937).

In relation to uncertainty, it was asserted by Lawson (1988) that the subjectivists considered uncertainty to correspond to a situation of probabilistic knowledge. However, for Keynes (1974), uncertainty is true uncertainty when numerically determinate probabilities are not to be had or associated with the absence of probabilistic knowledge (Lawson, 1988). For the objectivists, their understanding of uncertainty seemed to be similar to that held by the subjectivists. Uncertainty is thus a probabilistic knowledge that can be drawn from numerical determinate probabilities (Lawson, 1988). In contrast, Knight's position of uncertainty is similar to Keynes's (Lawson, 1988). This is apparent when he mentioned that probability based on *estimates* is an uncertainty. In other words, uncertainty corresponds to situations where:

“there is no possibility of forming in any way groups of instances of sufficient homogeneity to make possible a quantitative determination of true probability... it is this third type of probability or uncertainty which has been neglected in economic theory” (Knight, 1921).

In this view, probability and uncertainty is differentiated based on the ability to assign numerical determinate probabilities.

Later, Wilson (2007) elaborated on the relationship between probability and uncertainty in different angles. According to him, probabilities vary by the weight of evidence (Wilson, 2007). The weight of evidence is the key way in which Keynes and post-Keynesians conceptualized uncertainty. The weight of evidence is important

and our subject not entirely useless, then much the simplest and least controversial interpretation of the calculus is one in terms of frequencies” (p.158).

because Keynes distinguished between rational belief (probabilistic judgments) and mere opinion. The probabilistic judgments require the weight of evidence³⁰ to determine the confidence which is rational to feel in a given situation. Among the examples of weight of evidence was the state of confidence (Wilson, 2007). It was concluded that uncertainty arises when the direct intuition of probability fails. The failure is due to, among others³¹, the weight of evidence being low, which gives rise to fundamental uncertainty and ambiguity (Wilson, 2007). In other words, whenever a probability has low weight of evidence, in terms of the amount of relevant evidence and the completeness of the evidence, that probability remains as uncertainty.

Another view positioned uncertainty as different from probability, with probability being an element of uncertainty. This view introduced other concepts, namely fundamental uncertainty and ambiguity. Fundamental uncertainty refers to Keynes's true uncertainty which corresponds to situations where relevant information is not known at the time a decision is made because the future is yet to be created. On the other hand, ambiguity is a situation where there is uncertainty about the probabilities due to lack of information or missing information (Dequech, 2000). Based on the discussion therein, probability is an element of uncertainty/ambiguity but probability does not play any role in fundamental uncertainty (Dequech, 2000). This view is different from other views due to the new category of uncertainty it introduced, i.e., ambiguity. Fundamental uncertainty is quite similar to true uncertainty. In contrast,

³⁰ Keynes has been emphasizing two elements to prove the degree on rational belief. They are the evidence and the conclusion. It was equated as $\alpha = a/h$ where $a = \text{conclusion}$, $h = \text{evidence}$ and $\alpha = \text{degree of rational belief}$. The weight of evidence is related to the evidence of which the probability relation is based (Dequech, 2000). It was asserted that the weight of evidence may comprise the amount of relevant evidence and the completeness of the evidence (equivalent to the balance of relevant knowledge and relevant ignorance). At this point, the discussion on fundamental uncertainty and ambiguity becomes indispensable because weight is considered as a measure in both (Dequech, 2000, p.51).

³¹ Other than lower weight of evidence, probability also fails because an individual faculty of logical intuition is weak and the numerical probabilities are not applicable.

ambiguity is another type of uncertainty that relates to the inability of an individual to gather a complete list of probabilities of a proposition, due to lacking or missing information.

To sum up, probability and uncertainty are interrelated. Although uncertainty is based on probability, they are different based on the grounds of probabilities distribution that an individual can gather for an event or a proposition. The probabilities distribution that differentiates uncertainty from probability may be due to the ergodic or non-ergodic circumstances (depending on the objective or subjective probabilities) (Davidson, 1991), numerical determinate probabilities (Lawson, 1988), and weight of evidence (Wilson, 2007). In other words, probability is an element of uncertainty if the probability distributions are non-ergodic, non-numerical determinate probabilities and also when the weight of evidence in the probability is low. If there is lacking or missing information about probabilities that triggers uncertainty about the probability, it creates another type of uncertainty called ambiguity (Dequech, 2000).

3.3.3 Risk and Uncertainty

The relationship between risk and uncertainty has been frequently mentioned in previous studies, even among the earliest works on risk (Hardy, 1923; Haynes, 1895; Renn, 1992). In fact, risk used to be perceived in the insurance industry as uncertainty (Denenberg & Ferrari, 1966). For instance, risk was defined as uncertainty regarding cost, loss, and damage (Hardy, 1923). In addition to these, some have considered uncertainty to be an element of risk. Haynes (1895) defined risk as a chance of loss or damage, and this is associated with uncertainty when he said:

“If there is any uncertainty whether or not the performance of a given act will produce a harmful result, the performance of that act is the assumption of a risk”.

The same point was highlighted by Willet (1951). Meanwhile, O. G. J. Wood (1964), who studied the evolution of risk concept approved the assertion that uncertainty is embedded in risk. He found that there were three dimensions of risk concept during his time, i.e., risk as simply a chance of loss, risk as uncertainty, and risk as either chance or uncertainty. Some also considered risk as related to a certain degree of uncertainty (Willet, 1951). By this, Willet (1951) suggested that risk is associated with subjective uncertainty as embodied in the course of events in the external world.

These definitions showed that uncertainty can either be the risk itself or an element in a risk. Nonetheless, the non-existence of relationship between risk and uncertainty can also be possible. For instance, Rachev, Stoyanov, and Fabozzi (2008) pinpointed the subjectivity of risk that involves both exposure and uncertainty. They mentioned that, at some point, uncertainty is not necessarily an element in a risk, thus leaving risk as being an asymmetric phenomenon that relates to mere loss. This view was described in their statement below:

“For example, if an asset will surely lose 30% of its value tomorrow, then it is not risky even though money will be lost. Uncertainty alone is not synonymous with risk, either. If the price of an asset will certainly increase between 5% and 10% tomorrow then there is uncertainty but no risk as there is no monetary loss. As a result, risk is qualified as an asymmetric phenomenon in the sense that it is related to loss only” (Rachev, Stoyanov, & Fabozzi, 2008).

In fact, there were some studies which elaborated on the differences between risk and uncertainty. Among them was the work of Knight (1921). He contended that there is a clear demarcation line between risk and uncertainty, as the former involves

measurable probabilities, while the latter strictly relates to immeasurable probabilities (Knight, 1921, p.20). He declared there to be a distinction between measurable probabilities using statistical probabilities approach, *a priori* probabilities, and those using *estimates*. The third probability using *estimates* where instances are unavailable (immeasurable probabilities) is uncertainty (Knight, 1921, p.231). In this view, the quantifiable characteristics of risk and uncertainty is highlighted despite some criticisms made on it³².

The states of imperfect information and incomplete knowledge are dimensions of distinction between risk and uncertainty (Albert, 1992; Khalil, 1997). Khalil (1997) went on to contend that “future states are not given facts”, while “ignorance theory denotes risk in the sense that future states are facts in the world of certainty”. By the latter, he explained that future facts are still not perfectly known to humans, due to limited information, and therefore creates a risk.

In agreement with the above view, Hansson (1999) stated that lack of knowledge is divided into two: risk and uncertainty. In terms of decision making process, it is a risk when a decision is reached with knowledge of undesirable outcomes and probabilities of the outcomes’ occurrence, while uncertainty is when a decision is reached with entirely unknown probabilities or limited knowledge of the probabilities. Still, according to him, in real life cases, the true ‘known probabilities’ are scarce, e.g. dice and coin, thus most decision making are structured based on uncertainty.

Another dimension of distinction between risk and uncertainty is provided in subjective-objective paradigms (Hansson, 2011). This was already echoed by Bradbury

³² Knight’s argument was also contended by others, such as on the basis of availability of objective data in almost everything to measure risk, thus leaving unclear the distinction between risk and uncertainty (Grubel, 1971). Leroy and Singell Jr. (1987), further claimed a shift of Knight’s central idea as being ‘measurable and immeasurable’, ‘insurable and non-insurable’ to availability of market to represent the instances, based on objective probabilities, and not the subjective probabilities.

(1989), though not using the term ‘uncertainty’. According to Bradbury (1989), there are two concepts of risk, namely a concept where a risk is perceived as a “physically given attribute of hazardous technologies” implying that objective facts can be managed by science, and the other concept is where a risk is conceived as a “socially constructed attribute” that owes its existence to human perception and experiences. The subjective-objective paradigm of risk and uncertainty was illustrated by Hansson (2011) as follows:

“Whereas “uncertainty” seems to belong to the subjective realm, “risk” has a strong objective component. If a person does not know whether or not the grass snake is poisonous, then she is in a state of uncertainty with respect to its ability to poison her. However, since this species has no poison there is no risk to be poisoned by it. The relationship between the two concepts “risk” and “uncertainty” seems to be in part analogous to that between “truth” and “belief”.

The subjective-objective paradigms of risk and uncertainty are quite similar to the subjective-objective paradigms of probability. The linkage between risk, uncertainty, and probability was also echoed by Mahler (2007), who stated:

“The traditional, and rather pragmatic, answer is to reduce all uncertainty to risk through the use of beliefs expressible as probabilities.... For example, if we are uncertain about the probability of falling from a bicycle on an icy road and wounding a knee, we use the cyclist’s beliefs to assess the risk”.

Denenberg and Ferrari (1966) added on to this by clarifying the reasons why risk and uncertainty should be defined differently in insurance. The study put forward three underlying justifications to differentiate risk and uncertainty, namely because a similar definition of risk and uncertainty (1) will not be able to give adequate recognition and distinction between insurer risk and individual risk; (2) does not provide adequate

separation between quantitative and qualitative nature of risk; and (3) will make it difficult to recognize the function of increased knowledge as a tool to reduce risk. In view of these, they recognized the measurable and immeasurable elements in risk and uncertainty, respectively, and adequate information as a mechanism to discover risk, but not to create risk. This is not the same as uncertainty which will be eliminated with adequate information.

The real meaning of risk and uncertainty may also be conceived from different perspectives, like the event of risk and the method of measuring risk. It is evident in the definitions of risk and uncertainty, where risk is defined as the probability of an event together with its possible implications, while uncertainty “reflects the accuracy with which risk can be assessed” (Krebs, 2011). Another perspective is of its consequences; risk is where the insurance market exists and uncertainty is where it does not (Leroy & Singell Jr., 1987). This is to imply that situations where the insurance market can operate smoothly are considered as risks, while uncertainty is when the insurance market will suffer great loss due to, among others, moral hazard (Langlois & Cosgel, 1993b).

In sum, past literature have presented three types of relationship between risk and uncertainty. In the first part, risk is perceived as uncertainty itself (Denenberg & Ferrari, 1966; Hardy, 1923). In the second part, it can be observed that risk is not uncertainty but uncertainty is an element of risk (Haynes, 1895; Rachev et al., 2008; Willet, 1951; O. G. J. Wood, 1964). The third part of the literature distinguished risk from uncertainty but proposed some elements of the relationship between them. The relationship between risk and uncertainty lies in several aspects, namely:

1. its measurability (Knight, 1921);
2. its objective-subjective paradigms (Bradbury, 1989; John Maynard Keynes, 1921; Knight, 1921; Frank Plumpton Ramsey, 1978; Savage, 1961);
3. the perfection/imperfection of knowledge (Albert, 1992 Khalil, 1997);
4. confidence in reliability of the knowledge (Hansson, 1999);
5. uncertainty as a condition in risk (Gough, 1988; Hardy, 1923; Haynes, 1895; Krebs, 2011; Willet, 1951); and
6. the perspectives of risk to make it distinct from uncertainty (Krebs, 2011; Langlois & Cosgel, 1993b; Leroy & Singell Jr., 1987).

As discussed, aspects of the risk-uncertainty relationship seem to relate to the concept of probability. The aspects of relationship do not deal with risk and uncertainty, but with probability, or probabilities distribution. It is not possible to achieve the probabilities distribution when the instances are immeasurable (Knight, 1921) due to non-ergodic circumstances (Davidson, 1991) or due to imperfect or lack of knowledge (of the outcome and probabilities of the outcomes to occur) (Hansson, 1999; Khalil, 1997). This impossibility of probabilities distribution may lead to uncertainty. In contrast, when the instances are measurable, when the circumstances are ergodic, or when there is perfect knowledge of the outcomes and probabilities of their occurrence, then the probabilities distribution is possible. The possibility of the probabilities distribution may lead to risk. This is called “unknown probabilities” and “known probabilities”³³ for uncertainty and risk, respectively.

³³ This term was used by Hansson (1999) to denote a known list of probabilities in making decisions under risk. This is different from decision making under uncertainty where the probabilities are unknown. Nonetheless, the known probabilities do not necessarily mean completely known probabilities, but the decision maker has chosen to simplify his description of his decision’s problem by treating it as known probabilities (Hansson, 1999).

Even in the subjective-objective paradigms of risk and uncertainty, there is also consideration of probabilities distribution. For instance, in the subjective paradigm, a person who is in the state of not knowing (e.g., not knowing whether or not the grass snake is poisonous) is in a state of uncertainty. The state of not knowing as postulated by Hansson (2011) refers to unknown probabilities, while the objective state of the snake not being poisonous is a known probability. The use of probabilities to assess risk or to reduce uncertainty to risk was also mentioned by Mahler (2007).

Similarly, when uncertainty is assumed as a reflection by which risk can be assessed (Krebs, 2011), it implies the known and unknown probabilities that render an event to be a risk or an uncertainty, respectively. The probabilities distribution, being known and unknown, is also a consideration for the distinction between the definitions of risk and uncertainty as provided by Langlois and Cosgel (1993) and Leroy and Singell Jr. (1987).

As a result, it is practical to construe risk and uncertainty as different concepts. Apart from the definitions that regard risk as uncertainty or uncertainty as an element in risk, the discussions provided in the literature that support the distinction between risk and uncertainty are more detailed, thus more convincing and relates the distinction to the concept of probability. Therefore, the relationship between the concepts of risk, probability, and uncertainty can be built.

Based on the discussion provided above, the concepts of risk, probability, and uncertainty are illustrated as follows. The lengthy discussion above assists in the conceptualization of legal risk for the purpose of this research.

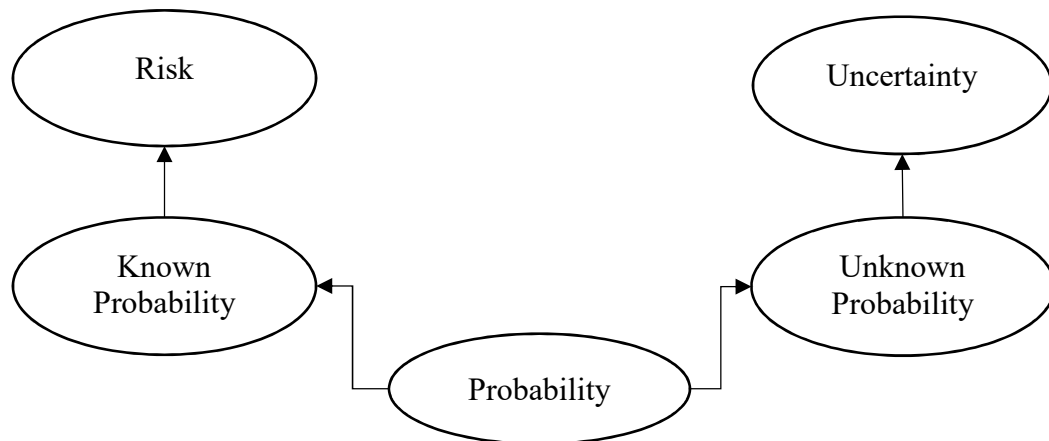


Figure 3.1 Illustration of the concepts of probability, risk, and uncertainty

3.4 RISK FROM AN ISLAMIC PERSPECTIVE

When discussing risk from an Islamic perspective, it is vital to direct the discussion to the main source of Islamic teachings, i.e., the Quran and the Sunnah. Since both the Quran and the Sunnah were written and recorded in the Arabic language, reference to certain terms to denote risk in Arabic language is crucial. Some of the terms used in the literature were *khatar* or *mukhatarah* and *gharar* (uncertainty) (Elgari, 2003; Waemustafa & Sukri, 2016).

Khatar, from a linguistic perspective, has various meanings. Among them are rising up (*khatara fi masyiyi*) or creating doubt (*khatara*) or rendering one to be between safe and danger (*akhtara*) or nobility that results in jeopardy (*al-khataru*) (Mustafa, Abd al-Qader, Al-Ziyat, & Al-Najjar, 1972). *Khatr* in *Mu'jam Lughah al-Fuqaha'* is not translated into English as risk, but as exposure to danger. Interestingly, the illustration given includes the use of *khatr* in a sale contract (Qal'ahji & Qanibni, 1988).

Waemustafa and Sukri (2016) highlighted that the definition of risk from an Islamic perspective covers more terms and concepts besides *khatar*, such as *gharar*³⁴, *maysir*, *al-ghanmu bi al-gharmi*, and *al-kharaj bi al-daman*. In fact, in their literature analysis, they found two approaches in defining risk, i.e., *al-khatar* as risk and *al-gharar* as risk. According to their analysis, there were three studies that employed the term *al-khatar* or *mukhatarah* to denote risk, instead of *al-gharar*. Nonetheless, the studies (Heck, 2006; Kozarevic, Nuhanovic, & Nurikic, 2013; Swartz, 2013) were not meant to explore the word risk as *mukhatarah* and did not produce any lengthy discussion on it, except for Swartz (2013). Swartz (2013) placed risk as *khatar* instead of *al-gharar* because the literal meaning of *gharar* does not imply the meaning of risk. According to him, unlike the case of *al-gharar*, risk is not prohibited. If that was the case, then every transaction will be rendered unlawful. Thus, “risk is something that is beyond our control, while *gharar* is within our reach and control” (Swartz, 2013).

Besides these three studies, another study also explored the relationship between risk and *al-mukhatarah*. The study reached the conclusion that there seems to be a difference between the use of the term “risk” (*mukhatarah*) in the classical *fiqh* and “risk” as used in modern finance. It was stated that:

“... *khatar* in the terminology of jurists is an attribute for a type of contract whose form implies rights and obligations that are “probable” for both sides. Risk within the meaning of financial literature is linked to forces that govern the ultimate outcome of the contract. The difference between the first and second case mentioned above is only legalistic. Financially, they are the same” (Elgari, 2003).

³⁴ In classical *fiqh* literature, *al-gharar* was discussed in the main topic of sale contract. It was generally discussed by ‘examples’ or types of contracts which were prescribed by the Prophet Muhammad s.a.w. as having the elements of *al-gharar*. These contracts are *bay’ al-hasah*, *bay’ al-munabazah*, *bay’ al-mulamah*, *bay’ muzabanah*, *bay’ al-mulahaqah*, *bay’ atan fi bay’ ah*, *habl al-hablah*, and also under the topic of *najsh*, *bay’ muzara’ah*, *bay’ al-mukhadarah*, *bay’ salaf*, *bay’ urbun*, *bay’ almaghanim*, *bay’ ma laisa`indah*, etc (Awang, 2005; Daradikah, 1973)

In other words, the terms risk and *al-mukhatarah* are different because the former implies a condition in a contract where one party is more secured than the other, while the latter refers to external risk factors that may affect the contract.

In sum, the term *al-mukhatarah* which denotes a similar meaning to risk is rarely employed in literature. In addition, only two of the studies discussed the relationship between risk and *al-mukhatarah* (Elgari, 2003; Swartz, 2013). Therefore, the following discussion on the definition of risk from an Islamic perspective will be confined to the term *al-gharar* that has been widely employed in the past literature.

3.4.1 Al-Gharar

In his well-known book, *al-umm*, Imam Syafii' wrote on *bay'al-gharar* as a 'sale contract on something that is not with you' (*bay' ma laisa `indaka*), a sale contract on a foetus in its mother's womb (*bay'al-haml fi batni ummihi*), a sale contract on a runaway slave (*bay'al-`abdu al-aabiq*), a sale contract on a bird or fish yet to be caught (*bay'al-tayr wa al-hut qabla an yusada*), and any contract that falls under the same meaning (Al-Syafi'i, 1903). These contracts are defective contracts because at the time they were contracted, it was not known whether the subject matter existed or otherwise³⁵.

Daradikah (1973), who wrote at length on *al-gharar*, compiled definitions of *al-gharar* from classical *fiqh* based on various *mazahib* (schools of thought). His analysis on the definitions found that some definitions are broader than others. For instance,

³⁵ Discussion on *gharar* was also mentioned in other topics of sale contract, including sale contract on unharvested wheat (*bay' al-qamhi fi sunbulihi*) (Al-Syafi'i, 1903, Vol. 3, p.59) and forward sale contract (for agriculture) (*bay' al-salaf*) (Al-Syafi'i, 1903, Vol. 3, p.85). In the former, the *gharar* is due to the fact that the buyer does not see what he is buying. In the latter, it was explained that *bay' salaf* is permitted only when the quantity (*al-kail*), the weight (*al-wazn*), period (*al-ajal*) and characteristics (*al-sifat*) are known to both buyer and seller (Al-Syafi'i, 1903, Vol. 3, p.89).

while some scholars restricted *al-gharar* only to the existence or nonexistence of the contract's subject matter, others are more general, to include the 'unknown'³⁶ elements of the subject matter and even the deliverability of the subject matter. Daradikah (1973) also pinpointed the elements of doubt (*al-syak*) since some definitions provided by the classical *fiqh* scholars describe it as the state of hesitation between two matters (*al-taraddud bayna amrain*)³⁷. Nevertheless, Daradikah (1973) preferred the definition provided by al-Mawardi from the Syafii school that defines *al-gharar* as 'anything which consequences are unclear from us (*ma intawat `anna `aqibatuhu*)'³⁸.

Ad-Darir (2012), who conducted an extensive study on *gharar*, has also assembled definitions from the classical *fiqh* scholars. The definitions were from the four major *fiqh* schools and covered the linguistic meaning of *gharar*. He discovered similarities among the definitions, i.e., the definitions of *al-gharar* denotes uncertainty, either in general terms or restricted to certain conditions, such as the existence of the item sold and its obtainability (deliverability). Still, he opted for a definition derived from *al-Sarakhsi* due to its all-in nature. *Al-Sarakhsi* defined *gharar* as "anything whose

³⁶ Definitions compiled by Ad-Darir (2012) have also accentuated the issue of the reach of uncertainty, either being known, unknown, or absolutely unknown. This is evident in the definition derived from, for instance, *Ibn Qayyim*, "A sale involving *gharar* is the sale of undeliverable item, whether such an item exists or not". Although (Ad-Darir, 2012) commented on this as being confusing, as to the state of being undeliverable or the state of inexistence, it is in fact very observant that *Ibn Qayyim* wanted to highlight the state of inexistence as being the absolute unknown, and the state of undeliverability as being the unknown. Another example is the definitions given by *Ibn Taymiyyah* and *al-Sarakhsi*, where the former referred to the term *unknown*" (*al-majhul*)" (*Taymiyyah*, 1982, p. 138) and the latter referred to the term "*hidden*" (*mastur*). The former is to indicate the absolute unknown, and the latter to indicate the unknown. This was made clear, as according to Ad-Darir (2012), *Ibn Taymiyyah* has revised his former definition of *gharar* to include three aspects of *gharar*, i.e. the inexistence of the sale's subject matter, the undeliverability of the subject matter and an absolute unknown subject matter or known subject matter which types and quantity are unknown. Here, the unknown and absolute unknown characteristics have been highlighted.

³⁷ For instance, definition postulated by al-Abi, from Maliki school is, *al-khatr* (risk), a 'balanced uncertainty' between one that fulfils the contract's objectives and one that does not.

³⁸ His preference on this was nonetheless not clear in his writing since there are other similar definitions by other scholars such as *al-Sarakhsi* (*mastur `aqibatuhu*), *al-Babarti* (*ma tawa `anka ilmuhu*). In fact, the term used, *`aqibah* (consequence or end result) have been understood differently. For instance, Daradikah (1973) perceived it as the subject matter, Ad-Darir (2012) took it literally to mean the contract's consequences when he said the *al-Sarakhsi*'s definition is broader in that sense, and *Taymiyyah* (1982) seemed to understand it as the 'inexistent', 'undeliverable' and 'unknown'.

consequences are hidden”. This definition is all-encompassing, according to him, to include the overwhelming concern on existence and obtainability of the sold item in a commutative contract (*`aqad al-mu`awadat*).

The works by Daradikah (1973) and Ad-Darir (2012) on the classical writings are very significant for this study because they have evidently shown that the definition of *gharar* is not attached to risk, but to uncertainty. Nonetheless, it was noted that the linguistic meaning of *al-gharar* is similar to risk (*khatar*). This linguistic meaning was employed by Imam al-Syafii’ and *Ibn Taymiyyah*. However, according to Ad-Darir (2012), it was merely an observation by both scholars on *gharar* from a linguistic aspect³⁹.

3.4.2 Risk as Synonymous to al-Gharar

In describing *bay’ al-gharar*, Ibn Taymiyyah stated that it involves risk (*khatar*). According to him, *al-gharar* is something with unknown consequences (*al-majhul al-`aqibah*). When a person sells a subject matter that consists of *gharar*, e.g., a runaway slave, horse or camel, one is considered as trading in *mukhatarah* or risk (Taymiyyah, 1982). According to him, there are three types of *al-gharar*, namely (1) the ‘non-existent’ (*al-ma’dum*), e.g., trading on a camel’s foetus; (2) the ‘undeliverable’ (*al-ma’juz `ala taslimihi*), e.g., a runaway slave; and (3) the ‘absolute unknown’ (*al-majhul al-mutlaq*) either in its type (*jinsihi*) or in its quantity (*qadarihi*), e.g., when a person says to a purchaser, “I sell you a slave”. All of these types of *al-gharar*, especially those in his examples, incorporated risk (Taymiyyah, 1982).

³⁹ The terminological aspect of *gharar*, for instance by *Ibn Taymiyyah* was “anything whose consequences are unknown” (Taymiyyah, 1982, p.138) or in his other book, “anything whose consequences, outcome and nature are hidden. It is also defined as the uncertainty over the soundness and unsoundness of the object”. That is, the terminological meaning of *gharar* was not made equivalent to risk or *khatar*.

Some contemporary studies have delineated the concept of risk based on the concept of *al-gharar*. One study asserted that *bay' al-gharar* has the meaning of 'trading in risk' (El-Gamal, 2001). In this view, *gharar* incorporates risk. It was mentioned in the study that:

“The literal meaning of the term *gharar* according to Qadi Iyad (c.f. Al-Qarāfī (n.d., vol.3, p.266) is: “that which has a pleasant appearance and a hated essence”, c.f. The origin of the term is the three-letter past tense verb *gharra*, meaning “to deceive”. Thus, the Encyclopaedia of Jurisprudence (vol.21, CDROMversion, Cairo: Harf, 1998) states that *tadlīs* = cheating (in trade) and *ghabn* = fraud and deception are among the categories of *gharar*. The type of uncertainty regarding future events which constitutes *gharar* may be one-sided or two-sided, and it may be intentional or unintentional. However, in all of the definitions that follow, one thing is common: the incorporation of risk” (El-Gamal, 2001).

Another study was found to be of quite similar view. In the said study, permissible *gharar* was considered synonymous to risk.

“In the Islamic context, jurists define *gharar* to mean risk, and some of them tend to prohibit all risks and *gharar* but we found that only gambling and gambling-like activities are prohibited. In this context (i.e. under the sub-topic of the acceptable *gharar*), risk and uncertainty are considered synonyms to *gharar*” (Al-Saati, 2003).

Kamali (2002) also used risk and uncertainty interchangeably to denote *gharar*, although he did not define *gharar* as risk. According to Kamali (2002):

“Gharar can be summarized as occurring in four main ways. These are on account of uncertainty and risk pertaining to the existence of the subject matter of a sale, or its availability about the quantities involved and lastly, uncertainty about time of completion and delivery” (Kamali, 2002).

Based on these definitions or statements, *al-gharar* involves uncertainty that results in risk, or the elements of risk and uncertainty that are embedded in *al-gharar*.

Nonetheless, these definitions or statements were confined to risk and uncertainty (*al-gharar*) in a transaction or a contract.

3.4.3 Risk as Different from al-Gharar

From an Islamic perspective, permissible wealth creation must be accompanied by the concepts of *al-ghanmu bi al-gharmi* and *al-kharaj bi al-dhaman*. These concepts mean that gaining returns (profit) in Shariah is permissible when it involves risk (Waemustafa & Sukri, 2016). Hence, engagement in risk is permissible, unlike *al-gharar* that can render a contract void. According to *Ibn Taymiyyah*, there is no specific Quranic verse or Prophetic narration on the illegality of risk, thus leaving risk to be theoretically permissible.

Based on the permissibility and non-permissibility grounds of risk and *al-gharar*, respectively, S. Al-Suwailem (1999) asserted that risk and *gharar* are two different things. While risk is not prohibited by Shariah, *gharar* is prohibited. This was echoed by him when he stipulated that Shariah does not prohibit a contract just because it involves risk. According to him, *gharar* refers to a situation when risk is manipulated to make profit for one party at the expense of the other. In his view, *gharar* is a zero-sum game with uncertain payoff⁴⁰. Still, his definition of *al-gharar* as a zero-sum game with uncertain payoff seems to acknowledge the expense of one side than the others, while in the classical literature of *bay' al-gharar*, both sides of losses were

⁴⁰ By zero-sum game, it was meant as a game of two parties, where one party will only win at the expense of another losing (Al-Suwailem, 1999). In the study, *gharar* was not grouped into permissible and non-permissible types as formulated by other researchers. His stand on this was perhaps based on the literal meaning of the hadith where Prophet Muhammad s.a.w described *bay' al-gharar* as trading between two persons on a horse, or camel, or slave on loose (or lost), where the market price of each is fifty dinar. Yet, the buyer said to the seller, "I am buying it for twenty dinar". If the buyer found the loose item, the seller lost the thirty dinar, and if the buyer did not find it, the seller gained the twenty dinar.

acknowledged. An example of *bay' al-hasah* is a sale contract by way of 'gamble' through throwing a pebble (Awang, 2005). In this contract, both buyer and seller may lose simultaneously since the buyer does not know what he will get and the seller does not know what he is selling⁴¹.

Dusuki (2012) and Swartz (2013) were of the same opinion in differentiating risk from *al-gharar*. According to Dusuki (2012), although risk or *mukhatarah* is frequently associated with *al-gharar*, prohibition of risk cannot be found in the Quran and Hadith unlike the case of *al-gharar*. Nevertheless, he opined that risk which falls under the category of non-permissible risk is *al-gharar*. This was derived from the interpretation of 'unjust consumption of property' in the Quran, to include excessive uncertainty or non-permissible risk. Swartz (2013), on the other hand, stated that risk is inevitable in nature and is beyond human being's control. Unlike risk, *al-gharar* is more manageable. Therefore, risk and *al-gharar* are two different things. In addition, one study viewed *al-gharar* as a sub-category under *al-khatr*. Waemustafa and Sukri (2016) said:

“Though some scholars in Islamic banking usually define risk as “Gharar” that does cover only part of the meaning. The available literature defined risk as limited only to the perspective of “Gharar”, though risk in Islamic contract is much wider than just the concept of “Gharar”.

Another study also opted for a similar view. The study contemplated that the risk discussed in the classical fiqh is a type of risk that is embedded in a contract and has the effect of invalidating it. The risk as discussed in the field of finance is a type of risk that

⁴¹ The view that risk is a zero-sum game was nonetheless rejected. This is because some types of contracts that involve the elements of *al-gharar* as prescribed by the Prophet s.a.w. were not zero-sum games. For instance, two sales in one contract (El-gamal, 2001, p.7). Rather, the contracts were forbidden because of the excessive risk involved.

relate to the circumstances surrounding the contractual relationship that arises from the contract. Among the examples of risk in the classical *fiqh* are the existence and non-existence of the subject matter of the contract, while risk in finance deals with a change in economic climate or adverse circumstances faced by one of the parties, etc. (Elgari, 2003). These two types of risk in the past literature has drawn a difference between *gharar* and *mukahatarah* from the definition of risk as perceived in modern finance (Elgari, 2003).

Observing the two opposite views of risk from an Islamic perspective, it is noted that the different aspects of risk *vis-à-vis al-gharar* were discussed. Risk and *al-gharar* were viewed as similar in relation to a contract or a transaction. It is evident in the studies that the scholars were focusing on the elements of risk in a contract or transaction including gambling transaction (Al-Saati, 2003; El-gamal, 2001; Kamali, 2002; Taymiyyah, 1982). At the end of the spectrum, risk was viewed as different from *al-gharar*. This view was, however, not focused on risk or *al-gharar* as elements in a contract or a transaction. The differences between risk and *al-gharar* lie on several grounds. They are:

1. Risk denotes a wider meaning that is not confined to contract or transaction (Swartz, 2013; Waemustafa & Sukri, 2016);
2. There are different uses of the term risk (*mukhatarah* and *al-gharar*) in the *fiqh* and in modern finance (Elgari, 2003);
3. While risk is permissible, *al-gharar* is not (Al-Suwailem, 1999); and
4. While risk validates the legal rights and obligations in a contract, *al-gharar* invalidates a contract (Waemustafa & Sukri, 2016).

3.5 LEGAL RISK

As risk is usually associated with unwanted events and their probabilities (Hansson, 2002, 2011), legal risk is of no difference. When a risk is juxtaposed with the term ‘legal’, the context of the risk is presumed to be limited to the legal aspect. With this, the question left is what is meant by ‘legal’.

3.5.1 Literal Meaning of Legal Risk

From a linguistic perspective, ‘legal’ simply means being connected to the law. The closest terms that can be studied to determine the meaning of ‘legal’ is legality and legitimacy. While legality is defined as ‘the fact of being legal’, legitimacy is a state of ‘being allowed and acceptable according to the law’ (Oxford Advanced Learner's Dictionary, 2010). Still, these two terminologies are different. As legitimacy is left to be determined by political scientists, determination of legality is placed in the hands of the lawyers (DÉntréves, 1963).

Legitimacy is a source and basis of political power. According to Max Weber (1954), as quoted by DÉntréves (1963), legality is *‘the prevailing type of legitimacy in modern society’*. Weber further explains that the most common form of legitimacy is the belief of legality where there is an acquiescence in law (DÉntréves, 1963). This was explained in the prominent writings of Lon Fuller (1969), *‘The Morality of Law’*, legality means a state where a law does not have any of the eight ways of failure, i.e., failure to achieve rules (when issues are decided on add hoc basis), failure to publicize the rules, the abuse of retroactive legislation, failure to make rules understandable, failure to prevent contradictory rules, rules requiring the affected party to do beyond his powers, frequent changes in the rules, and failure of congruence between the announced

rules and their actual administration (Fuller, 1969). Legality is thus, a state of a law being a law, i.e., established by procedures, properly structured, and fits in its system to give a binding effect on the subjects of the law. Principles of legality is also another common term used in the field of law, particularly when discussing criminal liabilities and human rights (Eagher, 2010; Meagher & Groves, 2010; Robinson, 2009; Worster, 2011). In fact, different conceptions of legality offers different standards of legality (Dworkin, 2004). As far as this research is concerned, it is not related to the issue of legality of risk. In fact, it refers to the scope of risk that is legal in nature, or of a 'legal' quality (McCormick, 2013). With this, it is best to take the literal meaning of 'legal', which is being connected to the law.

3.5.2 Definitions of Legal Risk

In order to understand legal risk, the historical background of defining the said term is worth mentioning. At the time the Legal Law Review Committee (LRRC) was formed in the early 1990s, legal risk was perceived generally by the practitioners as risk related to the technical aspect of documentation or defective documentation risk (McCormick, 2013). For bodies like, International Institute for the Unification of Private Law (UNIDROIT) and Financial Market Law Committee (FMLC), the principal focus of legal risk was on legal uncertainty (McCormick, 2013).

In fact, various definitions of legal risk were issued by the legal committees, some of the important ones are as compiled by McCormick (2013):

Table 3.1 Definitions of Legal Risk

| Definitions of legal risk | Entity | Year |
|--|--|-------------|
| <p>“the risk that the law is proved to operate in a way adverse to the interests or objectives of the insurer where the insurer:</p> <ul style="list-style-type: none"> (a) Did not consider its effect; (b) Believed its effect to be different; and (c) Operated with uncertainty as to its effect” | <p>Financial Services Authority (FSA) (insurance)</p> | 1986 |
| <p>“the risk that the unexpected interpretation of the law or legal uncertainty will leave the payment system or members with unforeseen financial exposures and possible losses”</p> | <p>Bank of England (risk in payment system)</p> | 2000 |
| <p>Legal risks were grouped into three headings, organizational legal risk (related to the company’s assets and property), legal methodology risk (risk of inadequacy of methods adopted and steps taken to protect the company against claims and damages) and conduct-of-business legal risk (risk of liabilities or obligations due to the conduct of the company’s commercial operation)</p> | <p>Financial Law Panel (FLP)</p> | 2001 |
| <p>“Legal risk commonly refers to a situation where the applicable law does not provide for a predictable and sound solution”</p> | <p>International Institute for the Unification of Private Law (UNIDROIT)</p> | |
| <p>“Legal risk is the risk of loss to an institution which is primarily caused by;</p> <ul style="list-style-type: none"> (a) A defective transaction; (b) A claim being made or some other event occurring which results in liability for the institution or other loss; (c) Failing to take appropriate measures to protect assets owned by the institution; or (d) Change in law. | <p>International Bar Association (IBA)</p> | 2003 |

Several observations can be made from the definitions given. First, legal risk is defined from the aspect of ‘concern’ of the related committee, such as consumer protection and company’s interest (insurance). Second, there are cause-based

definitions (Bank of England, IBA), effect-based definitions, and risk management-based definitions (FLP). Third, legal risk as defined by the committees is intertwined with legal uncertainty, where some considered legal uncertainty to be the legal risk (UNIDROIT definition), while others considered legal uncertainty to be embedded in the legal risk (IBA definition).

Finally, emphasis was also directed towards acknowledging ‘legal risk events’ that later led to the legal risk being materialized, for instance, negligence of a bank to keep its legal documentation up to date, corresponding with the law updates, and failure to train its staff on related legal matters. The legal risk events may be conceived as legal risk arising from the operation of an organization.

In sum, there are similarities in the definitions provided above in terms of the uncertainty element within the law (i.e., legal uncertainty) and the judicial decision or situations within the company’s operation that exposes the related entity to losses, damages, and liabilities (i.e., liability risk). The exposure may be due to either direct causes (such as defective transactions and claims) or indirect causes (such as failure to take appropriate measures, underestimation of the risk, and change of law).

Besides the definitions offered by the legal committees, other definitions were also found in the existing literature. Legal risk was defined as a type of risk that exposes an entity to either civil or criminal liability (McCormick, 2013). From the perspective of finance, a legal risk is linked to technical defects (McCormick, 2013) or the material elements in a contract and thus risking the contract’s legal validity (Rubock, 2010). These definitions deal with two types of legal risks, one that relates legal risk to liability and another that relates legal risk to validity. This observation was also noted by Mahler (2007). Thus, these definitions were narrowed to the legal aspects of risk, i.e., liability

and validity, in accordance to the law. In this view, it signals the relationship between legal risk and compliance with the law.

At the same time, the law itself can give rise to legal risk⁴² (Whittaker, 2003) due to change of law, unclear law, incomprehensibility of law, the way the law is arbitrarily applied by the regulators, and others (Wood, 2013). This type of legal risk was described by EY (2016) as risk of financial and reputational loss arising from either lack of awareness or misunderstanding of, ambiguity in, or reckless indifference to, the way a law or a regulation is applied to a business, its relationships, processes, products, and services.

A similar point was also observed in Trzaskowski (2005), who said that legal risk is related to the norms settled by the law and interpreted by the judiciary (Trzaskowski, 2005)⁴³. In fact, in the International Bar Association Symposium on Legal Risk, it was concluded that the sources of legal risk, among others, is the problem within the law itself (Pigott, 2004). According to the Symposium's report, it means that legal risk may arise from bad law (inconsistent legislation), policy concerns (the law having the effect of constraining particular market participant), inaccessible law, and unpredictable judicial reasoning (Arnott, 2004). Thus, these definitions and descriptions imply uncertainty of law as an element of legal risk. This position was also affirmed in (Libson & Parchomovsky, 2022)

Just like the uncertainty element found in the definition of legal risk by the legal committees, the uncertainties of legal aspect as an element to constitute legal risk was

⁴² Legal risks that are sourced from the law itself are defined as the “risk that the law itself gives rise to a result which is both unplanned and unwelcome” (Whittaker, 2003, p.5)

⁴³ He defined legal risk as “a potential detriment caused in connection to a legal relation and which may be imposed by enforcement through the judiciary”. By legal relation, he meant a relation that entails rights and obligations that are enforceable by the judiciary power. The legal relation can be divided into two, one that is based on contract (contractual relation) and another is based outside of contractual relation, i.e. norms that are settled by the law and interpreted by the judiciary (Trzaskowski, 2005, p.2).

also stated by Mahler (2007). According to him, legal uncertainty is the uncertainty over the correct or likely legal judgement to be made on a set of facts. This uncertainty is caused by numerous factors, including the vagueness of law, the variation of legal sources, the differences in interpreting the legal sources, and the inherent uncertainty involved in legal norms (Mahler, 2007). Factual uncertainty⁴⁴, on the other hand, refers to facts or conditions of a case that will trigger the basic legal norms of an antecedent and its consequences. In his definition of legal risk, both factual uncertainty and legal uncertainty are elements of legal risk.

A study has been conducted through a random survey to determine apprehension of practitioners of different sectors of legal risk. The results showed that most respondents agreed that there was a connection between risk and legislative or regulatory issues, i.e., compliance with the regulations (Berwin Leighton Paisner (BLP), 2013), dispute/litigation management, and contractual risk (Berwin Leighton Paisner (BLP), 2013). Compliance with the regulations as a legal risk was described as “risk of legal violations” (Collins, 2010). In fact, it was asserted that legal risk was treated synonymously with compliance risk (Terblanché, 2013).

Other researchers have extended the scope of legal risk to include risk that arises from contracting parties’ creditworthiness, incentives by third party⁴⁵ (Rubock, 2010),

⁴⁴ According to Mahler (2007), every legal norm consists of two elements, an antecedent (e.g. A) and a consequent (e.g. B). “If we assume that the consequent (B) is negative for the stakeholder, then we need to determine if the norm will “fire.” This depends on two questions, which are essential here: first, whether the set of facts (A) is or will be true; and second, whether the application of the norm to the set of facts (A) then renders the consequence (B). Uncertainty may prevail with respect to both aspects. The norm’s likelihood of firing may depend on legal uncertainty, e.g., if an obligation depends on the interpretation of the law. In addition, the likelihood of the norm firing depends on uncertain facts or conditions, which are described in the antecedent and which trigger the consequent of the norm. A judge, or anyone applying the norm, compares these conditions to the “facts” of the case. The uncertainty about these conditions described in the antecedent is hereinafter referred to as factual uncertainty” (Mahler, 2007, p.10-11).

⁴⁵ In structured finance transactions, there are more than one party involved. Thus, the transactions require the numerous parties to fulfil their responsibilities. Failure of one party to perform its duty may create legal risk for the transaction. Servicer risk, or risk arising from conduct of servicer in collecting payments, observing payment performance and calculating periodical payments to investors, is one of

bankruptcy legal risk, regulatory legal risk, extraterritorial legal risk, contract legal risk, litigation risk, and rule of law risk (P. R. Wood, 2013). A similar description of legal risk was provided by Basel Committee on Banking Supervision (BCBS) in 2006 when it stipulated that a legal risk includes, but is not limited to, “exposure to fines, penalties, or punitive damages resulting from supervisory actions, as well as private settlements” (BCBS, 2006). These definitions or descriptions offer an extensive range of legal risks. In other words, risks that are related to the legal system, legal liability, and legal contract are all considered as legal risk.

The operational nature of legal risk is also inevitable, as is evident from the definition of operational risk as issued in Basel II⁴⁶. In addition, documentation risk as part of legal risk (McCormick, 2013) also resides in the “execution, delivery, and process management” in an operation (Carse, 2002). Past literature on legal risk has also shown that legal risk is operational in nature. It is a type of risk that stems from an organization’s poor operational management of risk. Legal risk from the operational aspect was defined as:

“the risk that the organization is found to have acted unlawfully because, although the law itself was in no doubt, its own internal arrangements left it with a legal problem. It may be that it acted unlawfully, failed to ensure that its contracts adequately reflected its commercial objectives or became embroiled in litigation. In these cases, legal risk is a form of operational risk arising because the organization’s own operational risk controls were inadequate to enable it to respond to legal issues.” (Whittaker, 2003)

the examples. Delay in collecting payment as a result of poor management of the service may trigger legal risk. It is also called exogenous risk. See <https://www.bis.org/publ/cgfs23cousseran.pdf>

⁴⁶ Operational risk is defined as “the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events. This definition includes legal risk, but excludes strategic and reputational risk” (Basel Committee on Banking Supervision (BCBS), 2006, p.144)

The same point was also mentioned in terms of legal risk that arises from technical defects in relation to how a transaction is executed (McCormick, 2013)⁴⁷. The former type of legal risk can be described as operational legal risk and the latter was also described by EY (2016) as contractual risk or documentation risk⁴⁸. Contractual risk was also mentioned as legal risk that arises from contractual relations (Trzaskowski, 2005).

Based on these definitions, there are additional elements of legal risk besides those offered by the legal committees. The additional elements are factual uncertainty as attached to legal uncertainty, extensive types of legal risk that include regulatory risk, compliance risk, contract risk/ documentation risk, litigation risk, and risk relating to dispute management as mostly mentioned in the literature. The operational nature of legal risk was nonetheless mentioned by both the legal committees and past literature. These elements of legal risk are summarized as below:

Table 3.2 Summary of Legal Risk Elements in the Literature

| Elements of Legal Risk | Details | References |
|-------------------------------|---|--|
| Consequences of legal risk | Loss (Financial and reputational loss) | EY (2016) Basel Committee on Banking Supervision (BCBS), 2006) International Bar Association (IBA) |
| | Liability (Civil or criminal liability) | McCormick (2013) Whittaker (2003) International Bar Association (IBA) |
| | Uncertainty in law | Financial Services Authority (FSA) Bank of England |

⁴⁷ It is also called a transaction risk. Transaction risk is the risk of financial loss as a result of a transaction not being executed properly (Currington, 1993, p.8)

⁴⁸ In Schuhmann and Eichhorn (2017), the description of the former risk fits their categorisation of contract risk arising from contract handling and the latter is the contract risk arising from the functional dimension of a contract. Nevertheless, their study was not meant to define legal risk.

| Elements of Legal Risk | Details | References |
|-------------------------------|--|---|
| Causes of legal risk | | International Institute for the Unification of Private Law (UNIDROIT) change of law (International Bar Association (IBA)) together with factual uncertainty (Mahler, 2007) rule of law risk (P. R. Wood, 2013) McCormick (2013) Whittaker (2003) Wood (2013) EY (2016) Trzaskowski (2005) Pigott (2004) Arnott (2004) |
| | Validity of a contract/transaction | Technical defects of a contract McCormick, 2013) Defective transaction (International Bar Association (IBA)) Rubock (2010) Mahler (2007) |
| | Operational | Whittaker (2003) McCormick (2013) Failure to take appropriate measures to protect assets owned by the institution (International Bar Association (IBA)) |
| In relation to | Regulatory risk/ Compliance risk | Berwin Leighton Paisner (BLP) (2013) Collins (2010, p.1) Terblanché (2013, p.10) |
| | Litigation risk (including dispute management) | Berwin Leighton Paisner (BLP) (2013) P. R. Wood (2013) Basel Committee on Banking Supervision (BCBS) (2006, p.144). |
| | Contractual risk | Berwin Leighton Paisner (BLP)(2013) Trzaskowski (2005, p.2) EY (2016) P. R. Wood (2013) |

| Elements of Legal Risk | Details | References |
|-------------------------------|------------------------------------|---|
| | Documentation risk | Defective documentation risk (McCormick, 2013, p.264) |
| | Contracting party creditworthiness | Rubock (2010) |
| | Third party incentives | Rubock (2010) |
| | Extraterritorial risk | P. R. Wood (2013) |
| | Bankruptcy risk | P. R. Wood (2013) |

Other than that, legal risk arising from a contract (contractual risk) can be understood as legal risk that emerges from the law itself (e.g., validity of a contract from the legal perspective) and as legal risk arising from the operational aspect (e.g., contract risk arising from the handling of a contract by an organization) (Mahler, 2007; McCormick, 2013; Schuhmann & Eichhorn, 2017). Therefore, legal risk encompasses three aspects, i.e., risk arising from the law itself, risk arising from a contract, and risk arising from the operations of an organization.

Below is an illustration of legal risk as defined and described in past literature:

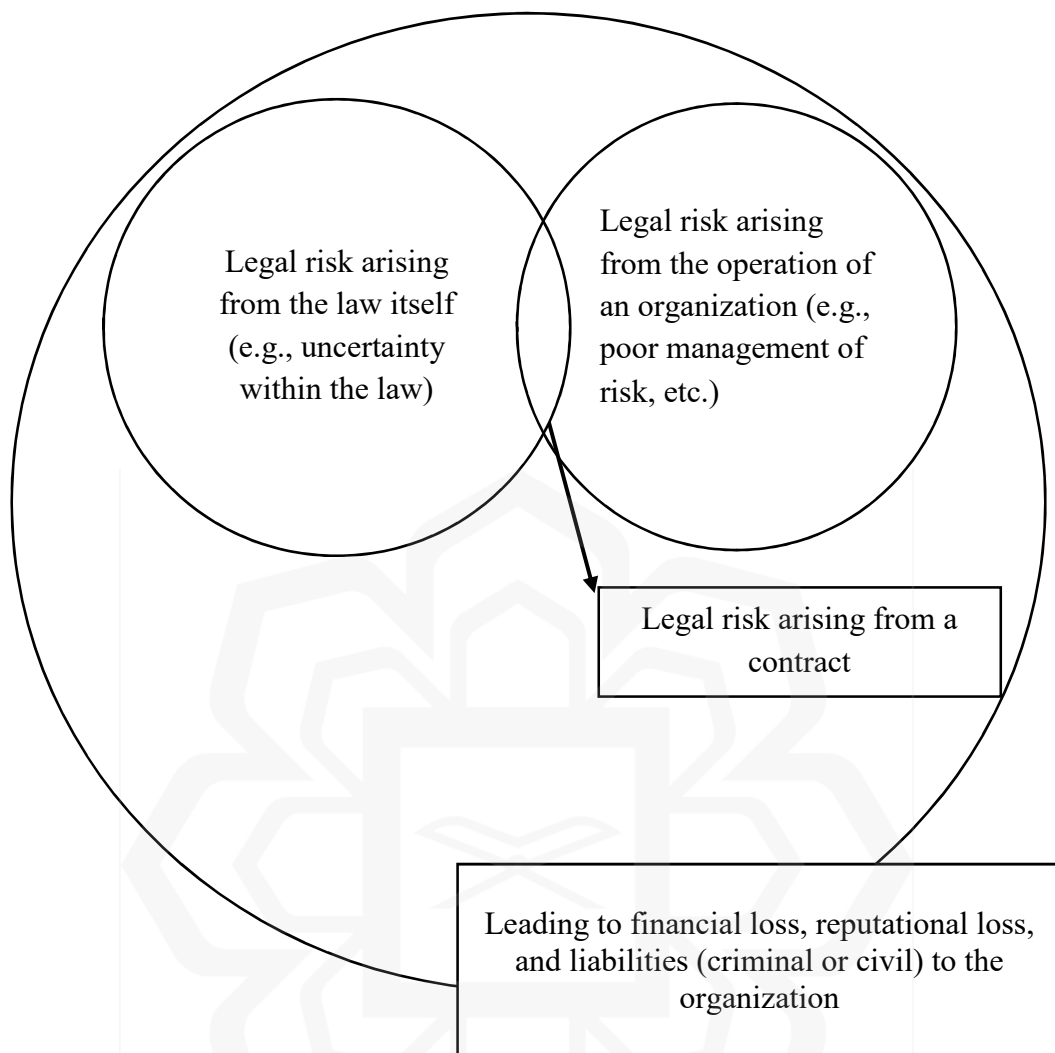


Figure 3.2 The Conceptual Framework of Legal Risk

In order to delineate the concept of legal risk for the purpose of this research, analysis on similar terms used in the literature to imply legal risk will be carried out. The discussion will contribute towards distinguishing the concept of legal risk from synonymous terms/risks or to determine the relationship between legal risk and the terms/risks.

3.5.3 Similar Risks or Types of Legal Risk

When assessing past literature on legal risk, a few risks which are similar to legal risk have been identified. As discussed, most of these risks have been mentioned to form part of legal risk. These risks will be explored in terms of their features and their relationship with legal risk. The discussion will assist in the conceptualization of legal risk for the purpose of this research.

3.5.3.1 Uncertainty in Law or Legal Uncertainty

Legal uncertainty has been defined more narrowly as compared to legal risk. Legal certainty, as opposed to legal uncertainty, is prevalent in the ideology of Max Weber. Legal security is an indispensable element to his capitalist ideology which attaches paramount importance to economic stability. Weber stated:

“...the increasing calculability in the functioning of the legal process in particular, constituted one of the most important conditions for the existence of economic enterprise intended to function with stability and, especially, of capitalistic enterprise, which cannot do without legal security” (Weber, 1978).

He further stated that it was in the interest of the bourgeois to demand an unambiguous and clear legal system that is free from unnecessary arbitrariness and irrational privileges, and that can guarantee legality and abidingness of their contracts. By ‘legal security’, Weber meant an unambiguous and clear legal system (Raban, 2000), hence legal certainty.

Nevertheless, from a purely legal perspective, legal uncertainty is defined in a restricted way that excludes the association of legal risk. It has been described as unpredictability of legal sanctions (criminal liability) due to prediction-post diction

distinction (Guttel & Harel, 2007) or variance of predicted judicial judgements (Weiss, 2005).

Similar to the objective-subjective paradigms of risk uncertainty, legal uncertainty is also discussed in the same sense. According to Wagner (2005), legal uncertainty occurs when an individual actor is uncertain of the consequences of one action from the perspective of legal provisions in the system. With this, he also elaborated on subjective legal uncertainty and objective legal uncertainty. By the former, he meant a subjective assessment of legal uncertainty by marginal cost and marginal utility as perceived by an individual, or as to 'what the law is'. The latter, on the other hand, is an objective paradigm of legal uncertainty which must be equally accepted, for instance, absence of law, changes in law, and prevention of legal rights by the state (Wagner, 2005).

Legal uncertainty is also perceived as uncertainty in the eyes of a legal advisor. In a study by D'Amato (1983), legal uncertainty is limited to a situation "when the rule that is relevant to a given act or transaction is said by informed attorneys to have an expected official outcome at or near the 0.5 level of predictability. Meanwhile, in Betlem (2002), legal uncertainty is perceived as an effect of inconsistent judicial interpretations.

Others, like Katsoulacos and Ulph (2016) and Lang (2017), associated legal uncertainty with the regulatory aspect. Lang (2017) stated that legal uncertainty is a situation where the legality of a specific action is unclear *ex ante*, while Katsoulacos and Ulph (2016) defined legal uncertainty as the inability to predict with certainty how a certain action taken would be judged by a regulatory authority, civilly or criminally. With these definitions or descriptions, legal uncertainty is associated with legality issues from a legal perspective and predictability issues from a judicial perspective.

Simultaneously, some even considered both aspects of legal uncertainty. Thus, legal uncertainty is highlighted as uncertainty of law and the notion of “difficult to predict perfectly *ex ante*, on how a law will be applied by the court, *ex post*” was employed (Giuseppe & Bruno, 2007)⁴⁹. Another definition that considers both aspects is as follows:

“... it may be said that it is more important for a rule to be certain than for it to be just. If I know that certain acts will involve me in certain legal consequences, ... It would be intolerable for a man to have to rely on his own moral judgement in order to know whether a court would approve his actions or not” (Wade, 1941).

Despite the in-depth discussion on the definitions of legal uncertainty in past literature (D’Amato, 1983; Giuseppe & Bruno, 2007; Guttel & Harel, 2007; Katsoulacos & Ulph, 2016; Wade, 1941; Wagner, 2005; Weiss, 2005), it can be observed that legal uncertainty is an independent concept and it does not relate to risk or legal risk. Nevertheless, there is the need to embed legal uncertainty in legal risk because most literature on legal risk relates it to uncertainty in law (Arnott, 2004; EY, 2016; Mahler, 2007; McCormick, 2013; Pigott, 2004; Trzaskowski, 2005; Whittaker, 2003; P. R. Wood, 2013).

3.5.3.2 Regulatory Risk

Regulatory risk has been addressed significantly in past literature of various fields such as finance, medical, and engineering. Regulatory risk has also been defined differently. It is a type of risk that is caused by regulatory interventions, such as adjustment of price cap by regulators (Rammerstorfer, 2009). This risk is subject to the inability to predict

⁴⁹ The author also recognized the use of the concept of uncertainty as in economics as opposed to risk as proposed by Knight (Giuseppe & Bruno, 2007, p.628 in footnotes)

the regulatory outcome (Herget & Sandberg, 2014). It may arise from a few aspects of regulation itself, i.e., application and execution of regulatory decisions, absence of decisions, changes in rules, discretion, interpretation of vaguely specified rules, political and social interventions in the regulatory decisions, as well as the absence of enforcement procedures for regulatory decisions (Ferro, 2001).

In a study conducted by the Economic Intelligence Unit (EIU), regulation was found to be a major source of risk because of the cost involved in compliance (cost of regulation), complexity in international regulations that may cause non-compliance, and the deterrence of investment decisions in overseas markets (The Economist, 2005, p.2). In these views, regulatory risk is compressed to the regulations and uncertainties that it brings.

When regulatory risk is given an effects-based definition, it heightens the financial effects on an entity as shown in the following definition:

“Regulatory risk arises when the interaction of uncertainty and regulation changes the cost of financing the operations of a firm. This definition is broad enough to include all of the important sources of uncertainty, but restricted to those for which the effect on the firm arises from, or is magnified by, the existence of regulation” (Ergas, Hornby, Little, & Small, 2009).

At the same time, legal risk is a type of risk that exposes an entity to be fined, or sanctioned by the regulator for violation of certain laws or regulations, or be sued by a third party, or be denied its rights in a transaction due to failure to comply with certain regulatory requirements (Bennett & Marin, 1999, p.8). In these definitions, regulatory risk is linked to legal liabilities (e.g., fines, sanctions, and claims) and the issue of compliance. The interrelation of regulatory risk with non-compliance issues was made clear in another study that stated as follows:

“All instances of noncompliance give rise to some regulatory risks. Some instances of noncompliance may also involve other risks, such as credit, interest rate, liquidity or market risk. Where noncompliance with a law, regulation or agency issuance exposes an institution to one of these other risks, there may be market-based incentives for compliance (Gross, Clarke, & Gross, 1995)”.

Based on the definitions provided in past literature, it can be observed that regulatory risk is only attached to financial loss due to change of cost (cost of regulation), and legal sanctions or legal liabilities due to non-compliance. Notably, most definitions of regulatory risk as provided above link the risk only to “regulation” and to the uncertainties it brings, like regulatory intervention (Rammerstorfer, 2009), application and execution of regulatory decisions, absence of decisions, changes in rules, discretion, interpretation of vaguely specified rules, political and social interventions in the regulatory decisions, procedures for the regulatory decisions (Ferro, 2001), and inability to predict the regulatory decisions (Herget & Sandberg, 2014). Equivalent points were echoed in the description of regulatory risk, where the sources of the risk were “restricted to those for which the effect on the firm arises from, or is magnified by, the existence of regulations” (Ergas, Hornby, Little, & Small, 2009). Although non-compliance was deemed to be part of regulatory risk or even the regulatory risk itself by Bennett and Marin (1999)⁵⁰ and Gross et al. (1995)⁵¹, the definitions provided by both studies only highlighted the effects of the risk (effect-based

⁵⁰ Regulatory risk in this study was defined based on the effects of regulatory risk, “Regulatory risk encompasses several distinct kinds of risks. Among the regulatory risks that exist in the financial derivatives market are the risk that a market participant will be fined or otherwise sanctioned by regulators for violating a law or regulation, the risk that a market participant will be sued by a counterparty in connection with a derivatives transaction, and the risk that a participant will not be able to enforce its rights with respect to a derivatives transaction because it failed to comply with a certain regulatory requirement” (Bennett & Marin, 1999, p.8).

⁵¹ In this study, regulatory risk is defined also based on its effects, “regulatory risk is defined as exposure to adverse reaction by an agency with regulatory authority over a financial institution to its condition, operation or management” (Gross et al., 1995, p.34).

definitions) and neglected the source of the risk. Therefore, it is posited that non-compliance is also due to the regulation itself and its uncertainties.

In sum, regulatory risk is the risk of financial loss due to the cost of regulation and legal sanctions arising from non-compliance issues, and the risk originated from the regulation itself and the uncertainties it entails. Therefore, regulatory risk can also be considered as a type of legal risk.

3.5.3.3 Compliance Risk

Compliance denotes an action to comply, accommodate, or conform to certain standards or requirements (Oxford English Dictionary). In the same vein, it was suggested that compliance relates to enforcing an organization's established policies and procedures (Band, Hopper, Mayhew, & Buckingham, 2008). In the banking sector, compliance risk is defined as a risk associated with legal and regulatory sanctions, as well as significant financial or reputational losses as a result of failure to comply with the relevant laws, regulations, internal rules and standards, and codes of business conduct (Asenov, 2015).

Other definitions are:

“a risk of adverse consequences that can arise from systemic, unforeseen, or isolated violations of applicable laws and regulations, internal standards and policies, and expectations of key stakeholders including customers, employees, and the community, which can result in financial losses, reputation damage, regulatory sanctions, and, in severe cases, loss of franchise or rejected mergers and acquisitions.” (Kelsey & Matossian, 2004)

In April 2005, the Basel Committee issued a high level paper on compliance in the banking sector. In the said paper, compliance risk was defined as:

“the risk of legal or regulatory sanctions, material financial loss, or loss of reputation that a bank may suffer as a result of its failure to comply with laws, regulations, rules, related self-regulatory organization standards, and codes of conduct applicable to its banking activities (together, “compliance laws, rules and standards”)”.

Since these definitions of compliance risk were offered by the banks, it is crucial to explore the definition of compliance risk by the BNM. In the Compliance Guidelines issued by BNM in 2nd October 2015, compliance risk is defined as:

“the risk of legal or regulatory sanctions, financial loss or reputational damage which a financial institution may suffer as a result of its failure to comply with legal and regulatory requirements applicable to its activities”.

Observing these definitions, it seems that compliance risk consists of two pivotal elements, i.e., the consequences of the risk and the sources of the risk. The consequences of compliance risk are legal sanction, regulatory sanction, financial loss, and reputational loss. The sources of compliance risk may be direct and indirect sources. Direct sources are the laws that range from code of conduct, internal policies, to laws and regulations which are relevant and applicable to the entity’s operations. The indirect sources are ‘failure to enforce established policies and procedures’ (Band, Hopper, Mayhew, & Buckingham, 2008), ‘failure to comply’ (Asenov, 2015; Basel Committee on Banking Supervision (BCBS), 2006) and ‘systemic, unforeseen, isolated violations of applicable laws’ (Kelsey & Matossian, 2004). The second element may be considered the point that differentiates between regulatory risk and compliance risk. As the former relates merely to laws and the uncertainties they entail, the latter relates to the laws and the operational aspect to manage compliance with the laws.

In relation to legal risk, some definitions in the past literature have drawn stark differences between legal risk and compliance risk. For instance, compliance risk was defined in Basel II (2005) as,

“the risk of legal or regulatory sanctions, material financial loss, or loss to reputation a bank may suffer as a result of its failure to comply with laws, regulations, rules, related self-regulatory organisation standards, and codes of conduct applicable to its banking activities”.

This refers to statutory requirements, which includes legislation, regulation, or other guidance (such as best practices) issued by the relevant regulators or in terms of industry or company codes, standards, and policies” (Terblanché, 2013). It is different from legal risk that was defined as:

“the risk of financial, reputational or other losses incurred due to the non-adherence to legal requirements of all aspects of the law, including private, public, procedural or international law. It includes the codified and uncodified aspects of a mixed legal system” (Terblanché, 2013).

In other words, compliance risk is a type of legal risk. Similar view was found in Esayas & Mahler (2015) who regarded compliance risk as an aspect of legal risk.

Another approach was to treat both risks as independent from each other. In this view, compliance risk is narrower than legal risk because legal risk may originate from an unlimited space, such as legal and contractual rules, while compliance risk can only originate from a limited universe of clearly defined risks. For instance, specific regulations for the financial industry or for pharmaceutical companies, or specific laws such as antitrust or anti-bribery laws. At the same time, compliance risk can be outside the reach of legal risk, i.e., the risk may originate from non-legal (not strictly ‘legal’)

sources such as codes of conduct, ethical requirements, and contractual obligations (Kurer, 2015).

In another study, it was pointed out that some organizations regard issues of legal risk to revolve around the legal advice given to an operational section of the business. As a result, legal risk becomes the responsibility of the business which decided to accept the legal advice. In contrast, compliance risk is the responsibility of a chief executive of an organization, and compliance is limited to enforcing the organization's established policies and procedures (Band, Hopper, Mayhew, & Buckingham, 2008). In this view, legal risk and compliance risk are differentiated based on the ownership of the risk in an organization.

Based on the three distinctions between compliance risk and legal risk, it is observed that compliance risk is a type of risk that is concerned with compliance with a specific law, not the legal system or laws in general. This point may explain the distinctions drawn by Terblanché (2013), who claimed that compliance risk is related only to codified law. Kurer (2015) claimed that compliance risk is restricted to clearly defined risk in specific laws and regulations and to any non-strictly legal requirements, such as contractual obligations, code of ethics, etc. Similarly, when Band et al. (2008) discussed the distinction between legal risk and compliance risk, the underlying distinction that can be observed is the nature of compliance risk that is related to the specific laws that regulate the organization. Legal risk, on the other hand, is related to the legal system or general laws that may have effect on the organization. With these views, compliance risk can be treated as a risk of legal sanction, regulatory sanction, financial loss, and reputational loss due to non-adherence to specific laws, despite the legal system or general laws that are relevant to an organization. It is a risk stemming from law itself, i.e., the risk arises from the fact that there is a law that requires

compliance. Nonetheless, the risk is due to systemic violation or failure to comply. The latter implies the operational side of compliance risk. Either way, compliance risk is a type of legal risk.

3.5.3.4 Contract Risk

There is a very limited number of literature which provide a definition of contract risk (Schuhmann & Eichhorn, 2017). Nevertheless, contract risk may sometimes be understood as being part of legal risk or liability risk (Haapio, 2007). For instance, an organization may face liability if it breaches its obligations in a contract. Similarly, the organization may incur legal consequences if it fails to implement the terms of its contracts or if the contract is not valid (Haapio, 2007).

Schuhmann and Eichhorn (2017) stated that contract risk has been defined as “the possibility that the contract leads to negative deviations from the expected business outcomes”. He did not agree to this definition⁵². He himself defined contract risk as “every circumstances that lead to the failure of the contract in one of its functional dimensions and hereby endanger the transaction success” (Schuhmann & Eichhorn, 2017). There are three functional dimensions of a contract (based on the contract implicit purposes):

1. To secure the legal positions, i.e., the legal interests of the contracting parties;

⁵² According to Schuhmann and Eichhorn (2017), by “business outcomes”, it means the transaction underlying the contract and not the contract itself. On the one hand, “the contract leads to negative deviation” is unclear because, in a narrower sense, it refers to the contract as a source of risk, but in broader sense, it refers to any impact of the contract in a risk scenario (Schuhmann & Eichhorn, 2017, p.508).

2. To generate transparency. This function covers three aspects. Firstly, the aspect where the contract's function is to unambiguously define the contribution of each party to the contract and the associated risks, and to foster communication between the party. Secondly, the aspect of language, and thirdly, the visual representation used in the contract to ensure that it is managed appropriately; and
3. To stabilize the relationship of parties to the contract, i.e., to foster and secure cooperation between the parties.

Contract risks that arise from securing legal positions are the contract's legal and actual enforceability, the contract's compliance, and other risk sources grouped together under "robustness" that determine the reliability of the contractual provisions in cases of conflict. Contract risks, arising from the contract's function to generate transparency, are risks resulting from insufficient specification of contract goals and performances in the contract, incomplete contract documents, and shortcomings in the presentation of the contract. In addition, contract risks arising from the contract's function to stabilize party relationship are risks that the cooperation model used in the contract does not reflect the attitudes of the contracting parties, the used template for the contract does not match the actual business situation, and uncommon template that the parties have inadequate experiences with (Schuhmann & Eichhorn, 2017).

In addition to these risks, contract risks may also be risks arising from contract handling, which covers another two aspects, i.e., contract management and contract initiation and negotiation. These contract risks are thus the first and second level contract-related risks (Schuhmann & Eichhorn, 2017, p.511).

3.5.3.4.1 Documentation risk

Documentation risk can be grouped into three categories, i.e., (1) risk that a legal document is not valid and binding (risk of invalidity); (2) risk that a legal document does not stipulate the matters that the contracting parties assume to have been stipulated; and (3) risk that a legal documentation does not address a relevant situation that may arise, or addresses it inadequately (Balfour, 1999). The risk can arise in a single document or sets of documents, where there is additional documentation risk that the sets of documents do not work together (Balfour, 1999).

The risk of invalidity may arise from many situations, such as lack of capacity to contract by the contracting parties, either due to failure to undergo the necessary approval procedures based on their memorandum and articles of association, or because the legal document has been signed in an incorrect manner (Balfour, 1999). Similarly, the risk that the legal document does not state the matters intended by the contracting parties can also arise due to numerous reasons, especially in tailor-made contracts, like the standard terms used in the document were not reviewed, the drafting of the document was too complicated that it has not been evident to the contracting party that the terms do not reflect their intention, and also due to miscommunication between the drafter or a lawyer and his client that resulted in misunderstanding on the effect of the terms (Balfour, 1999).

3.5.3.4.2 Transaction risk

Another similar risk is known as transaction risk. Transaction risk is the risk of financial loss as a result of a transaction not being properly executed (Currington, 1993). Risks

relating to each type of transaction depend on quality of control, personnel and systems, transaction volume, and complexity of the particular instrument (Currington, 1993).

Based on these definitions and descriptions, contract risk and documentation risk entail similar meanings. A key concern is the legal effect of the contract. The second concern is the transparency of the contract to stipulate its intended purpose and the contracting parties accurately and to address the relevant situations that may arise from the contract adequately. The third concern is the handling of the contract which is operational in nature, which was also highlighted by Schuhmann and Eichhorn (2017) and Currington (1993) as transaction risk. A slight difference between contract risk and documentation risk, as impliedly mentioned by Balfour (1999), is that the latter may also arise from the incompatibility of a document with other sets of documents. In other words, contract risk relates to a single contract while documentation risk may relate to two or more contracts used in a single documentation. At the same time, slight differences between contract risk and transaction risk can also be observed. The differences lie in the fact that the latter is mostly concerned with the transaction or operational side of a contract.

The relationship between contract risk and legal risk was mentioned by some to highlight the legal risk management aspect, i.e., via a contract (Mahler, 2010; Schuhmann & Eichhorn, 2017; Trzaskowski, 2006). On the other hand, the relationship between documentation risk and legal risk was mentioned in relation to the need for standardization of documentation in order to reduce the legal risk (Carse, 2002). As a result, it is proper to regard contract risk or documentation risk, as well as transaction risk, as types of legal risk.

3.5.3.5 Litigation Risk

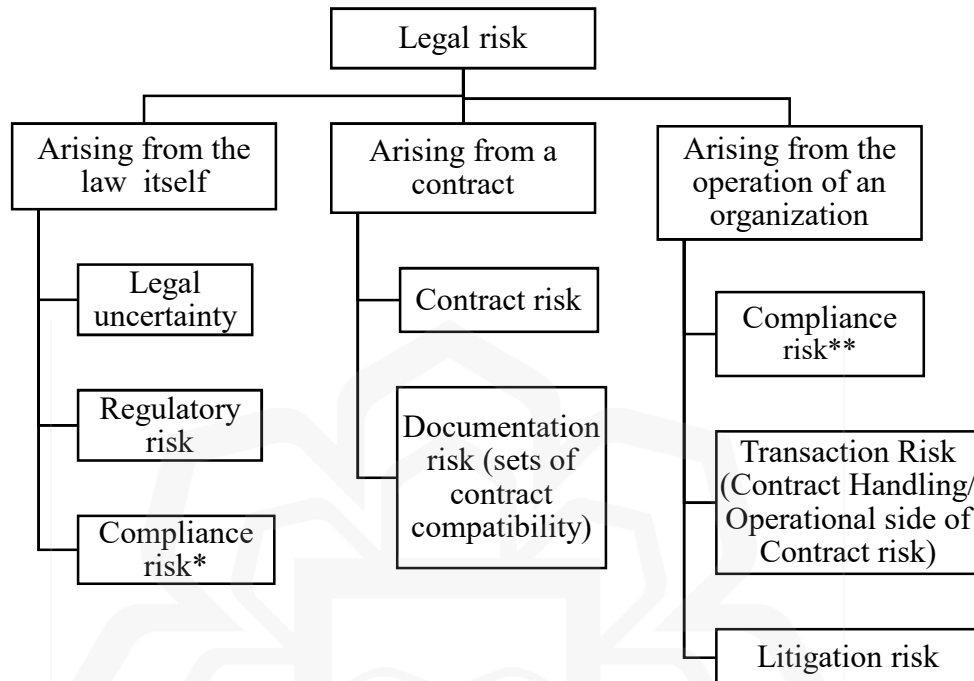
Litigation is generally perceived as the final resort in terms of dispute resolution mechanisms. The risk of litigation can be depicted in a few ways, i.e., the risk of getting embroiled in dispute, the risk of a party not being able to pursue or defend their claim, the risk of unenforceable award or judgement (closely related to counterparty risk) (Sandler, 2010). Litigation risk may involve regulatory enforcement actions and a few types of private litigation claims (Allen and Overy, 2014). The most common type of claim is breach of contract, including breach of investment mandate and breach of conditions. Other than that, the claims can also emerge during the pre-contractual stage, e.g., claims against inaccuracy of document and information, inadequate advice, and lack of disclosure of material facts (Sandler, 2010).

The relationship between litigation risk and legal risk has been mentioned in some studies. For instance, it was noted that litigation risk is a legal risk (McCormick, 2013) or emerged from the advising services provided by lawyers on legal risks (Molot, 2009). Litigation risk that includes claim is part of legal risk and this is also evident in the definition of legal risk as contemplated by McCormick (2013)⁵³.

Besides the discussion above, similar effort was seen in the study by Eldred (2020) who considered litigation risk, legislative risk, reputational risk, risk of misinterpretation of legal regulation, and risk of loss to be categories of legal risk. However, some of these risks were neglected in the above discussion since they are considered are not commonly associated with legal risk as found in the literature.

⁵³ He said, “ Legal risk... is commonly understood to relate to the risk of being sued or being the subject of a claim or proceedings due to some infringement of laws or regulations, or the commission of a tort such as negligence or some other act giving rise to civil liability’ (McCormick, 2013, p.21).

Based on the above discussion on similar risks or types of risk, legal risk can be illustrated as follows:



* Compliance risk is treated as risk arising from the law because the risk stems from the law that requires compliance.

** Compliance risk is treated as risk arising from the operation of an organization, i.e., the organization's failure to comply.

Figure 3.3 Types of Legal Risk

3.6 CONCLUSION

After analyzing the concepts of risk, probability, uncertainty, and legal risk itself, it was found that legal risk encompasses more than a concept of 'risk'. Even though risk and uncertainty were differentiated based on known and unknown probabilities respectively, it was discovered that legal risk comprise both risk and uncertainty.

When dealing with a legal risk, consideration must be given to the aspect of risk, i.e., known probabilities, as well as the aspect of uncertainty, i.e., unknown probabilities. It was discovered that, legal risk is a risk itself because there are known probabilities, e.g., compliance and non-compliance with law. Simultaneously, there are also uncertainties, e.g., unpredictability of judicial decisions, changes in law, etc.

Analysis of past literature shows that legal risk consists of a few types of risks. These risks have been discussed abundantly in the past literature, either being associated with legal risk or not. Nonetheless, the definitions of the risks have shed some light on their nature, hence their relationship with legal risk.

Based on the discussion provided above, legal risk can be defined in terms of both its consequences and its causes. Therefore, legal risk is a risk that arises from the law itself, from contract as well as from the operation of an organization that results in financial loss, reputational loss, or legal liability. It encompasses legal uncertainty, regulatory risk, compliance risk, contract risk, documentation risk, transaction risk, and litigation risk. As a result, the following chapter of this study will employ the legal risk's conceptual framework, i.e., the definition and scope of legal risk as elaborated in this chapter.

CHAPTER FOUR

LEGAL RISK IN *WAKALAH SUKUK* IN MALAYSIA

4.1 INTRODUCTION

In the previous chapters, a review on literature related to legal risk in Islamic finance, legal risk/legal issues in *sukuk* and definitions, concepts, as well as types of legal risk have been provided. In this chapter, more focused review will be presented on legal risk in *wakalah sukuk* in Malaysia. Building from the aspects, definitions, and types of legal risk in Chapter 3, this chapter will highlight theoretical and observed legal risk that may arise from *sukuk* and *wakalah sukuk* from the perspective of the Malaysian jurisdiction. This chapter begins with a discussion of legal risk in *sukuk* which will be narrowed down to three aspects, i.e., legal risk arising from the Malaysian legal environment, legal perspectives of *sukuk* contracts, and legal risk arising from *sukuk* operation.

4.2 LEGAL RISK IN SUKUK

Sukuk is a more complicated instrument to structure compared to conventional bonds (Mahayni, 2012). The complexities of *sukuk* are more apparent when structured in a western legal framework, whereas conventional bonds are more simple and straightforward (Nazar, 2011). This is because *sukuk* typically consists of a number of contracts or a series of contracts to create financial obligation on the obligor and to generate profits to the investors without any prohibited elements, e.g., *riba* and gambling. Thus, cautious steps need to be taken by both the issuer and the investor to

uphold the essential requirements of the *sukuk* contract, to ensure Shariah and legal compliance, as well as to safeguard their rights and obligations.

Similar points were echoed by Mahayni (2012) who stated:

“A *sukuk* may only be evaluated, in terms of investment prospectively, following a careful read of the marketing material relating thereto. All typical *sukuk* structures require a substantial amount of descriptive information and the provision of comfort regarding the titles and performance ability of the parties involved ... This level of detail and complexity increases the risk of misunderstandings, disputes, and plain failure. Western bonds are usually securitized simply by the creditworthiness of the issuer. In the case of *sukuk*, risk factors are more significant and may include such things as the risk of loss of the underlying asset (in the case of *ijara*, *murabaha*, or *istisna*) or the loss of title (e.g. the ownership or leasehold title in the case of *ijara*).”

Thus, how legal risk is defined, identified, and managed is of utmost importance. Defining legal risk is crucial for facilitative, control, and ownership purposes (Moorhead, Richard, Vaughan, 2015). In other words, better understanding, control, and management of legal risk can be achieved by clearly defining it. In addition, identification of risk is the most important stage in risk management (Dickson, 1995; Williams & Heins, 1985). Identification of legal risk is in fact partly a by-product of defining it and partly a result of applying the definition of legal risk in the day to day operation of an institution (McCormick, 2013).

Although there are a few related studies on legal analysis of *sukuk* (Al-Amine, 2012; Djojosingito, 2008; M. K. Hassan & Oseni, 2014; Kordvani, 2009; Nazar, 2011; Oseni, 2013; Oseni & Hassan, 2011; Oseni & Hassan, 2015) and studies on general risks in *sukuk* (Al-sayed, 2013; Haider & Azhar, 2010; ISRA, 2017b; Najeeb, 2013; Nanaeva & Pandey, 2010; Noor & Shahimi, 2013; Ramasamy, Munisamy, & Helmi, 2011; Shazly & Tripathy, 2013; Tariq, 2004; Tariq & Dar, 2007), so far, a specific study on the legal risk of *sukuk* in terms of *sukuk* structure and jurisdiction cannot be found.

Hence, this chapter attempts to examine the legal risk of a specific *sukuk* structure, i.e. wakalah *sukuk* in a specific jurisdiction, i.e.. Malaysia.

In past literature, there were several ways to encapsulate risks in *sukuk*. Risks in *sukuk* have been observed from the types of *sukuk*⁵⁴ (Tariq & Dar, 2007), stakeholders' perspectives⁵⁵ (IFSB, 2009), as well as structures of *sukuk*⁵⁶ (Alswaidan, Daynes, & Pasgas, 2017; ISRA, 2017b).

As stated in the previous chapter, legal risk encompasses three aspects, i.e., risk arising from the law itself, risk arising from a contract, and risk arising from the operation of an organization. In the first aspect, it is the law itself that gives rise to legal risks (Whittaker, 2003) in instances such as change of law, unclear law, incomprehensibility of law, and the way it is arbitrarily applied by the regulators and others (Wood, 2013). It is a risk of financial and reputational loss arising from either lack of awareness or misunderstanding of, ambiguity in, or reckless indifference to, the way a law or a regulation is applied to a business, its relationships, processes, products, and services (EY, 2016). In the context of *sukuk*, this refers to legal risk arising from the law or the legal environment⁵⁷ governing the *sukuk*. Risks expected from this aspect are compliance risk, legal uncertainty, and regulatory risk.

The second aspect is the legal risk arising from a contract (contract risk). It was observed in the previous chapter that contractual risk may emerge from the law itself

⁵⁴ That are: Zero coupon *sukuk*, fixed rate *ijarah sukuk*, floating rate *ijarah sukuk*, fixed rate hybrid/pooled *sukuk*, *musyarakah* term finance *sukuk* and *salam sukuk*.

⁵⁵ They are risks associated with the originator, issuer, special purpose entity (SPE), servicer and holder.

⁵⁶ Each *Sukuk* structure has a distinctive risk profile that is influenced by the Shariah principles underlying the financing structure as well as the type of *sukuk*. As a result, each *sukuk* structure may have different types of risks (Alswaidan, Daynes, & Pasgas, 2017; ISRA, 2017, p.398).

⁵⁷ Legal environment of the *sukuk*. This term is used to indicate a wide range dimension of laws, including the legal system and the government policies related to the *sukuk*. This term is not widely used in the literature on *sukuk*. The use of this term is however inevitable since the *sukuk* practices in Malaysia may be governed and affected by the legal system and government policies of Malaysia. Hence, it has become among the sources of legal risks in *sukuk*.

(e.g., validity of a contract from the legal perspective) (Mahler, 2007; McCormick, 2013; Schuhmann & Eichhorn, 2017). In the context of *sukuk*, this refers to the legal risk that may arise from the actual contracts used in the *sukuk*, in terms of the contract's validity or enforceability, contract structure and provisions, as well as incompatibility of one contract with another. Risks expected under this aspect are contract risk and documentation risk.

The third aspect is legal risk that is operational in nature. It is a type of risk that stems from an organization's poor operational management of risk. This exposes the organization to legal problems including legal liability, failure to ensure its commercial objectives (Whittaker, 2003, p.3), or technical defect in terms of how a transaction is executed (McCormick, 2013). In the context of *sukuk*, the expected legal risks are those that arise within the operation of the *sukuk*, i.e., risks that emerge from the operational aspect of the contract (e.g., contract risk arising from the contract's handling by an organization/ transaction risk) and risks due to failure to comply (compliance risk) particularly in activities within the issuance processes⁵⁸ that include the *sukuk* structuring (ISRA, 2017).

The legal risk to be explored within these three aspects are either hypothetical risk or observed risk. Hypothetical risk refers to risk arising from hypothetical situations while observed risk refers to risk that arises from real situations.

⁵⁸ *Sukuk* issuance processes covers four phases, namely capital raising, *sukuk* structuring, *sukuk* prospectus and *sukuk* offering (ISRA, 2017, p.232). Focus will be made on the phase of *sukuk* structuring, *sukuk* prospectus and *sukuk* offering. Within the *sukuk* structuring itself, i.e. to identify the appropriate *sukuk* structure to meet the objectives of capital raising, a few activities will be executed, such as the appointment of Shariah advisors, production of draft documentation, Shariah and legal opinions as well as obtaining initial ratings (ISRA, 2017, p.233).

4.3 LEGAL RISKS OF *SUKUK* ARISING FROM THE MALAYSIAN LEGAL ENVIRONMENT

4.3.1 Shariah Non-Compliance of Sukuk

Shariah compliance is an essential element in the issuance of *sukuk*. Shariah compliance risk refers to risk of failure of the Islamic financial instrument to comply with Shariah, and this includes the risk of non-compliance being declared at a later stage (Alswaidan et al., 2017). In terms of *sukuk*, the importance of Shariah compliance is reflected in the Capital Market Services Act (CMSA) 2007, the Lodge and Launch framework (LOLA), as well as the Guidelines for Retail PDS or CBSR 2017 and *Sukuk* Guidelines. Section 316A and section 316B of the CMSA 2007 provide for the establishment of Shariah Advisory Council (SAC) to ascertain the application of Shariah principles in matters pursuant to the Islamic capital market *vis-à-vis sukuk*. Section C, Chapter 3, Para 3.01 of the LOLA framework states that the structure of ringgit-denominated *sukuk* must comply with the approved Shariah rulings, principles, and concepts that are provided within the framework (Chapters 1, 4, 5, and 6 of Section C) as well as any other Shariah rulings, principles, and concepts endorsed by the SAC from time to time⁵⁹. A similar requirement is stated in Para 16.01 of the CBSR 2017.

To ensure that the *sukuk* is Shariah compliant, the Shariah advisor is required to make Shariah disclosures which involve, among others, the issuance of a detailed Shariah pronouncement on the *sukuk* structure. The pronouncement must prescribe (a) the basis and rationale of the pronouncement, the structure and mechanism of the *sukuk*;

⁵⁹ Chapter 1, Section C of the framework specifies all the applicable Shariah rulings based on types of *sukuk*, i.e. *ijarah sukuk*, *musyarakah sukuk*, *mudharabah sukuk* and *wakalah bi al-istithmar sukuk*. Section 3.02 further states that if the structure does not comply with any of the rulings, new rulings must be sought from the SAC before the lodgement is made.

(b) the applicable Shariah rulings, principles, and concepts used in the *sukuk*; and (c) the relevant Shariah matters relating to the documentation of the *sukuk* (ISRA, 2016).

In addition, compliance with the Shariah must also be observed throughout the tenure of the *sukuk*. For instance, the issuer must ensure that the utilization of the proceeds of the *sukuk* is Shariah compliant and any revision to the principal terms and conditions of the *sukuk* does not result in Shariah non-compliance. If the revision to the principal terms and conditions brings any Shariah implications, the issuer through the principal advisor must first refer such matters to the SAC for endorsement prior to the re-lodgment or update to the SC, or prior to seeking approval from, or submission of notification to, the SC. This is provided by Para 6.16 and Para 13.15 of the LOLA framework as well as CBSR 2017, respectively.

It is noteworthy that in a report issued by Fitch Ratings (Al Natoon, Shawqi, & Brown, 2021), significant changes will be expected due to the compulsory requirement to comply with Shariah standards of AAI OFI. A number of international issuers have revised their *sukuk* documents to satisfy the requirement, as also urged by the UAE Central Bank's Higher Shariah Authority (HSA). One of the changes is the tangibility ratio above 50% throughout the tenure of the *sukuk* rather than merely at the point of issuance (Al Natoon et al., 2021). Failure to maintain the 50% tangibility ratio will trigger delisting event or exercise of put option by the investors. Prior to this, tangibility issue was not associated with dissolution event or put option exercise (Al Natoon et al., 2021). Based on these, it can be argued that Shariah non-compliance risk within *sukuk* may emerge from tangibility ratio as well.

Non-compliance with the Shariah may also be alleged in the later stage of *sukuk*, i.e., when the *sukuk* defaults or nearly defaults. For instance, in the Dana Gas *sukuk* case, the issuer claimed that its *sukuk* was no longer Shariah compliant based on the

laws of the UAE. According to the facts of the case, Dana Gas claimed the Shariah non-compliance was due to the guarantee of fixed rate return of its *mudarabah sukuk* (Zada, 2019). On 30th June 2017, an injunction was issued by the Shariah Court stating that the *sukuk* was not Shariah compliant (Busari, AbdulAziz, Zakariyah, & Amanullah, 2019). As a result, Dana Gas was not in a position to make payment until after restructuring the *sukuk* into a Shariah-compliant instrument. Similarly, the effect of purchase undertaking as a means to guarantee returns to *sukuk* holders was made pending (Busari et al., 2019). Grieved by the situation, the *sukuk* holders approached the English High Court and the case was tried in July 2017 (Zada, 2019, p.289). It was reported that the English High Court⁶⁰ had ruled against the issuer, i.e., Shariah non-compliance and unenforceability issues would not have effect on the English law governing contractual obligations (Convington & Burling LLP, 2017). Should the English Court have ruled in favor of the *sukuk* obligor/*mudarib* (Dana Gas PJSC), the Shariah non-compliance would be detrimental to the *sukuk* holders and the legality of all the *sukuk* documentation⁶¹.

In addition, Shariah non-compliance risk is a legal risk in *sukuk* because compliance with Shariah principles is a statutory requirement⁶². Moreover, it was

⁶⁰ *Dana Gas PJSC v Dana Gas Sukuk Ltd & Ors* [2017] EWHC 2928

⁶¹ Theoretically, if the court applied Islamic law, non-compliance with Shariah would render the contract void or invalid (H. Hassan, 2017, p.7). Hence, unenforceable. In contrast, *sukuk* that is partially governed by English law, as evident in *Dana Gas PJSC v Dana Gas Sukuk Ltd & Ors* has shown that Shariah non-compliance of the *sukuk* has no effect on the contractual obligations of the *sukuk*. This is because the payment to be made under the contract, the Purchase Undertaking contract, was not conditional upon the transfer of assets under the UAE law governed documents. Besides that, the transaction account of the *sukuk*, where the payment to be made pursuant to the contract was maintained in London (Convington & Burling LLP, 2017). As opined by some (Dey et al., 2017), Shariah non-compliance of the *Dana Gas sukuk* may not necessarily have adverse legal consequences and that Shariah compliance and legal enforceability are two distinct issues.

⁶² This statement is true for some countries. In Malaysia, the requirement for a *sukuk* to comply with Shariah is prescribed in the Guidelines on Issuance of Private Debt Securities and Sukuk to Retail Investors, Part D, Chapter 16 or Para 16.01 and 16.02. For a country like UAE, the requirement to comply with Shariah is not literally provided within its laws. In addition to non-literal provision in the laws, UAE does not possess a centralized body to supervise the Shariah compliance.

opined that Shariah non-compliance risk leads to legal and compliance risk (Ginena, 2014). The general implications of Shariah non-compliance risk in *sukuk* are the unenforceability of *sukuk* and the possible default of the *sukuk* if Shariah non-compliance is listed as a default event in the *sukuk* documentation.

In sum, Shariah compliance in a *sukuk* covers three stages. The first stage is Shariah compliance prior to the submission of issuance to the SC, the second stage is continuous observation of Shariah compliance within the tenure of the *sukuk*, and the third stage of Shariah compliance may also arise in situations like default, litigation, or during recovery processes. Within these three stages, the Shariah non-compliance risk may arise, as follows:

1. Within the first stage: infringement of Shariah principles within the *sukuk* but it is not adequately disclosed or addressed in the *sukuk* prospectus and documentation. For instance, the appointed Shariah advisor has failed to address the Shariah non-compliant elements adequately.
2. Within the second stage: changes in operation or restructuring of the *sukuk* that may render the *sukuk* to be Shariah non-compliant. For instance, utilization of the *sukuk* proceeds, nature of investment of the *sukuk*, or the underlying pool assets of the *sukuk* has become Shariah non-compliant, but they are not rectified or reported to the SC.
3. Within the third stage: Shariah non-compliance of the *sukuk* is claimed or declared at the dispute resolution stage or in the court, as evident in the case of Dana Gas *sukuk*.

Shariah non-compliance within the aforementioned first and second stages may cause the relevant parties to incur liabilities for failure to address or disclose the non-

compliance upfront. On the other hand, Shariah non-compliance of the *sukuk* in the third stage may be argued to render the *sukuk* unenforceable, subject to the courts' decisions on the matter. In addition to these three stages of Shariah non-compliance risks in *sukuk*, the issuer's overall operation's compliance with Shariah is also indispensable if the issuer falls under the definition of 'Islamic institution' that is bound by the legal Shariah compliance requirements. However, the effects of this type of Shariah non-compliance risk towards the *sukuk* issued by the issuer are indirect or do not necessarily render the *sukuk* Shariah non-compliant.

4.3.2 Failure to Comply with Regulatory Requirements related to Sukuk Issuance and the Legal Liabilities

According to ISRA (2017), the regulatory requirements for bonds and *sukuk* are: (1) a trust deed; (2) mandatory rating;⁶³ and (3) an offering to eligible persons only. At the same time, there are other specific requirements for the *sukuk*. The specific regulatory requirements are (1) structure disclosure; (2) authorized Shariah advisors; (3) disclosure of use of proceeds; and (4) additional Shariah compliance requirements for the issuance of the *sukuk* (ISRA, 2017, p.217). These regulatory requirements can be found in several guidelines issued by the SC and they may be encapsulated in three aspects: (1) the issuance process; (2) the parties involved; and (3) the structure of the *sukuk*. Legal risks

⁶³ However, in June 2014, the Prime Minister of Malaysia at that time has announced the removal of mandatory ratings on bonds and *sukuk*. The removal was due to numerous reasons, such as to reduce transactions' costs, to attract foreign issuers, to attract demands from wider market particularly firms with low credit rating. These would encourage high demands of *sukuk* and lead to modest long-run growth for the *sukuk* market. See <http://www.theedgemarkets.com/article/malaysias-scrapping-mandatory-bond-credit-ratings-will-cut-costs-diversify-issuers>. Accessed on 25th October 2018, at 8:10 am. Nonetheless, the mandatory rating was only removed in 2017 as the SC has relaxed the rule in 2015, to allow all unrated debt that had been outstanding for at least two years and sold to sophisticated investors to change hands. See <https://www.thestar.com.my/business/business-news/2017/01/13/malaysia-to-scrap-mandatory-ratings-in-bid-to-deepen-bond-market/>. Accessed on 25th October 2018, at 8:13 am.

embedded in the structure of the *sukuk* will be discussed thoroughly in a subsequent section on legal risks arising from *sukuk* contract.

The CMSA 2007 is the main legislation in the ICM. It consolidates three statutes which are under the purview of the SC, namely the Securities Industry Act 1993, the Futures Industry Act 1993, and Part IV of the Securities Commission Malaysia Act 1993 (ISRA, 2015). In giving full effect to the principles of Shariah in relation to Islamic capital market products, section 316(3), now amended to section 316A(2) of the CMSA 2007 gives the SC powers to specify: (a) any model agreement or documentation relating to a transaction or arrangement in respect of Islamic securities; (b) the duties and responsibilities of the different parties involved in a transaction or arrangement in respect of Islamic securities; and (c) any other matter as may be deemed appropriate,

From the aspect of *sukuk* issuance, a few guidelines have been identified⁶⁴. On 15th June 2015, more comprehensive guidelines have been issued by the SC pursuant to Section 377 of the CMSA (ISRA, 2017). The Guidelines on Unlisted Capital Market Products under the Lodge and Launch Framework (LOLA framework) has superseded some other guidelines⁶⁵, particularly the *Sukuk* Guidelines. Simultaneously, the Guidelines on Issuance of Private Debt Securities and Sukuk to Retail Investors (Retail PDS and *Sukuk* Guidelines) has also become effective on the same date⁶⁶. The

⁶⁴ They are Guidelines on *Sukuk* (hereinafter “*Sukuk* Guidelines”), Guidelines on the Offering of Private Debt Securities (hereinafter “PDS Guidelines”), Guidelines on the Offering of Islamic Securities (hereinafter “IS Guidelines”), Guidelines on the Offering of Asset-Backed Securities (hereinafter “AB Guidelines”), Guidelines on Minimum Content Requirements of Trust Deed (hereinafter “TD Guidelines”), Prospectus Guidelines and additional requirements for Ringgit denominated *sukuk* and foreign currency denominated *sukuk* (Bank Negara Malaysia & Securities Commission Malaysia, 2009).

⁶⁵ It supersedes Guidelines on the Offering of Private Debt Securities (2014), Guidelines on the Offering of Asset-Backed Securities (2004), Practice Note 1- Specific Requirements and Disclosure of Information on Primary Collateralised Loan Obligations Transaction (2008) and Guidelines on *Sukuk* (2014) (ISRA, 2017, p.218) and Guidelines of Wholesale Funds (Securities Commission, 2015).

⁶⁶ Retail PDS and *Sukuk* Guidelines issued on 15th June 2015 as disclosed at <https://www.sc.com.my/regulation/guidelines/bonds>. Retrieved on 23rd March 2020 at 9.09 am.

guidelines cater to regulatory requirements for the issuance of listed capital market products in Bursa Malaysia and unlisted capital market products intended for retail investors (Rahmat Lim & Partners, 2016), including *sukuk* for private and public offering. Similarly, the guidelines have replaced the Guidelines on the Offering of Private Debt Securities (the PDS Guidelines) as well as other relevant sections relating to retail PDS and *sukuk* in the previous guidelines. The Retail PDS and *Sukuk* Guidelines have, however, been revised and renamed Guidelines on Issuance of Corporate Bonds and *Sukuk* to Retail Investors in November 2017 (CBSR, 2017 herein). Thus, these two guidelines provide the latest regulatory requirements for the *sukuk* to be issued. Compliance with these regulatory requirements is necessary, otherwise it exposes the *sukuk* to legal risks.

4.3.2.1 LOLA Framework

The LOLA framework is designed to accommodate all the unlisted products in the market, namely wholesale funds, structured products, private debt securities and *sukuk*, as well as asset backed securities. Unlisted Capital Market Product is defined as:

“a capital market product, whether manufactured or issued in or outside Malaysia that is not listed and traded on the stock exchange, or traded on the derivatives exchange, in Malaysia. For the purpose of this framework, “unlisted capital market product” includes PDS or *sukuk* under the Exempt Regime” (SC, 2015).

In view of this, the LOLA framework is applicable to all *sukuks* that fall under the exempt offering. Exempt offering refers to an offering that is not approved by the regulator, but is instead exempted from the need for approvals under certain conditions (ISRA, 2017). The offering has restricted marketing to a limited number of

institutional/sophisticated investors (ISRA, 2017) e.g., accredited investors and high-net-worth entities and individuals (ISRA, 2016). It is different from *sukuk* of private and public offerings.

The objective of the framework is to shorten the time taken in the process of obtaining approval from the SC for the unlisted capital market products, including *sukuk*, via the SC online submission system, as compared to the previous 14 to 21-day approval timeframe (SC, 2015; “SC Introduces Lodge and Launch Framework,” 2015). Hence, it promotes process, efficiency, and certainty in terms of product offering (SC, 2015).

The provisions dealing with *sukuk* are allocated in Part 3 of the LOLA framework. One of the regulatory requirements of *sukuk* under this framework is the appointment of a Shariah advisor (Para 1.04). The Shariah advisor must be either a person or a corporation registered with the SC, a licensed Islamic bank, a licensed bank, or an investment bank carrying approved Islamic banking business (Para 1.08). Para 2.01 of the LOLA framework imposes the requirement for credit rating by approved credit rating agency for all ringgit denominated *sukuk*. Some exclusions of credit rating requirement are specified under Para 2.02(b) (*sukuk* convertible to underlying shares, units of unit trust, or prescribed investment that are listed in the stock exchange), Para 2.02(c)(foreign currency-denominated *sukuk*) and Para 2.02(d) (non-tradable *sukuk* and its rating is exempted by the *sukuk* holders). The LOLA framework also places responsibility on the *sukuk* issuer to provide sufficient and relevant information necessary for the credit rating, on a continuous and periodical basis (Para 2.06 and Para 2.07).

Para 2.13 of LOLA sets out the requirement to appoint a trustee. Where a *sukuk* does not appoint a trustee, there must be adequate provisions in the principal terms and

conditions (term sheet) on the rights of the *sukuk* holders to declare that the *sukuk* is due and payable in the event of default of the *sukuk* principal/profit/rental (Para 2.14(a)) and a provision stating the issuer's responsibility to cancel the redeemed or purchased *sukuk* (Para 2.14(b)). It is the responsibility of the *sukuk* trustee to actively engage in the documentation process of the *sukuk*. His active engagement must be ensured by the issuer and the principal advisor of the *sukuk* (Para 2.15).

Proceeds of the *sukuk* are also subject to certain requirements in terms of their utilization. Para 2.19 and Para 2.20 restrict the utilization of the proceeds only for Shariah compliant purposes and in accordance with the purposes as disclosed to the SC. In terms of issuance of the *sukuk*, Para 2.21 requires the issuance to be made through the Fully Automated System for Issuing/Tendering (FAST) and settled through Real Time Electronic Transfer of Funds and Securities (RENTAS) for ringgit denominated *sukuk*. For foreign currency denominated *sukuk*, the announcement through FAST is compulsory but the issuance on scriptless basis, depository and settlement through RENTAS are optional (Para 2.23 and 2.24). In addition, prior to lodgment of the ringgit denominated *sukuk*, the issuer or the principal advisor is required to obtain endorsement from the SAC.

Other than that, Para 2.25 also warrants compliance with other regulatory requirements, such as the requirements imposed by other regulatory bodies and the Controller for Foreign Exchange prior to its submission for SC approval of the issuance. Another requirement to be fulfilled by foreign currency denominated *sukuk* through roadshows is the conduct of the roadshow by authorized representatives and a principal advisor appointed by the foreign issuer. There is also the need to provide adequate documentation that conforms to international standards or standards which are acceptable in the Malaysian market (Para 3.01). In terms of lodgment, endorsement of

the SAC must be sought before the *sukuk* is lodged (Para 4.01). Para 4.04 specifies the responsible party for the lodgment.

4.3.2.2 Guidelines on Issuance of Private Debt Securities and Sukuk to Retail Investors 2015

In addition to the LOLA framework, section 377 of the CMSA 2007 empowers the SC to issue specific guidelines for the issuance of *sukuk* by retail investors. Meanwhile, the CBSR 2017 is arranged in six parts:

- i. Part A deals with general provisions;
- ii. Part B stipulates the regulatory requirements for issuance of *sukuk*;
- iii. Part C delineates additional regulatory requirements for the SC's approval of the *sukuk* issuance;
- iv. Part D sets out the Shariah requirements;
- v. Part E is essentially designed for Sustainable and Responsible Investment (SRI) *sukuk*; and
- vi. Part F is designed for ASEAN Green Bonds and *Sukuks*.

Among the regulatory requirements of the *sukuk* issuance are:

- i. the eligibility of the issuer (Para 4.01);
- ii. characteristics of the *sukuk* (that are governed by the guidelines) (Para 4.02);
- iii. credit rating requirement (Para 4.05);
- iv. trustee and trust deed requirements (Para 6.01);
- v. time frame requirement (Para 7.01);

- vi. requirements pertaining to the utilization of *sukuk* proceeds (Para 8.01);
- vii. mode of issuance requirement (Para 9.01);
- viii. requirement on other regulatory approvals and compliance with relevant laws and guidelines (Para 10.01);
- ix. requirements for the approval of the SC (Para 11.01);
- x. requirements for *sukuk* offered over the counter (OTC) (Para 12.01);
- xi. requirement for *sukuk* offered on the stock exchange (Para 12.04);
- xii. requirements for revision to principal terms and conditions (Para 13.01);
- xiii. appointment of Shariah advisor (Para 15.01); and
- xiv. requirement to comply with Shariah rulings, principles, and concepts (Para 16.01).

Analysis on the party responsible for compliance with the regulatory requirements in both LOLA framework and CBSR 2017 reveals that there are specific significant duties vested on the issuer, the principal advisor, and the Shariah advisor. Nonetheless, the framework and the guidelines do not provide specific penalties should these parties fail to perform their respective duties. Further, some of the regulatory requirements to be fulfilled by the responsible party do not result in liabilities, such as compliance with some of the regulatory requirements before lodgment or issuance is made.⁶⁷ In this situation, failure to comply with such requirement would only result in the failure to lodge. On the other hand, failure to comply with the post-issuance

⁶⁷ For example, failure to obtain endorsement from SAC prior to the *sukuk* lodgment would only result in refusal of approval by the SC. In contrast, failure to provide material information of the *sukuk* in the lodgment kit may result in criminal as well as civil liabilities under the DDGL. Such liability is also stipulated in s 215(1) and 215(5) of the CMSA. S. 215(1) mentions the duty vested in the responsible party to practice due diligence in disclosure of information submitted to the SC. S. 215 further strengthens the criminal liabilities accompanied with the failure to perform the duty. While the former is a technical flaw in the process of *sukuk* application, the latter is an unlawful act by the responsible party.

regulatory requirements would result in legal liabilities. Some of these instances are the criminal liability arisen from issuing or providing false and misleading information, making false or misleading statement, or willfully omits to state any matter or thing without which the statement is misleading in a material aspect (s92A(2) of CMSA 2007), the criminal liability arisen from capital market intermediaries' ⁶⁸ failure to follow the regulatory requirements pertaining to the establishment of trust account to receive monies from the purchase and selling of securities (s111(3) of CMSA 2007) and to withdraw of the monies (s113(3) of CMSA 2007), and liabilities arisen from contravening the Act's in relation to the protection of clients' assets, through sanctions provided by the SC s125(2)(A) to s125(2)(D) for a licensed person (includes principal adviser) and trustee.

A report issued by the SC mentioned that the duty of monitoring (after the lodgment) is borne by the SC itself (SC, 2015). To ensure that approval exemption does not erode investor protection, the SC continues to monitor and take action against any person who is responsible for preparing disclosure documents containing false or misleading information (SC, 2015). As found in the case of Aldwich bonds in *AmTrustee Berhad & Ors v Aldwich Bhd & Ors* [2017] MLJU 1166, among the steps taken by the SC to ensure continuous compliance by the issuer was to issue a conditional approval, i.e., the approval to issue the bonds is subject to certain conditions. In this case, the conditions were for the issuer to obtain SC's approval for subsequent amendments, to fully disclose any conflicts of interest, and to disclose risks associated with the proposed issuance of bonds. In the letter, the SC also reminded the issuer and the lead arranger on the liabilities attached to failure to comply.

⁶⁸ In CMSA 2007, this refers to "a holder of a Capital Market Services License" who carries the business of dealing in securities.

The liabilities arising from failure to comply with the *sukuk* regulatory requirements are spelt out in the CMSA 2007 and the Guidelines on Due Diligence Conduct for Corporate Proposals (SC, 2008) (DDG) (effective 1st February 2008). For instance, the DDG provides general requirements of due diligence⁶⁹ for the purpose of timely, sufficient, and accurate disclosure of material information as required by the CMSA 2007. An example of due diligence to be performed by the issuer as stated in the Guidelines, Appendix 3.0 (g) is:

“reviewing all aspects of the business, including but not limited to material contracts, contingent liabilities and on-going material litigations, material legal, business and economic/geo-political risks which may have a material impact on the corporate proposal. In this regard, the PA should undertake a detailed risk analysis of the applicant/issuer and ensure the adequacy of the risk disclosures in the offering document (if any)”.

On the other hand, the CMSA 2007 specifies the criminal offences and civil liabilities pursuant to securities, including *sukuk*. For instance, Part V of the CMSA 2007 stipulates the offences relating to securities, i.e., market misconduct and other prohibited actions, section 215 on false and misleading information, sections 246, 248 and 249 on liabilities arising from a prospectus, and Part XI on the power of the SC to execute administrative and civil actions on related offences.

Among the administrative actions taken by the SC under the CMSA 2007 are reprimand, fine, revocation of license for misconduct (particularly of the CMSL), issuance of directions etc., and the civil actions include filing of civil suits, entering settlement agreements, as well as regulatory settlement with the SC⁷⁰. Since there are

⁶⁹ Due diligence refers to “the process by which persons must conduct enquiries for the purposes of timely, sufficient and accurate disclosure of all material statements/ information or documents which are required under Part VI of the CMSA” (SC, 2008)

⁷⁰ Available on https://www.sc.com.my/post_archive. Accessed on 7th August 2018 at 12:59 pm.

specific legal liabilities arising from some of these regulatory requirements, the liabilities create legal risks on the responsible parties and the *sukuk* itself.

4.3.3 Failure to Comply with Regulatory Requirements of Other Jurisdictions or Other Relevant Regulatory Bodies

Legal risk in *sukuk* can also be anticipated from non-compliance of regulatory requirements in other jurisdictions. One example is the Axiata *wakalah sukuk*⁷¹. Axiata is a multinational telecommunications groups in Asia which provides mobile network, communications infrastructures, and digital services to Asian countries like Malaysia, Indonesia, Sri Lanka, Bangladesh, and Cambodia⁷². Axiata *wakalah sukuk*, which commenced from 2012, was issued under Axiata's Multi-Currency *Sukuk* Programme initiated on 17th July 2012. Based on the contents of the Axiata *sukuk* offering circular⁷³, it can be argued that there are legal risks relating to the regulatory environment governing the Axiata group and its business in different regulatory frameworks. In addition, the underlying asset of the *sukuk* is 100% airtime vouchers⁷⁴ that are subject to multiple jurisdictions where subsidiaries of Axiata reside. The following was stated in the PTC:

“The Group’s operation of mobile telecommunications networks and the provision of related services are subject to stringent statutory licensing requirements and regulated to varying degrees by national, state, regional or local governmental and/or regulatory authorities in each of the jurisdictions in which the Group operates and/or has investments. The Group’s operating licences specify the services it can offer and in some

⁷¹ Axiata *sukuk* refers to a *sukuk* programme that is based on the Shariah principle of *wakalah*. It is a multi-currency *sukuk* that used Airtime Vouchers, Shariah compliant shares, lease assets, as well as *Murabahah* receivables arising from the sale of commodities as the underlying assets. The structure for the *sukuk* programme has been approved by the Shariah Committee of HSBC.

⁷² <https://www.axiata.com/corporate/group-profile>. Accessed on 5th September 2018, 9.40 am.

⁷³ Available at <https://www.bondsupermart.com/main/file-depository/download-file?...1365>. Accessed on 12th February 2018.

⁷⁴ The airtime vouchers represent entitlement to a specified number of airtime minutes on the mobile telecommunications network of subsidiaries of Axiata for on-net calls.

instances specify the spectrum allocated to the Group although increasingly, spectrum allocations are specified in spectrum licences or spectrum assignments, separate from operating licences. Notwithstanding, these licences are subject to renewal, review, interpretation, modification or termination by the relevant authorities. New conditions and obligations may be imposed for new licences and upon renewal of expiring licences and such conditions and obligations may be more onerous than those of existing or expiring licences. There is no assurance that the relevant authorities will not take any action that could materially and adversely affect the Group. Certain operating licences contain obligations with respect to network roll-out and population coverage. Failure to meet such obligations stipulated in the relevant operating licences may result in such licences being suspended and eventually revoked and/or financial penalties being imposed. There can be no assurance that the Group will be able to identify and rectify every breach by it when such a breach occurs due to the scale of its operations.”

In view of this, there are legal risks attached to the *sukuk*. This is due to the possible non-compliance of the Axiata group towards the laws of the jurisdictions it operates in. The jurisdictions are Malaysia, Singapore, Bangladesh, India, Sri Lanka, Cambodia, and Indonesia. Since its operation is subject to the laws of different jurisdictions, the *sukuk* is exposed to numerous legal risks.

Other than these, there is also the obligation to comply with the relevant policies, laws, and regulations of regulatory bodies. However, it depends on the business conducted by the issuer. For instance, an issuer who conducts a business or project related to natural resources may be subject to various environmental laws set by the government or by specific local regulatory bodies. Non-compliance with these policies, laws, and regulations may have implications on the *sukuk* and the *sukuk* holders as well. This is because the non-compliance may affect the operation of the issuer, hence affect the payments to be made to the *sukuk* holders.

4.3.4 Inadequate Statutory Obligation in Laws to Observe Legal Risk in Sukuk Prospectus.

In the Malaysian context, a *sukuk* prospectus which forms part of the *sukuk* documentation is governed by the Prospectus Guidelines (SC-GL/PG-2012 (R3-2017)).

There is no provision found to document the potential legal risk faced by the investors.

According to the guidelines, the provision on risk in the *sukuk* prospectus must:

“disclose the risk factors that would have a material adverse effect on the corporation’s business operations, financial position and results, and shareholders’ investments in the corporation” (p.10).

It does not highlight legal risk or any risk associated with laws.

Legal risk within the *sukuk* structure may be highlighted by the appointed legal advisors. The duties of the legal advisors are stipulated in the Guidelines on Due Diligence Conduct for Corporate Proposals (DDG). Based on the DDG, there is a duty of due diligence on all persons involved in the preparation and submission of a corporate proposal. Among the due diligence duties is reviewing all aspects of the business including material legal risk. Thus, it is evident that while there is a duty to review the material legal risk, the prospectus guidelines does not make it compulsory to disclose it in the *sukuk* prospectus.

4.3.5 Legal Uncertainties Arising from Sukuk Dispute or Default

Legal risk in *sukuk* may arise when there is a challenge made in a dispute, event of default⁷⁵, insolvency⁷⁶, or bankruptcy⁷⁷. For instance, the application of Shariah principles in the *sukuk* cases typically comes to the surface when there are *sukuk* defaults or near defaults. Default events can also be due to breach of contractual obligations as in agent-based or partnership-based *sukuk* (ISRA, 2017).

Malaysia is well-known for its extensive experience in the *sukuk* market. Although there have been several Malaysian *sukuk* defaults⁷⁸, they did not result in severe negative perceptions towards the country. This situation has been different from other *sukuk* defaults or *sukuk* near defaults in other countries like *Golden Belt 1* in Saudi Arabia⁷⁹ and *Nakheel sukuk* in Dubai⁸⁰. It was asserted that the Malaysian *sukuk* defaults were mainly caused by the credit issues of the issuers due to the deterioration in the issuer's business or external events (Securities Commission Malaysia, 2009). These were also apparent in the recent defaults in 2020, as the effects of COVID-19 (Bernama,

⁷⁵ When a debtor fails to pay his debt, he is considered to be defaulted. His failure to pay may be due to his inability to pay or his unwillingness to pay (ISRA, 2017, p.578). Other definitions of default are also provided by Capital Intelligence (2016).

⁷⁶ Refers to the inability due to financial difficulty or due to a lack of cash liquidity (total liabilities exceed total assets) of a debtor to pay his debts when they fall due (ISRA, 2017b).

⁷⁷ Refers to a situation when a debtor is unable to pay his debts and his inability has been declared by judicial authority, hence the debtor is deprived from having a full control over his assets (ISRA, 2017, p.579).

⁷⁸ There were 24 Malaysian *sukuk* defaults from 1997-2010 (Majid et al., 2011). However, a total number of 15 *sukuk* defaults was recorded globally at the end of 2009 (Khniifer, 2010). Malaysia *sukuk* defaults account for less than 0.5% of Malaysian total *sukuk* market, at the amount of RM741 million with 7 default cases (Securities Commission Malaysia, 2009, p.3). Nevertheless, 9 *sukuk* defaults in Malaysia were recorded in another report during the year (Khniifer, 2010)

⁷⁹ When the *sukuk* defaults, a royal commission was appointed to restructure the debts. It was reported that the commission merely addressed the debts owed to the local investors, and not the foreign investors. (ISRA, 2017, p.592).

⁸⁰ The *Nakheel sukuk* was a near default *sukuk* that was finally redeemed by the Abu Dhabi government. If the *sukuk* were to default, there will be numerous legal issues involved like the imperfect proprietary rights and unprotected rights of the investors. It was noted that when the *sukuk* nearly defaulted, lawyers have reported significant analysis about the possibility that the investors will not receive the protection they have expected. The *sukuk* was however successfully redeemed when the Abu Dhabi Government improvised USD 10 billion bailout package to refund the principal amount to the investors (ISRA, 2017, p.615).

2023)It was also opined that the investor protection provided by the country is the distinguishing factor for the *sukuk* market. The intact and market tested protection for investors, orderly legal and recovery process, compulsory rating requirements, and centralized Shariah supervisory board are significant elements for the protection of *sukuk* investors in the country. Other than that, it was claimed that the strict laws that bind the *sukuk* market has helped to protect the country from negative perception (Ab Majid, Shahimi, & Abdullah, 2011).

Despite all the claims on the strength of Malaysian regulatory framework to support Islamic finance or *sukuk* (Ab Majid, Shahimi, & Abdullah, 2011; Abdul Rauf, 2013; Azmi, 2007; Hassan & Oseni, 2014), so far no specific data or analysis has been made available to prove these claims. There were some studies which highlighted the negative aspects of the Malaysian legal environment that may result in legal problems in *sukuk*, thus creating legal risk. This is particularly apparent when there are issues of legal uncertainty in *sukuk* cases. The Malaysian legal system is governed by English common law. The Shariah laws in the country is restricted to the Shariah courts that adjudicate mostly Muslim personal law. Commercial matters, including Islamic finance, fall under the jurisdiction of the civil courts which are handled by judges of common laws. As a consequence, legal uncertainty in regards to *sukuk* cases, particularly those involving Shariah matters, can be anticipated. Added to this is the legal uncertainty arising from differences of Islamic school of thought on *sukuk*, such as on the issue of purchase undertaking of assets at their nominal price (Shamsiah & Nor Fahimah, 2013).

4.3.5.1 *The Limited Roles of SAC of SC in Sukuk Cases*

Oseni and Hassan (2011) highlighted the limited roles of Shariah Advisory Council (SAC) of the Securities Commission (SC) in Islamic financial disputes in the Malaysian legal system. They stated:

“Though Section 316F⁸¹ provides for a sort of “mandatory reference” to SAC for ruling from the court or arbitration panel with the use of the word “shall”, the High Court may invoke its inherent jurisdiction to circumvent such mandatory reference as it did in the earlier cases. This attitude may bring about more problems when the courts refuse to refer Shariah issues in Islamic financial matters before them to the SAC”.

The roles of the SAC in *sukuk* cases before the court or arbitrator is important. The function of the SAC is to ascertain the application of Shariah in the Islamic capital market business or transaction⁸². This function is significant due to the uncodified nature of the Shariah, where a centralized committee is needed to ensure standardization of its practice. If the function of the SAC is impeded or limited and the *sukuk* cases are widely left to the civil court judges, re-categorization of risk may appear and the *sukuk* cases may be subject to legal uncertainty. A lengthy study was conducted to analyze the acceptance of the High court judges towards the practice of referring their cases to the SAC (Kunhibava, 2015). Although all the cases referred to in the study were not related to *sukuk*, it is believed that acceptance of the practice would be the same for *sukuk* cases. These cases dealt with the position of the SAC of BNM instead of the SAC of the SC.

It was found that prior to the Central Bank of Malaysia Act (CBMA) 2009, when the reference to SAC was merely discretionary, the judges were reluctant to refer their

⁸¹ Section 316F of the CMSA 2007 stipulates that in any proceedings before the court or arbitrator concerning a Shariah matter in relation to Islamic capital market business and transaction, the court or the arbitrator shall take any ruling of the SAC into consideration, or refer such matter to the SAC for its ruling.

⁸² S 316B CMSA 2007

cases to the SAC⁸³. It was noted that the effects of the CBMA 2009 at the time was considered minimal (Moharani, 2012, p.c). Some interpreted their cases as being non-Shariah matters, which merely involved interpretation and application of the terms of the contractual document⁸⁴. Some judges differentiated between Shariah matters that are theoretical and Shariah matters that are practical. In the case of the former, the judges must refer the theoretical matters to the SAC. In contrast, if the Shariah matters are practical in nature, then they are left to the judges to decide. Some examples of the latter are the views of the judges on the appropriateness of the matters to be referred to the SAC and how the Shariah contracts were executed⁸⁵. After the CBMA 2009 became effective and reference to the SAC of the BNM was made mandatory and binding⁸⁶ (Mohammad Azam Hussain, Hassan, & Hasan, 2015), there was still room for

⁸³ S16B(8) and (9) of the Central Bank of Malaysia Act 1958 (Act 519), Central Bank of Malaysia Act (Amendment) (2003)

⁸⁴ For instance, *Affin Bank Bhd v Zulkifli bin Abdullah* [2006] 3 MLJ 67 [2006] 1 CLJ 438, *Arab Malaysian Merchant Bank v Silver Concept Sdn Bhd* [2008] 6 MLJ 295, *Malayan Banking Bhd v Ya'kup bin Oje & Anor* [2007] 6 MLJ 389 [2007] 5 CLJ 311.

⁸⁵ For instance, in the case of *Arab-Malaysian Merchant Bank Bhd v Silver Concept Sdn Bhd* [2005] MLJU 201, the judge, Suriyadi Halim Omar said, "With the above mind boggling minefield awaiting lawyers and judges alike it is small wonder that the Syariah Advisory Body has been mandated to be formulated. It is when rulings are required that the latter body must give its opinion. Under the above new section 16B of Act A1213, the Syariah Advisory Body appears to have a rather wide scope of referral, and not merely confined to the issue of whether the matter at hand involves any element which is not approved by the Religion of Islam. Needless to say the final say must rest with the presiding judge (see section 16B (9) (a))". In *Arab-Malaysian Finance Bhd v Taman Ihsan Jaya Sdn Bhd & Ors* [2008] 5 MLJ 631 [2009] 1 CLJ 419, a demarcation line between the theoretical Shariah issues and their practical issues was drawn by the court. In that view, the former falls under the authority of SAC to issue ruling while the latter is upon the discretion power of the court. Abdul Wahab Patail, the judge of the case said "The court has authority therefore, where warranted, as in a consideration of whether there are any elements that are not approved by the religion of Islam, to look beyond the words of agreement to the actual facts of the case in order to determine the substance of the transaction between the plaintiffs and the defendants before it draws any conclusions on the nature of the *Al-Bai' Bithaman Ajil* transactions. It is necessary to look beyond the labels used and look at the substance particularly in light of the fact that the interpretation advanced by the plaintiffs result in the defendants being burdened with a debt far in excess of that if they had taken an interest based on conventional loan, a result which, on the face of it, contradicts the intent and purpose of the Qur'an to banish the burden of *riba* in *riba*-burdened loans. To refuse to do so and to look exclusively to the PA would only be a refusal to acknowledge reality or facts before the court."

⁸⁶ S55-58 Central Bank of Malaysia (2009) Act (Act 701) and S316A-316H for similar provisions in CMSA (Amendment) Act 2010.

the civil court judges to refuse to refer to the SAC. This was seen in the case of *Bank Islam Malaysia Bhd v Azhar Osman & Other* [2010] 5 CLJ 54⁸⁷.

Although Kunhibava (2015) reported other cases⁸⁸ where reference to the SAC were made, she opined that the role of the SAC should be limited merely to ascertainment of the Islamic law which should not be binding on the court. This is because, according to her, the trial judge has more knowledge on the case and is therefore in a better position to decide (Kunhibava, 2015). In addition, the application of the rulings of BNM's SAC, although mandatory, is not considered as a judicial decision. This is because the SAC is not vested with judicial or quasi-judicial power.

In view of the limited role of the SAC of the BNM in the courts, the role of the SAC of the SC may also be limited in the *sukuk* cases. As a result, where Shariah matters are subject to only judgements in the civil courts, the outcome of the cases may be unpredictable, thus exposing the *sukuk* cases to legal uncertainty. A similar point was noted in ISRA (2015) where legal risk in *sukuk* remains because the final ruling will be decided by the conventional courts. Even with the effect of section 316F of CMSA 2007 (Act 671), this point was highlighted by ISRA (2015). Perhaps, it is due to the lack of *sukuk* cases being adjudicated in the court and the rulings sought from SAC of the SC still not being adequately evident.

⁸⁷ The key issue of the case was whether the Bank can claim for the full sale price of the *Bai' Bithman Ajil* (BBA) financing facility since the facility has been prematurely terminated due to the respondent's default. Consequently, there was also the issue as to whether *ibra'* falls under the discretionary power of the Bank to decide or to the power of the court to decide. In this case, the judge did not refer the issue to the SAC of the BNM as the judge presumably regarded the issue as a mere case of interpretation of documents (Kunhibava, 2015, p.xlii).

⁸⁸ *CIMB Islamic Bank Bhd v LCL Corporation Bhd & Anor* [2012] 3 MLJ 869 (on the issue of *ta'widh*), *Bank Muamalat Malaysia Bhd v Kong Sun Enterprise Sdn Bhd & Ors* [2012] 10 MLJ 665, *Tan Sri Abdul Khalid bin Ibrahim v Bank Islam Malaysia Bhd* [2012] 7 MLJ 597 (on the validity of s.56 and s57 of the CBMA 2009).

4.3.5.2 Legal Uncertainties that Result in Re-characterization of Risk

Another concern with the legal uncertainties surrounding *sukuk* disputes or cases is the possibility of re-characterization of the *sukuk* risk. Re-characterization of risk is a product of legal risk, particularly when there are practices of ‘creative compliance’, i.e., structuring a product to fall outside certain strict legislative regime (Arnott, 2004). One example is by structuring the product based on the letter of law and not the spirit of law (Arnott, 2004). In the case of *sukuk*, it was argued that the *sukuk* holders are exposed to the risk of the *sukuk* being re-characterized as asset-based instead of asset-backed (Marinescu, 2012).

If the *sukuk* is re-characterized as asset-based instead of asset-backed, the implications are on the rights of the *sukuk* holders to the underlying asset. In that situation, the *sukuk* holders will not be entitled to the underlying asset but they will have recourse merely upon the originator. In this scenario, their rights are secured based on the creditworthiness of the originator. In the case of insolvent originator, the *sukuk* holders rank *pari passu* with other unsecured creditors (Marinescu, 2012). In other words, the re-characterization will affect the *sukuk* holders when the *sukuk* defaults.

4.3.6 Legal Uncertainties in Sukuk that Involve Multiple Jurisdictions or Governing Laws

While the well-known *sukuk* near default like *Nakheel sukuk* and *sukuk* defaults like *East Cameron sukuk* and *Golden Belt 1 sukuk* dealt with international investors, the default of locally-issued Malaysian *sukuk* only relates to local investors. The former *sukuk* cases have demonstrated numerous legal uncertainties in terms of cross-border insolvencies, poor transparency, contract unenforceability in regards to Shariah

compliance issues, and unequal treatment between local and foreign investors (ISRA, 2017).

It is argued that the defaults and near defaults of Malaysian *sukuk* are mostly channeled to arbitration and restructuring plans, since only a few cases of *sukuk* defaults can be found in Malaysian judicial records. In view of this, defaults of local *sukuk* could face less issues of legal uncertainties. Hence, there would be less legal risk. Nevertheless, there is still room for legal risk to arise. Some of the relevant situations are when:

- i. the *sukuk* is offered to foreign investors or issued by a foreign issuer in Malaysia;
- ii. the *sukuk* has multiple governing laws;
- iii. the *sukuk* is subject to counterparty risk that has the potential of creating legal issues; or
- iv. the underlying assets of the *sukuk* are located worldwide.

In-depth discussion on some of these risks is provided in the later sections, since these risks are relevant to legal risk arising from *sukuk* contracts and *sukuk* operations. However, these risks are mentioned in this section to highlight the legal uncertainties that may arise from the legal environment of the *sukuk*. An example of this is when there are incompatibility issues between the laws of Malaysia (where the *sukuk* is issued) and the laws of foreign countries. For instance, uncertainties may arise from clauses of the GIC *wakalah sukuk*. From the PTC of the *sukuk*, it can be observed that the governing law of the *sukuk* is the Malaysian laws. Simultaneously, in the Dissolution Events clause, it was stipulated that the *sukuk* is to be dissolved when there are analogous events occurring in the issuer's country of origin, i.e., Kuwait. The analogous

events are events of unsatisfied judgement, enforcement of security, insolvency, winding up, and failure to take action. When these events occur in Kuwait, they are deemed to be binding on the Malaysian courts to follow. The issue is whether the Malaysian courts are bound to follow the decisions of foreign courts. It is argued that such a situation exposes the *sukuk* to legal uncertainty *vis-à-vis* legal risk in regards to the outcome of the Dissolution Event clauses upon the *sukuk* itself or upon the contracting parties.

A practical example is evident in the facts of the Dana Gas *sukuk* case (Zada, 2019). It was reported that Dana Gas filed a case in the UAE court (i.e., Federal Court of First Instance in the Emirate of Sharjah) to declare their *sukuk* to be non-Shariah compliant. Simultaneously, Dana Gas also applied for an interlocutory injunction to prevent its *sukuk* holders from taking any action pending the decision of the Sharjah Court. Similar injunctions (pre-emptive lawsuit) was also applied by Dana Gas in the English High Court of Justice in London to prevent any action taken by its *sukuk* holders. Some Dana Gas shareholders also took additional measures by applying for an injunction order from the Sharjah Court to prevent them from attending any UK court proceedings. Meanwhile, the Dana Gas *sukuk* holders filed a case in the UK court in July 2017 claiming their *sukuk* repayment. The *sukuk* holders also applied to court to ban Dana Gas from issuing any new *sukuk*. Despite pending decisions in the Sharjah Court and the absence of Dana Gas during the trials at that time, the UK Court decided in favor of the *sukuk* holders in November 2017.

Facts of the Dana Gas case revealed that there are legal risk and legal uncertainty surrounding *sukuk* that involves multiple jurisdictions, particularly when there are

foreign parties involved⁸⁹. In addition to the complexity of legal aspects involved (e.g., which Court has the power to decide, which laws to follow etc.), legal uncertainties in term of which Court decisions should prevail and how the Court will decide, may pose legal risk to all the parties involved. Based on the latest report of the Dana Gas dispute, the issuer has agreed to full redemption of its USD309 million *sukuk*. Nevertheless, considering this out-of-court settlement, the legal uncertainties surrounding cases of *sukuk* at UAE court has remained untested.

Additionally, there is also legal risk in terms of the arbitration forum selected by the contracting parties. In the case of ABHC *sukuk*, the governing laws as prescribed in the *sukuk*'s PTC are the laws of Malaysia and the laws of the Kingdom of Saudi Arabia. It was further described that any dispute pertaining to the transaction documents must be subject to the Kuala Lumpur Regional Centre for Arbitration (KLRCA) (now renamed to the Asian International Arbitration Centre or AIAC) of Malaysia and the Committee for Resolution of Securities Disputes (CRSD) in the Kingdom of Saudi Arabia. A possible legal uncertainty arising from an arbitration forum outside Malaysia is the enforceability of interlocutory reliefs issued by the Malaysian High Courts on the foreign arbitrators, or arbitration outside Malaysia. The Arbitration Act 2005 (Act 646) stipulates that its provisions are only applicable to domestic and international arbitration held in Malaysia. Hence, arbitration outside Malaysia is not bound by the same legal provisions, thus conferring no power to the Malaysian High Court⁹⁰. Although the PTC of ABHC *sukuk* describes separate transaction documents for separate arbitration forum and governing laws⁹¹, default, insolvency, or similar events will trigger one party to

⁸⁹ Approximately 70% of Dana Gas *sukuk* was subscribed by international investors, as indicated in <https://www.ft.com/content/83ace1c2-56a4-11e8-b8b2-d6ceb45fa9d0>. Retrieved on 4th June 2020.

⁹⁰ S. 3 and 8 of Arbitration Act 2005 (Act 646)

⁹¹ Declaration of Trust, Trust Deed, Programme Agreement, Wakalah Agreement, Investment Management Agreement, Subscription Agreement and Securities Lidgegment Form must be arbitrated in

initiate interlocutory relief, such as injunction. It is uncertain whether interlocutory relief on arbitration outside Malaysia would be enforceable. In a similar vein, the effects of CRSD decisions on arbitration in Malaysia is also unknown.

There are also legal uncertainties surrounding the restructuring of *sukuk* in multiple jurisdictions. As quoted by A. Hassan (2013), there are no specific guidelines to handle Islamic finance cross-border restructuring except for general laws like UNCITRAL Model Law of Cross Border Insolvency. When a defaulted *sukuk* is attached to multiple jurisdictions, there is lack of legal certainty as to how the restructuring should be handled.

4.4 LEGAL RISKS ARISING FROM THE LEGAL PERSPECTIVES OF THE *SUKUK* CONTRACT

Legal risk within the *sukuk* contract denote the legal risk that arise from within the contract itself. This is called contractual risk⁹² and documentation risk⁹³. Such risks as described above (Mahler, 2007; McCormick, 2013; Schuhmann & Eichhorn, 2017) arise from both the law and the operation of the *sukuk*. Under this, the legal risk of the *sukuk* covers: 1) Legal perspectives (legality) of *sukuk* contract; 2) Legal uncertainties embedded in the *sukuk* contract; and 3) Legal risks arising from the structuring of the *sukuk* contract.

KLRCAs or otherwise governed by Malaysian laws; while Kafalah Agreement, Asset Purchase Agreement, Ijarah Agreement, Service Agency Agreement, Substitution Undertaking, Asset Exchange Agreement and Purchase Undertaking must be arbitrated in CRSD, or otherwise governed by KSA laws (ABHC *wakalah sukuk* PTC, p.44-45).

- ⁹² Contractual risk is a risk related to the wordings of a contract, the language used as required by the regulators that results in the contract to be enforceable, fair and accurately representing the expectations of the contracting parties (EY, 2016, p.9).

⁹³ The risk that a legal document is not valid and binding; or that the legal document does not say what one or other party believes it should have said; and/or the risk that a legal document does not address adequately, or at all, a situation that arises (Balfour, 1999, p.49).

4.4.1 Unenforceability of Sukuk Contracts due to Governing Law Clause

This is a type of risk that relates to the legality of *sukuk* contracts and legal uncertainties embedded within them. In terms of legality, legal risk may arise in the form of unenforceability of *sukuk* contract as it contravenes the laws of its origin. Such legal risk has been discussed in Section 4.3.3 of this chapter.

On the other hand, legal risk may arise from the unenforceability of *sukuk* contracts as there are legal uncertainties in the contracts' terms and conditions. These legal uncertainties are prevalent within the provisions in the *sukuk* contracts, particularly provisions on purchase undertaking under the *musyarakah* and *mudharabah* structure, provisions on governing law (choice of law), and multiple governing laws.

In terms of choice of law by the parties, there have been some significant insights on it in non-*sukuk* cases. The UK courts in *Shamil Bank of Bahrain v Beximco Pharmaceuticals Ltd* [2004] EWCA Civ 19 ruled that the governing law chosen must be the law of a country and not a non-national law, like the Shariah (Colon, 2011; McMillen, 2007). In contrast, the US courts in the case of *National Group for Communication & Computers v Lucent Technologies International* 331 F. Supp. 2d 290, 292 (D.N.J 2004) ruled in favor of the Saudi Arabian law and acted upon the precepts of Shariah on the issue of ambiguity (*gharar*).

In the case of *sukuk*, the US court has shown positive approach on the choice of law made by the parties in *musyarakah sukuk* arrangement (Yaacob, 2011) in *Re East Cameron Partners L.P.* [2008] LEXIS 3918. In contrast, in countries like UAE (Dubai), Kuwait and Bahrain, parties' choice of law have been rejected by the court or declared uncertain due to its incompatibility with local laws (al-Amine, 2012).

Although most *sukuk* is governed by English law due to its established position (Alexander, 2011; Bälz, 2008; Colon, 2011; Graham, 2011; McMillen, 2007; Oseni &

Hassan, 2015; Salah, 2010), some issues prevail. Some examples are the use of other laws as a separate governing law for different contracts (Abdul Khaleq et al., 2007; Colon, 2011) which may trigger legal conflicts, inapplicability of English law in some jurisdictions (Oseni & Hassan, 2015; Salah, 2010), act of parties to bring *sukuk* cases to courts other than the English court (U. Oseni & Hassan, 2015) and lack of reciprocity in the enforcement of foreign jurisdictions (al-Amine, 2012; (Colon, 2011; Graham, 2011; Oseni & Hassan, 2015). As mentioned before, these conflicting and incompatibility-related issues yield uncertainties in the outcome of *sukuk* cases, especially cases that opted for local governing laws and intended to be a litmus test for laws other than English law (Oseni & Hassan, 2015), for instance, the Saudi Electricity Company *Sukuk*.

More intricacies were evident in the case of Dana Gas *Sukuk*. Applying the UAE laws, the Sharjah Court ruled the *sukuk* to be Shariah non-compliant, hence, unenforceable. Based on the Dana Gas *Sukuk* Prospectus, the governing laws of the *sukuk* was English law⁹⁴. Nonetheless, Dana Gas brought the case of their *sukuk*'s compliance with Shariah to the Sharjah Court, taking the view that the Sharjah Court is the appropriate revenue. At the same time, the Prospectus merely prescribed English law to be the governing law in contractual and non-contractual obligations of the parties, excluding Shariah compliance. Therefore, it is uncertain how the unenforceability of the contract should be decided (Busari et al., 2019). Nonetheless, the UK Court has differentiated between contractual obligations and contract enforceability by favoring the contractual obligations of Dana Gas towards the *sukuk* holders (Busari et al., 2019).

⁹⁴ Available at <https://islamicmarkets.com/publications/dana-gas-sukuk-limited-prospectus>. Retrieved on 4th June 2020.

As a result, it can be argued that multiple governing laws or a single governing law for *sukuk* parties of different jurisdictions can affect the enforceability of a *sukuk* contract, hence creating a legal risk.

4.4.2 Lack of Post-Default Provisions in the Sukuk Contract

Legal risk arising from the *sukuk* contract is inevitable, as it may inherently stem from a product's structuring (McCormick, 2006). The probability of legal risk in *sukuk* structures and their documentation is heightened due to their detailed and complex nature (Mahayni, 2012). Moreover, a *sukuk* contract is drafted independently contingent to the proposed structure to meet the needs of the issuer or originator and the regulatory requirements (Oseni & Hassan, 2015). Based on the types of contract as delineated in BLP (2014), *sukuk* contracts can be classified as either a largely standard contract or a heavily negotiated contract. This is due to the nature of *sukuk* contracts that are generally issued with different adjustments. Hence, they become unstandardized (Abdo, 2014).

When a *sukuk* defaults, the post-default provisions to safeguard the rights of the contracting parties become very important (Oseni & Hassan, 2015). These provisions, if not properly documented, may trigger more legal risk for the *sukuk*. It was thus contemplated that the risk of post-default legal battles can be reduced through proper legal documentation, where debt restructuring, alternative dispute resolution, and debt liquidation are improvised (Oseni & Hassan, 2015).

4.4.3 Unstandardized Default Events in the Sukuk Contract

Given the importance of proper documentation that highlights potential legal risk in the *sukuk*, legal risk in *sukuk* may also arise from the failure to employ proper wordings and description of events in the *sukuk* documentation, such as the events of default in the *sukuk* documents. There are some similarities in the events that constitute default in *sukuk* (ISRA, 2017) such as non-payment by the issuer, breach of contractual obligation, incorrect or misleading representation or warranty by the issuer, and unenforceability of the issuer's obligations. However, as shown in some samples of Principal Terms and Conditions (PTC) of *sukuk*, there are slight differences in the default events. For instance, a few *sukuk*'s PTS listed additional events of default, such as maintaining minimum rating requirements⁹⁵, or unexhaustive events of defaults⁹⁶, specific events related to licensing⁹⁷, etc.

The differences led to different interpretations of *sukuk* defaults, different treatment of default risk as well as legal issues arising from them. The interpretation of default, treatment of default, and the relevant legal issues expose the contracting parties to some extent to legal risk and legal risk management. Other than that, it was also asserted that some *sukuk* documentation also import conventional bond default provisions (Marinescu, 2012). Hence, this has blurred the line between a Shariah compliant risk sharing instrument and a conventional risk transfer (Marinescu, 2012). In other words, remedies that are available for defaulted conventional bonds may be

⁹⁵ As in Edra Energy Sdn Bhd *wakalah sukuk*. In the 'Events of default', "(e) the HoldCo fails to maintain a minimum rating of AA3 or its equivalent by the Rating Agency or Malaysian Rating Corporation Berhad up until the Scheduled COD of the Third Generating Block"

⁹⁶ As in Tadamun Services Bhd *wakalah sukuk*. In the 'Events of default', "(1) any other dissolution events as advised by the Legal Counsel and mutually agreed between the JLAs, Issuer and Obligor".

⁹⁷ As in Lafarge Cement Sdn Bhd *wakalah sukuk*. In the 'Events of default', "there is expiry, withdrawal, revocation, termination, withholding, invalidation or modification of licence(s), permit(s), consent(s), authorisation(s) or approval(s) that impairs or prejudices the Issuer's ability to comply with the terms and conditions or the provisions of any of the Transaction Documents or any other related documents".

perceived to also be available for defaulted *sukuk* such as declaring the unpaid principal and interest (profits) that are not accrued.

4.4.4 Legal Risks Specific to Wakalah bi al-Istithmar Sukuk Structure

Legal risk in *sukuk* may arise depending on the structure of the *sukuk*. In other words, how the *sukuk* is structured determines the legal risks inherent within it. Each *sukuk* structure holds a different risk profile (Alswaidan, 2017; Shazly & Tripathy, 2013; Tariq, 2004; Tariq & Dar, 2007). For instance, the *sukuk* structure may lead to the non-viability of purchase undertaking⁹⁸ and imperfect proprietary rights⁹⁹ as exhibited in the case of *Nakheel sukuk*. As a result, there were effects on the recourse to the underlying asset and viability of the purchase undertaking due to several factors (Salah, 2010).

The Islamic Commercial Law Report 2017 noted that, by and large, most *sukuk* are still issued using asset-based structures; however, profit and loss sharing structures are not negligible in the overall issuance. In terms of *sukuk* structures, *wakalah* has been a preferred structure for international *sukuk* since 2015, and it has continued to be the most used structure in 2018¹⁰⁰ (International Islamic Financial Market, 2019). Compared to other structures, the *wakalah* structure eases the problem of shortage of underlying asset (International Islamic Financial Market, 2019). In the Malaysian context, the first *wakalah sukuk* was issued by the Government of Malaysia in 2011. It

⁹⁸ According to Salah (2010, p.27), viability of purchase undertaking of *sukuk* is subject to the issuer's financial ability. The execution of the purchase undertaking is thus impossible when the issuer becomes insolvent. Another factor influencing the viability of the purchase undertaking is that the convertible aspect of the underlying asset has ceased to be attractive to the issuer.

⁹⁹ In *Nakheel sukuk* for instance, the underlying asset was leasehold rights. There was a transfer of ownership of the leasehold rights in the sale and purchase contract between Nakheel Holding1 and Nakheel SPV. Nevertheless, under the UAE law, the leasehold rights or intangible properties are not regarded as real property without prior registration at the Dubai Land Department, hence the leasehold rights were imperfect and unenforceable. The effect of the foregoing is the fact that the *sukuk* investors' positions became similar to other creditors of the insolvent issuer (Salah, 2010).

¹⁰⁰ There was 50% composition of international *wakalah sukuk* and 7% hybrid *sukuk* (*mudarabah-wakalah*) of total international *sukuk* issuance in December 2018.

was the first global sovereign USD-denominated *wakalah sukuk* (ISRA, 2017). Since then, the trend of *wakalah sukuk* has been developing, particularly *wakalah sukuk bi al-istithmar* in 2016 (Thomson Reuters, 2016).

Nonetheless, risks associated with *wakalah sukuk* has remained undiscovered in the literature as opposed to other structures. As legal risk is inherent in any *sukuk* structure, legal risk in *wakalah sukuk* is mostly due to the nature of the agency plus investment contracts and the fiduciary relationship that is built between the issuer, the originator, and the investors.

4.4.4.1 Uncertainties Surrounding Indemnity for Misconduct, Negligence and Breach of Contract as Legal Risks to the Sukuk Holders

Wakalah bi al-istithmar sukuk is described as “certificates of equal value evidencing the certificate holder’s undivided ownership in the investment assets pursuant to their investment through the investment agent” in CBSR 2017. According to the Shariah Resolution of Islamic Finance¹⁰¹, the principles of *wakalah bi al-istithmar* are similar to the principles of *mudarabah* (Bank Negara Malaysia, 2010). It is also called an investment agency contract.

Since *wakalah bi al-istithmar sukuk* is an investment product, among the indispensable parts of the contract are the right to profit and the risk of loss. In view of the nature of *wakalah bi al-istithmar* structure, the *sukuk* holders as the capital providers are exposed to more risks compared to the issuer. The issuer as agent (*wakil*) is not exposed entirely to the risk of investment since they receive payment on the basis of fixed service charge or fee (*ujrah*). On the contrary, the *sukuk* holders are exposed to

¹⁰¹ On the application of *wakalah bi al-istithmar* on <http://www.sacbnm.org/wp-content/uploads/2018/03/66.E.pdf>

the investment risk as well as the performance risk of the issuer. The latter may be triggered by misconduct (*ta`addi*), negligence (*taqsir*), and breach of contract by the issuer as the investment agent (Bank Negara Malaysia, 2016). In order to protect the *sukuk* holders against both the investment risk and performance risk, the issuer as agent may be made liable to compensate the *sukuk* holders through the payment of compensation (*ta`widh*)¹⁰². Nonetheless, the payment of *ta`widh* as provided in the laws is only applicable in specific events¹⁰³ that do not include misconduct, negligence, and breach of contract that does not entail financial implications such as failure to distribute the realized profit or the periodic payment to the *sukuk* holders. In other words, if the agent has failed to take precautionary actions prior to dealing with a third party that affects the performance of the investment, but without causing failure to distribute realized profit, then there is no ground to claim for negligence.

Provisions relating to negligence and mismanagement are only dealt with in *mudharabah sukuk* provisions¹⁰⁴. These underlying grounds for indemnification may create legal risk for the *sukuk* holders. In addition, there are inconsistent requirements on liability of the agent prescribed between the LOLA framework and CBSR 2017 and the BNM policy document on *wakalah*. Although the policy document is not applicable for *sukuk* issuer, the guiding principles in the document are considered essential in the application of *wakalah* contract in any Islamic financial product. In the BNM *wakalah*

¹⁰² *Ta`widh* is a compensation on actual loss (Securities Commission Malaysia, 2019). According to Resolutions of the Shariah Advisory Council of the Securities Commission, *ta`widh* (compensation) can be imposed on the issuer/*wakil* if there is a breach of its fiduciary duty to distribute the realised profit and when there is delay in the periodic payment to the investors (Securities Commission Malaysia, 2019). A similar provision is stated in CBSR 2017 in para 17.12.

¹⁰³ In the LOLA framework and CBSR 2017, the liability to compensate the *sukuk* holders occurs only when the issuer breaches its duty to distribute the realised profit or delays the periodic payment. These are stated in para 4.12 of the LOLA framework and para 17.12 of CBSR 2017.

¹⁰⁴ Para 18.23 of CBSR 2017 states “However, any loss must be borne in entirety, solely by the *rabb al-mal*, unless the loss is due to the negligence or mismanagement of the *mudharib* in managing the *mudharabah* venture”.

policy document, there are three underlying grounds to make the *wakil* legally liable, namely misconduct, negligence, and breach of specified requirements (BNM, 2015). Based on para 4.12 and para 17.12 of the LOLA and CBSR 2017 respectively, compensation (*ta'widh*) is only applicable upon the breach of fiduciary duty as investment agent or manager. Specifically, the breach is confined to failure to pay the periodic payment or delay in making the payment. In view of this, the *ta'widh* may be perceived as different from the indemnity that arises due to misconduct, negligence, and breach of conduct by the investment agent. This is because the *ta'widh* deals with the failure or delay in making the periodic payment in a restricted way and there is a specific calculation of the *ta'widh*¹⁰⁵.

The fiduciary duties carried out by the agent are stipulated prescriptively under the Positive Covenants and Negative Covenants in the *sukuk* prospectuses. Upon observing the PTC of *wakalah sukuk* available at the SC's issuance website, it was discovered that breach of the covenants is considered to be a dissolution event. Accordingly, the *sukuk* will be dissolved and the *sukuk* holders shall enforce their rights under the transaction documents, i.e., their rights to enjoy the face value of the *sukuk* and enforce the purchase undertaking, if any. Under the clauses on covenants and dissolution events, there are no provisions stating that indemnity is to be borne by the agent or the issuer. This situation creates legal risk to the *sukuk* holders regarding the uncertainty surrounding their entitlement to the indemnity. Nonetheless, these observations are solely gathered from *sukuk* prospectuses. Thus, they are subject to further explanation to be obtained from the interviews.

¹⁰⁵ The rate of the *ta'widh* must be based on the actual loss. The actual loss is calculated using the daily overnight Islamic Interbank rate as stated in the website of Islamic Interbank Money Market (<http://iimm.bnm.gov.my>), fixed on the date when the judgment of the compensation is made and calculated monthly based on a daily rest basis (Securities Commission, 2014, p.5).

In addition to the above, uncertainties surrounding indemnity due to misconduct, negligence, and breach of contract may be understood through the PESAKA *sukuk* cases¹⁰⁶. The case reports as adjudicated in the Court of Appeal and the Federal Court have shed some light on the liability to pay indemnity, the amount of indemnity to be paid, and recourse of trustee to the issuer over the indemnity amount. In the said cases, it was found that breach of contractual clauses was the base of the lead arranger's negligence. On the part of the *sukuk* trustee, it was found that breach of statutory duty was based on section 82(1)(c) of the Securities Commission Act 1993 (SCA 1993)¹⁰⁷ and the clauses contained in the Trust Deed. In other words, there were breaches of contractual¹⁰⁸ and statutory¹⁰⁹ duties.

In the case of *Maybank Trustee Bhd v CIMB Bank Berhad and other appeals* [2012] 2 MLJ 187, the court made reference to a few clauses in the *sukuk* contract, i.e., the Subscription and Facility Agreement (SFA) and legal provisions contained in the SCA1993. The SFA clauses stipulated several conditions to be fulfilled before the

¹⁰⁶ *Pesaka Sukuk* refers to *Bai' Bithaman Ajil sukuk* issued by Pesaka Astana Sdn. Bhd (PESAKA) on 1st April 2004. The value of the *sukuk* was RM157,815,000. Proceeds obtained from the *sukuk* were to be used to finance the execution of three government contracts awarded to PESAKA. KAF Discount Bhd (KAF) was appointed as the lead arranger and Maybank Trustee Bhd (MTB) was appointed as the trustee. On 30th September 2005, the *sukuk* was declared as defaulted (The Star, 2010) and this resulted in claims by the *sukuk* holders and ten financial institutions that include MIDF Amanah Investment Bank Bhd., CIMB Bank Bhd., Abrar Discounts Bhd. and others (Kinibiz, 2014). According to the facts of the case in *Maybank Trustees Bhd v CIMB Bank Bhd and other appeals* [2012] 2 MLJ 187, the appointment of MTB as the trustee was to perform the ring-fencing of the revenue to be earned from the government contracts. The ring-fencing was to protect the *sukuk* security to be paid to the *sukuk* holders. Nonetheless, PESAKA had assigned the revenue to its commercial lenders including, among others, CIMB Bhd (CIMB) as the revenue account. The redemption of the revenue from the commercial lenders required an issuing agent of which KAF was appointed. It was alleged that between July 2004 and September 2005, the revenue that was deposited into the revenue account was disbursed by KAF to PESAKA. This led to fraudulent withdrawals of the entire revenue by PESAKA since the ring-fencing was not in place. When the *sukuk* defaulted, the revenue was not available to meet the *sukuk* holders' claims.

¹⁰⁷ This section was later deleted by Act 1305.

¹⁰⁸ Duty arising from the *sukuk* information memorandum that was used by the Court to decide on the negligence and breach of contract by the parties.

¹⁰⁹ The Court referred to s 82 of the SCA 1993 on the due diligence duty of a trustee.

issuance of the *sukuk*. In sub-clauses 3.1 and 3.2 of the SFA, KAF was required to have received a confirmation from PESAKA on the opening of a Shariah Designated Account (SDA) to transfer the *sukuk* revenue. In addition, clause 4.3 of the SF also dictated that the *sukuk* should not be issued unless the SDA has been opened with Maybank Trustee Bhd. (MTB) as the sole trustee and signatory. In issuing its decision on the negligence of the lead arranger (i.e., KAF Discount Bhd. (KAF)), the Court of Appeal pinpointed the failure to ensure ring-fencing. Hence, there was a breach of contractual duty.

On the other hand, the Court considered the negligence of MTB to be a breach of statutory duties as provided in section 82(1)(c) of the SCA 1993 (the provision was removed by Act 1305). According to the Court, MTB owed a duty under contract, tort and trust to ensure that it has sole control over the SDA. Nonetheless, MTB had failed to perform its duty and failed to exhibit an adequate level of professionalism, competence, and skill expected of professional trustees. It was also asserted that MTB had failed to show urgency to take control of the SDA. Thus, the Court apportioned liability to be shared in the ratio of 50:50 between KAF and MTB, respectively. The decision dismissed the 60:40 liabilities as adjudicated by the previous court. PESAKA was also ordered to indemnify MTB by 2/3 of the total loss sum of RM149,300,000. Meanwhile, CIMB Bhd (CIMB) as one of the commercial lenders of Pesaka of which the revenue of the government contracts financed by the BBA *sukuk* was transferred to (as Pesaka have accounts in CIMB) was also deemed liable for its position as a constructive trustee¹¹⁰.

¹¹⁰ According to the Court, the negligence and breach of contract or trust (in the case of MTB) was based on few materials facts, i.e. failure of KAF to get confirmation by Pesaka on the opening of designated accounts for the revenue to flow in before *sukuk* issuance, failure to ensure ring fencing of the *sukuk* security, fraudulent misappropriation by Pesaka and falsity to issue the *sukuk* before the ring

At the Federal Court, the apportioned liability was reviewed in the case of *CIMB Bank Bhd v Maybank Trustees Bhd and other appeals* [2014] 3 MLJ 169. According to the Federal Court, KAF has not breached its contractual duty. Through a letter from PESAKA and transactional letter, KAF was made satisfied that the conditions prescribed in SFA (i.e. ring-fencing of the SDA) had been fulfilled. Reference was made to CP11 on the confirmation of PESAKA to KAF on the opening of SDA (p.198). In addition, the court stated that the breach of contractual duty of KAF as held by the previous court was baseless (p.197, Note 77). In addition, KAF's duty of care on the information contained in the Information Memorandum (IM) was excluded by the IM's important notice/disclaimer (p.192).

The Federal Court held that the cause of loss was mainly due to fraudulent misappropriation by PESAKA and the failure of MTB. MTB owed the duty to the *sukuk* holders as prescribed under the Trust Deed, clauses 7.3, 8, and 12.3. Under clause 12.3, MTB having been appointed as PESAKA attorney has wide powers to ring-fence the SDA. It was found that MTB failed to take immediate and necessary action even though it has been informed of the *sukuk* date of issuance (p.199). Therefore, the liability which rested on MTB was a 100% liability. However, PESAKA was ordered to indemnify MTB in full for the total amount of RM107,000,000¹¹¹. This is because the Federal Court had agreed with the findings of the Court of Appeal that the actual cause of loss was the fraudulent misappropriation by PESAKA. The court also found that MTB was

fencing was in place. As a result, the decision of previous Court on KAF and MTB liability at 60% and 40% respectively has been dismissed and held at 50%-50% liability or equal liability.

¹¹¹ Revised amount. The Federal Court has revised the amount of indemnity to include only the face value of the *sukuk*, i.e., total loss to the *sukuk* holders. The amount excludes the foreign exchange loss claim.

not disqualified under the indemnity claim as provided under clause 14.1 of the Trust Deed¹¹².

In sum, it can be concluded that indemnity for misconduct, negligence, and breach of contract as found in the case reports was subject to a few uncertainties, i.e., in terms of whose liability, liability proportion, indemnity amount, and recourse of trustee to issuer. As seen in the cases, the liability to pay the indemnity shifted from KAF to MTB, and the proportion of liability changed from 60%:40% to 50%:50%, and then to 100% liability borne by MTB. Meanwhile, the indemnity amount changed from RM149,300,000 to RM107,000,000 at the Federal Court. The proportion of indemnity to be paid by PESAKA to MTB also changed from 2/3 of RM149,000,000 to full payment of RM107,000,000¹¹³. Therefore, it can be posited that there are legal risks faced by the *sukuk* holders on the issue of indemnity due to misconduct, negligence, and breach of contract by the issuer, trustee, and lead arranger. The uncertainties or legal risk may be heightened in the case of *wakalah al-istithmar sukuk*, since the issuer is appointed as agent for the investment.

Due to the uncertainties, there is the possibility that the agent and the *sukuk* holders would be embroiled in a time-consuming litigation process to determine the amount of indemnity or to have alternative resolutions to remedy the *sukuk* holders. These were also evident in the case of Pesaka *sukuk*. The *sukuk* was announced as

¹¹² Clause 14.1 of the Trust Deed provided that MTB would be indemnified 'save and except for its gross negligence, wilful default, wilful breach or fraudulent actions'.

¹¹³ In *CIMB Bank Bhd v Maybank Trustees Bhd and other appeals* [2014] 3 MLJ 169, the Federal Court has decided that the actual loss suffered by the *sukuk* holders must be based on the actual amount that was fraudulently misappropriated by PESAKA, i.e., RM107,000,000. The amount was considered the actual loss due to failure to ring-fence the SDA. Previously, the Court of Appeal has adjudicated that the actual loss or amount of indemnity was RM149,300,000. The Federal Court could not find reasons of the amount of indemnity because the amount that was adjudicated by the High Court was RM149,315,000 (p.201). The actual loss of RM107,000,000 was decided by the Federal Court by excluding RM31,529,388, which was the foreign exchange loss claim. The Federal Court stated that the amount of RM149,315,000, as a redemption value of the *sukuk* was not to be borne by MTB. This is because MTB was not the main debtor/guarantor of the *sukuk*.

defaulted in 2005 and the claims by the *sukuk* holders were initiated in 2007. A series of cases involving the *sukuk* parties have been adjudicated by the High Court, the Court of Appeal, as well as the Federal Court. These cases were resolved after a long period of time, i.e., nine years.

4.4.4.2 Changes in Pool of Assets Pose Legal Risk to the Sukuk

In addition to the foregoing, *wakalah sukuk* allows a pool of assets to be made the *sukuk* underlying asset. The pool of assets may be a mixture of tangible and intangible assets, shares, and receivables¹¹⁴. This position suits the Islamic financial institutions that normally hold a very large number of receivables, such as commodity *murabahah* receivables (ISRA, 2017, p.398). However, the pool of assets must comply with the Shariah requirements. Based on the Accounting and Auditing Organization for Islamic Financial Institutions (AAIOFI) 2008, there is a minimum percentage of debt/receivables required to allow the tradability of the *sukuk* (Lahsasna & Idris, 2008). Potential risk that may arise from this practice is the changes in the pool of assets. For instance, the pool of assets may change from being Shariah compliant to Shariah non-compliant¹¹⁵. One example is when the underlying asset of the *sukuk*, e.g., shares, have been re-classified to be Shariah non-compliant. The reclassification may occur due to changes in the company's (obligor/issuer) business operations or financial position¹¹⁶(Bursa Malaysia-i, 2014).

¹¹⁴ In Guidance Note on Issuance of *Sukuk Wakalah bi al-Istithmar* in Labuan International Business and Financial Centre, 33% of the *sukuk* underlying assets must be tangible assets that include *murabahah* receivables and *Istisna* ' receivables.

¹¹⁵ The underlying asset consists of Shariah non-compliant elements e.g. *riba* and *maysir*. One of the examples is the change of shares status from Shariah-compliant to Shariah non-compliant.

¹¹⁶ Based on the Shariah Screening Methodology, the financial ratios of the company calculated using cash over total asset and debt over total asset must be equal or higher than 33%. If the ratios are lower than 33%, the company will not be listed under Shariah Compliant Securities.

Another example is when there is a change in the tangible asset composition of the pool of assets from 51% or 33% to less than 51% or 33%. According to Shariah rulings by the Organization of Islamic Countries (OIC), “*a bond or note can be sold at market price provided that the composition of the group of assets, represented by the bond, consists of a majority of physical assets and financial rights, as compared to a minority of cash and interpersonal debts.*” (Ulusoy & Ela, 2018). However, there were various opinions on the minimum composition of tangible assets, i.e. 33%, 51%, or 70% (Alawi & Al-Quati, 2014). As a result, trading in *sukuk* of which the composition of tangible assets is below 51% or 33% of the total assets will render the trading to be Shariah non-compliant.

In view of these, it can be posited that changes in the pool of assets may expose the *sukuk* parties to legal risk, i.e., risk of Shariah non-compliance. This risk is heightened when the *sukuk* are traded in the secondary market. In addition to these, legal risk may also arise when there is a failure to maintain the Shariah tangible assets within the pool for the whole duration of the *sukuk* or *sukuk* programme. In para 1.03(c) of CBSR 2017, there is a provision requiring the *sukuk* principal advisor to notify any variation, substitution, or replacement of the *sukuk* underlying asset to the SAC after approval is obtained from the *sukuk* Shariah advisor. Failure to fulfil this requirement may make the party liable.

Outside of Malaysia, it was noted that a number of international *sukuk* issuers have revised their *sukuk* documents to comply with the Shariah standards of AAI OFI, i.e., in terms of tangibility ratio of above 50% throughout the tenure of the *sukuk* (Al Nator et al., 2021). Prior to this, the requirement to maintain the tangibility was only at 33% at the time of issuance. If the tangibility ratio decreases below the 33%, it merely warrants rectification action, as stipulated in Para 6.16 and Para 13.15 of the LOLA

framework as well as CBSR 2017, respectively. Based on the standards as well, the tangibility issue is associated with delisting event or the exercise of put option by the investors (Al Nator et al., 2021). Considering this recent development in AAOIFI standards, changes in the pool of assets for *wakalah sukuk* may trigger a contract risk if the current provisions in the contract are not revised to supplement the recent requirement.

As observed in some *sukuk*'s PTC available at the SC website, there is only a minimum risk management mechanism proposed for such change in the pool of asset. For instance, there are some PTCs that provide specific provisions to make the issuer or the investment agent responsible for the substitution of the asset. Nonetheless, provisions on the failure to substitute the asset and its consequences are not indicated in the PTCs. However, the legal risk is subject to further clarifications that will be sought through interviews.

4.5 LEGAL RISK OF *SUKUK* ARISING FROM THE OPERATION OF THE *SUKUK*

The nature of legal risk to be operational is also predictable. This is apparent in the definitions found in past literature that emphasized on the operational or organizational side of legal risk. For instance, definitions of legal risk provided by the Financial Law Panel (FLP)¹¹⁷ and the International Banking Association (IBA)¹¹⁸ highlighted the

¹¹⁷ Legal risk has been categorized into several types. Some of them relate to the operation of an organization. They are organizational legal risk, i.e. legal risk arising from operation and management of assets and property of the organization, legal methodology risk i.e. risk relating to inadequacy of methods adopted and steps taken to protect the company against claims and damages, and conduct-of-business legal risk, i.e. risk of liabilities or obligations due to the conduct of the company's commercial operation (McCormick, 2013, p. 271-284).

¹¹⁸ "Legal risk can be defined as operational risk events and losses that are triggered by a breach of obligations for the institution that derive from statutory or legislative provisions, of national or international origin, or from contractual arrangements, or internal rules and ethical conduct derived from national or international norms and practices" This definition is the compilation of aspects of legal risk as stipulated by EBA (Whalley & Guzelian, 2016, p.21).

operational perspectives of legal risk in an organization. In addition, there was also the incorporation of legal risk under the definition of operational risk as issued in Basel II (Basel Committee on Banking Supervision (BCBS), 2006).

Legal risk that is operational refers to risks that stem from an organization's poor operational management of risk, resulting in legal issues. Similar descriptions were also given by Whittaker (2003) and McCormick (2013). It covers risks arising from the unlawful act of an individual or an institution or due to internal operational risk management controls that has failed to respond to legal issues (Whittaker, 2003).

4.5.1 Sukuk Contract Handling that Can Create Legal Risk

Sukuk contract handling falls under the operational management of the *sukuk*. It has been noted that contract handling is a source of contract risk. It is a type of legal risk that may arise from contract management, contract initiation, and contract negotiation (Schuhmann & Eichhorn, 2017). Risk sources in contract management cover contracts that are frequently ignored or not applied to their content that they impact the contracting parties' relationship¹¹⁹, and deficits in an institution's process to manage contract, i.e., retrieval of contract and its monitoring (Schuhmann & Eichhorn, 2017).

Contract risk may also arise from contract initiation and negotiation. It may originate from essential aspects of the handling of the contract, such as the handling of confidentiality, language, and translation. When these aspects of contract risks' sources are applied to *sukuk*, there are some contract risks that may arise.

¹¹⁹ It was stated by Schuhmann & Eichhorn (2017, p.509), one of the function of a contract is to foster the relationship between the contracting parties. For instance, a contract may determine the relationship of the parties, either in a control based, adversarial way or in a trust-based, collaborative way. When the contract is not well managed or not applied to its' content, contract risk arises. This arises from the handling of the contact or poor contract management by the parties or institution.

4.5.1.1 Failure or Omission to Disclose Material Information in the Sukuk Information Memorandum (IM)

In the case of *Maybank Trustees Bhd (formerly known as Aseambankers Malaysia Bhd) v Amtrustee Bhd & Ors* [2020] 4 MLJ 405, a 15-year tenure bond with RM308 million in value was issued in 2003 under the Aldwich Bond Programme¹²⁰. The bond failed due to various reasons, including failure to ring-fence¹²¹, in its sixth year of tenure. Claims by the bondholders were brought to the High Court and the Court of Appeal to determine the liabilities to be borne by its DDWG. The DDWG comprised of the bond issuer, lead arranger, trustee, and accountants.

Unlike KAF as the *sukuk* lead arranger for the Pesaka *sukuk*, MIBB as the lead arranger of the 15-year bond was also the security agent and facility agent of the bond. It was deemed that the bond lead arranger in the latter case has wider powers. In this case, the Court of Appeal demanded higher level of deliberation for the duty to be discharged because: 1) the lead arranger also acts as security agent, whose duty is to monitor the ring-fence or at least, ensure that the counterparties have remitted funds to the designated accounts¹²²; and 2) the lead arranger was well-informed of the inexistence of the ring-fence or “not knowing that the fund was not flowing directly from contract counterparties into the Revenue Account, but first into AEM’s account and then into Aldwich’s account” (para. 241).

¹²⁰ Proceeds to be used to fund the AEM business expansion on waste oil refining (WOR) that requires the construction of WOR plant.

¹²¹ A total of RM265 million was found not ring-fenced by the High Court.

¹²² The Court stated that MIBB “had such a monitoring function is also borne out by the fact that express provision is made that it remained the sole signatory of the Designated Accounts, particularly the Revenue Account. The Security Agent was also to be informed of all business contracts entered into post-bond issuance. This again signifies the existence of a matching obligation on the part of the Security Agent to ensure that all subsequent contracts entered into with Aldwich were similarly assigned and charged in favour of the bondholders”. (para. 245)

As seen in the Pesaka *sukuk* case, the *sukuk* lead arranger's claim over its exclusion from liability arising from the *sukuk* IM was acknowledged and approved by the court due to the effect of the disclaimer on the *sukuk* IM. A similar claim was brought by the lead arranger, MIBB. It was envisaged that the outcomes would be the same. In contrast, the High Court and the Court of Appeal gave different verdicts.

It was argued by the courts that the effect of the disclaimer in the IM will only take place when there was no evidence of the information contained in it to be misstated and misleading. The Court of Appeal asserted that there were changes made to the initial IM and upon conditional approval procured from the SC, the lead arranger has failed to notify the authorities on the non-fulfilment of one of the condition precedents (CP 20 of the IM¹²³), failed to notify SC on its intention to vary the conditions and waive CP20 and failed to notify the *sukuk* holders on these matters. As a result, there was a breach of contractual duty (based on the Planning Memorandum) and statutory duty as prescribed in sections 38(3) and 32B of the SCA 1993. In this regard, the Court considered that failure of the lead arranger to disclose material information has rendered the disclaimer defense ineffective.

In view of the above, failure to disclose material information in the *sukuk* documents may pose legal liability on a related party. Hence, this constitutes legal risk in terms of contract handling.

¹²³ CP 20 requires that all business contracts be assigned by Aldwich to AEM prior to bond issuance. A similar condition precedent was provided in the Subscription Agreement, CP 12. It was also found by the High Court that some of the counterparties refused to give consent to the assignment of Aldwich's contracts to MIBB and no acknowledgements were returned to MIBB. Thus, this matter was not disclosed in the IM. In view of these, the bond security has been severely altered despite having strategic safeguards prior to the changes.

4.5.1.2 Failure to Secure Continuous Legal Review of Sukuk Contract

Based on the types of contract and their definitions as provided by BLP (2014), *sukuk* contract can be categorized under ‘largely standard contract’. It refers to a type of contract that is “usually negotiated, but are(is) based on a standard template, usually with pre-defined negotiating positions” (BLP, 2014). This is because *sukuk* as a structured instrument allows several considerations to be incorporated during its structuring (Ahmed, Amran, & Islam, 2018). Drafting a *sukuk* contract requires extensive legal review and the review must be continuous throughout the lifespan of the *sukuk*.

The continuous legal review is indispensable for *wakalah sukuk* particularly for two reasons. Firstly, *wakalah sukuk* comprises of pool of assets. These assets need to be maintained by the agent/issuer to ensure that they are Shariah compliant and that their portions (tangible and intangible assets) meet the minimum requirements as stipulated in the *sukuk* contract. Secondly, *wakalah sukuk* requires the *sukuk* issuer and principal advisor to comply with certain requirements throughout the lifespan of the *sukuk*, e.g., the utilization of the proceeds has to meet the purpose submitted to the SC and the investment has to be Shariah compliant (para 2.07, 2.8 of LOLA Framework, p. 56). Other than that, additional procedural requirements need to be fulfilled when adjustments are made on the details of the *sukuk* contract, e.g., revision of principal terms and conditions that require SC approval (para 6.01, 6.06, and 6.16 of LOLA Framework, p.64-68) as well as adjustment of profit rate and maturity rate that requires supplemental contracts to be made (para 6.02, para 6.06 of LOLA Framework, p.127-128). Non-compliance with these requirements may result in legal issues to arise because they are considered breach of duty or breach of contract. As a result, failure to secure continuous legal review is itself a legal risk to the *sukuk*.

4.5.2 Inadequate Legal Risk Management (LRM) Techniques within the Sukuk Operation

The inadequacy of LRM in *sukuk* is still foreseeable due to numerous legal uncertainties surrounding the question of management for post-default restructuring, lack of certainty in terms of *sukuk* default mechanisms, as well as the implications of the uncertainties to *sukuk* holders. These are considered hurdles to the growth of *sukuk* globally (Oseni, 2014; Marinescu, 2012).

4.5.2.1 Litigation Risks or Legal Uncertainties Arising from Arbitration

As discussed in the previous chapter, litigation risk can be considered a type of operational legal risk. Litigation risk includes the risk of getting embroiled in dispute, the risk of a party not being able to pursue or defend its claims, and the risk of unenforceable award or judgement (closely related to counterparty risk) (Sandler, 2010, p.166-167). Some of these risks have been delineated under the aspect of legal risk arising from the Malaysian legal environment¹²⁴ and legal risk arising from legal perspectives of *sukuk* contract¹²⁵. They are uncertainties relating to the Malaysian legal aspects that govern *sukuk* and *sukuk* contracts that can lead to litigation arising from the *sukuk*. Nonetheless, litigation risk as part of the operational legal risk in *sukuk* may be discussed from the aspect of legal uncertainties arising from arbitration and *sukuk* restructuring.

It was noted that the trend of litigation will be moving downwards due to the increasing practice of embedding arbitration clauses in corporate legal documentation for *sukuk* transactions (Oseni, 2016). In addition, *sukuk* restructuring has also been

¹²⁴ In 4.3 of this chapter.

¹²⁵ In 4.4 of this chapter

perceived to be preferable over the effects of bankruptcy and reputation deterioration due to defaulted *sukuk* (Ahmad, Muneeza, Farooq, & Hasan, 2018). It also offers *sukuk* holders chances for repayment (Ahmad et al., 2018). Nevertheless, both arbitration and restructuring still entail legal uncertainties, hence giving rise to legal risk.

Arbitration is a form of dispute management. It is an inextricable nexus of *sukuk* restructuring because the restructuring requires a series of meetings and negotiations to manage the dispute, i.e., for near-default and defaulted *sukuk*. In other words, there cannot be a *sukuk* restructuring without appropriate arbitration, or other forms of alternative disputes resolutions (ADR), e.g. ombudsman, mediation, etc. (Oseni, 2014). Embedding an arbitration clause as part of the *sukuk* governing law has been a practice for most *sukuks* (Oseni & Hassan, 2015). Although there are issues surrounding the implementation of arbitration, e.g., racial bias, excessive localization of arbitral proceedings, and excessive formalism (Oseni, 2016b), the legal uncertainties that remain are on: 1) the applicability of arbitration clause in some jurisdictions; 2) certainty within the arbitration clause; and 3) mutual agreement of the contracting parties on the arbitration clause (Clifford & Browne, 2013). In general, the certainties that are required in an arbitration clause are: 1) the law governing the arbitration agreement, or the law of the seat of the arbitration; and, 2) the court or jurisdiction in which the arbitration enforcement may be sought (Ustinov, 2016).

In the case of *Arch Reinsurance Ltd v Akay Holdings Sdn Bhd* [2019] 1 CLJ 305, legal uncertainties pertaining to dispute arbitrability have arisen. In the High Court, the arbitrability of the dispute¹²⁶ over the charge, i.e. the mine, was denied because of the

¹²⁶ The dispute was on the execution of sale of a leased mine that was made a charge of a bond by *Akay Holdings Sdn Bhd* to *Arch Reinsurance*. Upon default by the former, the latter proceeded to issue foreclosure proceedings at the High Court. In response to this, *Akay* applied for stay of the proceedings under section 10 of the Arbitration Act 2005.

fact that the dispute was a claim *in rem* and not *in personam*. In other words, a claim over a property does not fall under the arbitral dispute according to section 10 of the Arbitration Act 2005. However, the Court of Appeal reversed the decision. In concluding its decision, the Court of Appeal found that the dispute of the charge was interlocked by provisions of both the Subscription Agreement and Bond Conditions. Since the Subscription Agreement has provisioned a clause on arbitration of any emerging issues and the Bond Conditions was a prerequisite of the charge¹²⁷, the claim made by *Arch Reinsurance* was deemed prematured. Thus, the non-arbitrability of the dispute was upheld by the Court (Godwin & Chua, 2020). At the Federal Court, another twist of decision was presented. The Federal Court upheld the arbitrability of the dispute on two grounds: 1) the charge was documented in a separate contract and there was a clause that determined the enforcement of the charge overriding clauses in the Subscription Agreement and Bond Conditions. Hence, the arbitration clause was overridden; and 2) the execution of the charge was in contrast to public policy. The Federal Court was of the view that the comprehensiveness of the National Land Code provisions over the charge, (i.e., section 254 on the foreclosure of a charge and fulfilment of Form 16D) has diminished the arbitrability of the dispute. Thus, to decide on the arbitrability of dispute was considered contrary to public policy (Godwin & Chua, 2020). As these cases was on a charge made over a bond, legal uncertainties arising from the cases can be anticipated in *sukuk* as well. For instance, the arbitrability of *sukuk* purchase undertaking of an asset may be subject to legal uncertainties.

¹²⁷ The Bond Conditions set out the conditions to be fulfilled by the parties before the foreclosure of the charge can be executed. In this case, *Akay* alleged that denial of extension by *Arch* has frustrated the sale of the mine and it contravened the pre-agreed conditions.

4.5.2.2 Litigation Risks or Legal Uncertainties Arising from Sukuk Restructuring

Sukuk restructuring has its own issues. As elaborated by Bakar (2020), *sukuk* restructuring requires an in-depth check on the types of *sukuk* to be restructured. Otherwise, issues of Shariah non-compliance will emerge, e.g., agreeing to a lower rate of coupon compared to the original rate contracted in *musyarakah/ mudarabah sukuk* as it implies ‘capital guarantee’ in a partnership contract and agreeing to extend the *sukuk* maturity period with higher rate of coupon as it amounts to *riba*’.

To analyze the uncertainties surrounding *sukuk* restructuring, scrutiny can be made on the case of Dana Gas *sukuk*. In November 2012, Dana Gas and its *sukuk* holders agreed on a restructuring plan for the *mudharabah sukuk*. Unfortunately, the financial position of Dana Gas worsened even after the restructuring, partly due to political instability in the region (Zada, 2019). In June 2017, there was a claim by Dana Gas that the *sukuk* was Shariah non-compliant due to the fixed rate of return to the *sukuk* holders following the amended UAE law (Zada, 2019). Consequently, Dana Gas stated that it will not be able to make two scheduled distributions to the *sukuk* holders, that were due on 31st July 2017 and 31st October 2017 (Zada, 2019). Instead, Dana Gas proposed a restructuring plan of a new four-year security with a profit rate that was less than the current *mudharabah sukuk*. The restructuring plan was rejected by the *sukuk* holders. It is also worth noting that when Dana Gas defaulted in 2012, a restructuring plan had already been offered and eventually approved by the *sukuk* holders in May 2013 without any Shariah compliance issue. It was in 2017 that the restructuring was offered due to non-Shariah compliance.

From the day Dana Gas defaulted and until the case was finally resolved in May 2018, the restructuring that occurred in 2017 has exposed the *sukuk* holders to numerous uncertainties, i.e., the initial effect of Dana Gas’s declaration of “unlawfulness” and the

applicable governing law and court of jurisdiction (Mcaughtry, 2017). Luckily, the restructuring plan under the *wakalah* and *ijarah* was eventually approved by at least 52% and 30% of the *sukuk* holders in respect of the two tranches, i.e., ordinary *sukuk* tranche and convertible *sukuk* tranche, respectively. The plan was agreed to, with full dismissal of all pending litigation and payment of outstanding claims made (Mcaughtry, 2017). In contrast, if the final restructuring was not successful, the hypothetical uncertainties that will remain are: 1) the prevailing governing law and court of jurisdiction to follow¹²⁸; and 2) the rights of the *sukuk* holders over the proceeds of the “unlawful” *sukuk*.

Further, there are also uncertain issues in the Dana Gas litigation that still remain unanswered. For instance, the “unlawfulness” of Dana Gas *sukuk* was never officially declared by any specific body and was based on its own interpretation (Abdelhady, 2017; Mcaughtry, 2017). However, the “lawfulness” of the restructured *sukuk* was successfully declared by its Shariah advisors. The uncertainty here is that, it is unknown whose authority was relied on to declare the validity and Shariah compliance of the *sukuk* under this circumstance¹²⁹. It was also noted that the *sukuk* holders were not offered debt-for-equity swap. The debt was to be paid merely in cash or in payment (pay-in-kind)(Parker, 2017). In a study report issued by Mcaughtry (2017), it was

¹²⁸ The Dana Gas *sukuk* circular states, “*The Declaration of Trust, the Agency Agreement, the Purchase Undertaking, the Sale Undertaking, the Security Agreement, the Security Agency Agreement, the Ordinary Certificates and the Exchangeable Certificates will be governed by English law and subject to the non-exclusive jurisdiction of the English Courts. The Mudarabah Agreement, the UAE Share Pledges and the UAE Mortgage will be governed by the laws of the UAE*”. It was argued that this provision led to ‘competing litigation’ or in other words, uncertainties surrounding the laws to be applied and the court to be approached (Abdelhady, 2017). In contrast, it was claimed that the non-exclusiveness of courts as applied in *sukuk* is due to the owning of multi-jurisdictional nature of the *sukuk*, i.e., its underlying asset, issuer, investor, trustee, and arranger (U. Oseni, 2016, p.54).

¹²⁹ However, it was noted that during the negotiations for *sukuk* restructuring, advice was sought from the DDWG, particularly the Shariah advisors, and also from third parties, to assess the restructuring plan before it can be offered and approved by the parties (A. Oseni, 2014, p.208). These were the practices of the four *sukuk* default cases in the study. The practices were executed without specific guidelines on post-default management (A. Oseni, 2014, p.202).

claimed that there was a hidden motive that camouflaged the restructuring and time-consuming litigation. At this point, scholars opined that the restructuring plan offered by Dana Gas was a ‘relatively weak deal’ as it denied the initial debt-for-equity swap that may benefit the *sukuk* holders more, especially considering Dana Gas’s blooming financial growth in 2017 and 2018. As a result, the debacle of Dana Gas left the *sukuk* holders in a weaker position by having to accept poor restructuring plan to avoid a lengthy and costly court litigation. Thus, what remains uncertain is how these matters should be tackled in *sukuk* LRM.

Apart from poor documentation of post-default mechanisms as seen in the case of Dana Gas *sukuk* (where the issuer, *Dana Gas*, opted for multi-jurisdiction litigation rather than single jurisdiction, either UAE or English court/laws to follow), it can be argued that the *sukuk* documentation post-default is still lacking due to two reasons: 1) the post default provisions are imported from the provisions for conventional bond (Marinescu, 2012, p.460) where its entire applicability is not certain; and 2) there are still inadequate LRM techniques within the *sukuk* operation to manage post-default events, either ADR or *sukuk* restructuring. Therefore, it was suggested that some repercussions need to be improvised, even prior to the default of the *sukuk*. In the looming default stage, it is indispensable that certain LRM techniques be executed, e.g., preliminary announcement by the issuer/trustee on the performance of the *sukuk* and *sukuk* restructuring forecasts by the credit rating agency to warrant the *sukuk* holders and other relevant stakeholders (Oseni, 2014). It was also noted that *sukuk* restructuring can be a time-consuming process, taking at least two years, as seen in the restructuring of Tracoma Holdings Bhd (Tracoma) *sukuk* (2010-2012), *Sistem Lingkaran Lebuhraya Kajang Sdn Bhd (SILK) sukuk* (2006-2008), and Vastalux Capital Sdn Bhd (Vastalux)

sukuk (2010-2011) (Rusgianto, Sridadi, Retno, & Ahmad, 2020) which did not involve court intervention¹³⁰.

4.6 CONCLUSION

In this chapter, the conceptual framework of legal risk (see Figure 3.2) and types of legal risk (see Figure 3.3) as concluded in Chapter 3, has been used to determine legal risk in *wakalah sukuk* in Malaysia. The legal risk, either hypothetical or observed, are encapsulated within three aspects, namely: 1) legal risk arising from the Malaysian legal environment; 2) legal risk arising from the legal perspectives of the *sukuk* contract, including *wakalah sukuk* structure; and, 3) legal risk arising from the *sukuk* operation. In the first aspect, the legal risk discussed includes both hypothetical and observed risk. Legal risk in this aspect was observed from a few relevant cases, particularly the Dana Gas *sukuk*. In addition, hypothetical legal risk in this aspect was explored based on past literature, relevant laws and guidelines, as well as selected *wakalah sukuk* PTC. These legal risks are anticipated to emerge due to the law itself. Although the laws were enacted to manage *sukuk* operation in the country, the laws also gave birth to legal risk. Additionally, the legal environment supporting *sukuk* is also subject to legal uncertainties, particularly in terms of court decisions, incompatibility of several laws governing the *sukuk*, and enforceability of foreign judgements.

In the second aspect, legal risk was discussed mainly from the aspect of *sukuk* contract, i.e., unenforceability of *sukuk* contract clauses and legal uncertainties surrounding the effects of *sukuk* clauses. Legal risk specific to the *wakalah sukuk* structure was also discussed, in terms of uncertainties surrounding indemnity and risks

¹³⁰ Except for winding up order by the Court for Vastalux Capital Sdn Bhd (Vastalux) *sukuk*.

associated with changes of pool assets. These two risks are specific to *wakalah sukuk* due to its structure that allows representation by a *wakil*. Having a representation means that the original liability is shifted; thus, this may create an issue in terms of who will assume liability when it comes to misconduct, negligence, and breach of contract. The structure also allows a pool of assets. When there are changes in the ratios of tangible and non-tangible assets, this may as well pose Shariah non-compliance risk. Some legal perspectives of the *sukuk* contract were generally discussed previously. However, the second aspect has delineated the risks since they are related to *sukuk* contract clauses, i.e., clauses on governing laws, post-default provisions, and default events' provisions. Hypothetical legal risks under this aspect are to be delineated based on data collected from document analysis and interviews.

In terms of the third aspect, legal risk of *sukuk* is analysed from the lenses of *sukuk* operation, i.e., 1) *sukuk* contract handling; and 2) *sukuk* legal risk management. It was found that failure to secure continuous legal review of *sukuk* contract may trigger legal risk. This is anticipated since the laws provide numerous substantive and procedural requirements on *sukuk* contract review, e.g., SC approval is needed for PTC amendments, and supplementary contract is needed to adjust profit rates and maturity dates of the *sukuk*. Thus, failure to handle the contract diligently may pose legal risk to the *sukuk*. In the aspect of legal risk management, the risk management strategies that are available to manage litigation risks or legal uncertainties are arbitration and *sukuk* restructuring. Nevertheless, these two strategies are still susceptible to legal risks. These risks have been mentioned superficially in the previous sections of this Chapter. However, they are discussed in detail in relation to the topic of *sukuk* operation because they are interrelated with the overall operation of the *sukuk*, after the *sukuk* defaults or nearly defaults.

In sum, there are 12 types of legal risk identified in this chapter and they are depicted in the diagram below:

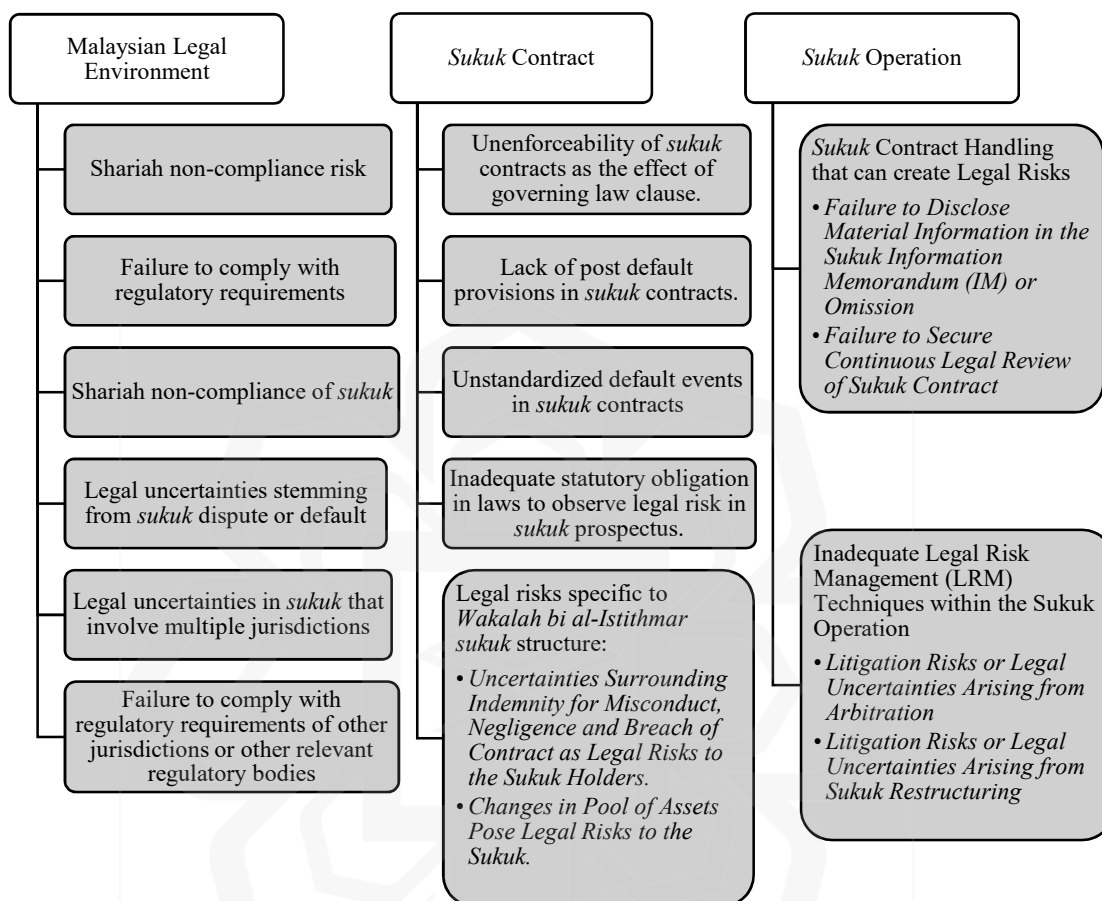


Figure 4.1 Types of Legal Risk of Wakalah Sukuk in Malaysia

CHAPTER FIVE

EVALUATION OF LEGAL RISK MANAGEMENT IN *SUKUK*

5.1 INTRODUCTION

While previous chapters have provided reviews on legal risk, this chapter has narrowed down the review to evaluating legal risk management (LRM) and its applicability in *sukuk*. It is the second most important part of this research, i.e., to determine the LRM of *wakalah sukuk* in Malaysia. Therefore, this chapter will discuss the concept and objectives of LRM in *sukuk*. Review of the literature revealed that LRM has been studied from two viewpoints. Accordingly, the evaluation is structured in two aspects, i.e., LRM from the perspective of an organization and LRM from the perspective of a legal adviser (lawyering).

5.2 CONCEPT AND OBJECTIVES OF LEGAL RISK MANAGEMENT (LRM)

The concept of management relates to the art of organizing and coordinating activities, resources, and processes by an organization in order to achieve predefined objectives (Panfil, 2014). It was claimed that the management of risk is a concept introduced in the United States of America (USA) during the early 1950s and later reached the United Kingdom (UK) in 1969 (Simister, 2000). The first discussion on risk management as being different from risk control was delivered by Doug Barlow of Massey Ferguson (Simister, 2000). According to Doug Barlow, “management” seeks to do more than just trying to stop certain incidents from occurring. It involves various aspects like funding, insurance, emergency planning, etc. (Simister, 2000). In fact, the tradition of risk

management has shifted significantly from being perceived as additional costs to the organization to something that can be used to reduce costs, particularly costs of unexpected events (Elahi, 2013). For instance, risk management can reduce taxes, litigation costs, and bankruptcy costs (Stulz, 1996).

There are different types of risk management, affiliated with different risks. Among them are project risk management, enterprise risk management, operational risk management, market risk management, and project risk management. LRM is another significant area which importance was heightened with the issuance of Basel II by the BCBS in 2005. The Basel II has warranted the significance of operational risk management that includes legal risk (Arnott, 2004).

Risk management can be defined according to, among others, its designed objectives (McCormick, 2013). In the context of legal risk, the objectives of risk management are (Reid & Clark, 1996):

- i. to proactively use legal strategies to achieve an organization's goals;
- ii. to ensure compliance with the rules and laws that govern the activities of the organization;
- iii. to avoid loss and civil liability from contractual and non-contractual obligations; and
- iv. to help to limit exposure to criminal and regulatory liabilities (Wu, 2007).

Based on these objectives, LRM may involve unique management strategies, e.g., using contractual provisions as a legal strategy to manage its legal risks, prioritizing compliance with laws instead of the interests of the contracting parties, and improvising arbitration forums to avoid and minimize losses and civil liabilities.

5.3 PERSPECTIVES OF LEGAL RISK MANAGEMENT

In the past literature, LRM has been discussed from two perspectives, i.e., LRM from an organization's perspective (Anderson & Black, 2013; Johnson & Swanson, 2007; McCormick, 2013; Trzaskowski, 2005)¹³¹ and LRM from a legal adviser's perspective (Apollon, 2015; Hamzah, 2010; Mahler, 2010; Susskind, 2008).

5.3.1 LRM from an Organization's Perspective

From an organization's perspective, LRM forms part of the operational risk management (McCormick, 2013). LRM must be based on considerations by the management of the organization because legal risk may affect each organization differently (McCormick, 2013).

From this perspective, LRM resembles the management of operational risk. It includes the process of risk identification¹³², risk assessment¹³³, risk monitoring¹³⁴, risk control and mitigation¹³⁵ (McCormick, 2013). In this view, legal risk is considered as

¹³¹ Legal risk management by an organization may also include the function of the organization and legal advisers. The function of the organization was heightened at the stage of legal risk identification (e.g. organization must decide to confine legal risk arising from specific jurisdiction). In assessing, monitoring, and reporting the legal risk, the functions of the legal advisers were discussed (Anderson & Black, 2013, p.2).

¹³² Identifying the sources of legal risk, i.e. where it is more likely the legal risk will arise. For example, the two broad categories of (1) adverse claims and (2) defective documentation are considered the direct sources of the legal risk (McCormick, 2013, p.395). Identification of legal risk is also a by-product of its definition.

¹³³ As opposed to measurement of risk, legal risks are assessed due to the impossibility to ascribe mathematical measurement to them. Among the factors for the organization's senior management to assess legal risk are the legal infrastructure where the organization conducts its business, the relevant sources of law, the extent of legal uncertainty, the historical track records of the organization in handling adverse claims and defective transaction etc. (McCormick, 2013, p.397)

¹³⁴ Involves regular reporting of the important information to those who can assess its significance and eventually rise to the senior management level. In order to affect the monitoring function, the in-house legal advisers must be given access to the necessary information. Reporting lines as well as the allocation of responsibilities must be made clear within the organization. The monitoring process requires identification of the indicators of legal risk such as new law, new case law, significant changes in the market, legal claims made on other equivalent organizations, etc. (McCormick, 2013, p.399-401).

¹³⁵ Control of risk may involve developing advanced strategies like controlling the loss from legal risk (e.g. a review of impact on documentation, resources to defend claims and analysis of the financial impact), periodic reviews and updates of documentation, specific control procedures and negotiation of

being part of operational risk (McCormick, 2013). LRM as part of operational risk management is inevitable since the legal risk itself originates from a broad set of operational interactions between an organization's business practices and the laws or regulations that apply to them (Whalley & Guzelian, 2016). Nonetheless, the LRM must depend on consideration of an organization's management because legal risk may impact each organization differently (McCormick, 2013).

There are several risk management techniques involved in LRM from this perspective. These techniques range from purely legal responses (e.g. direct advice on a contract) to other behavioral or managerial responses, e.g. training, effective risk communication, etc. (Moorhead & Vaughan, 2012). Other techniques highlighted were qualitative risk reporting mechanisms and review of risk assessment (Moorhead & Vaughan, 2012). LRM from an organization's perspective must also include allocation of tasks. This is apparent in the steps recommended in the report by Berwin Leighton Paisner (BLP) (2013). It was suggested that the LRM framework should consist of five steps:

- i. Defining the legal risk and how it affects the organization;
- ii. Allocation of responsibilities to identify and manage the legal risk within the organization (separate responsibilities for identification, management and assurance as promoting open communication between business lines and legal teams);
- iii. Prioritization of certain legal risks over other types of legal risks to put control in place to mitigate them;

certain types of provisions in a contract such as clauses that limit liability under warranties, clauses that limit liability under warranties by reference to 'disclosure letters' and due diligence report, choice of law and jurisdiction clause, disclaimer of liability, 'changes in circumstances', *force majeure* provision, 'material adverse change' etc. (McCormick, 2013, p.404-406).

- iv. Analyzing the level of exposure and the source of the legal risks and the proper proportionate mitigating action; and
- v. Reporting the materiality of the legal risks to the board.

LRM from an organization's perspective was also perceived as a form of enterprise risk management (ERM)¹³⁶. Based on this view, LRM consists of management techniques by which legal risk can be quantified and managed through compliance planning (Johnson & Swanson, 2007). The methods to quantify legal risk was discussed at length by Johnson and Swanson (2007). However, they were meant for compliance plan, i.e., to ensure that a business or a firm complies with state and federal laws. The main concern is to ensure that the business or the firm is in compliance with the regulations of agencies that license, certify, or otherwise have the authority to seriously affect the business or the firm (Johnson & Swanson, 2007). As a result, the methods suggested are only limited to compliance risk, not necessarily legal risk.

LRM from the organization's perspective also considers the important position of in-house legal advisers (Moorhead & Vaughn, 2010). It was also pinpointed that LRM was often relied on based on an experiential or intuitive approach. The approach relied mainly on the experience of senior in-house legal advisers to identify and manage the legal risk (Moorhead & Vaughan, 2012).

The critical function of the in-house legal advisers and the organization's risk management function is to enable the legal advisers to identify and tackle the organization's overall legal risk (Whittaker, 2003). In other words, the risk management

¹³⁶ "Enterprise risk management is a process effected by an entity's board of directors, management and other personnel, applied in strategy setting and across the enterprise, designed to identify potential events that may affect the entity, and manage risk to be within its risk appetite, to provide reasonable assurance regarding the achievement of entity objectives (Johnson & Swanson, 2007, p.22)"

of the legal advisers must not be specific to certain cases or transactions where the legal risks arise. Their functions as legal risk managers are to provide proactive legal support, e.g., provide training, legal awareness training and training on legal aspects on business, to ensure legal approval is sought on a project, and to do contingency planning for the organization where the legal advisers may provide legal advice to the internal audit and report potential legal risks to the risk committee (Whittaker, 2003).

5.3.2 Legal Risk Management (LRM) From a Legal Adviser's Perspective

Some literature on the LRM has taken a narrower perspective by limiting the LRM in a contract (Mahler, 2010) and LRM within lawyering or in providing legal services to a person or an entity¹³⁷ (Hamzah, 2010). This shows that LRM can also be perceived from a legal adviser's perspective, i.e., the people entrusted with contract drafting and giving legal advice.

From a legal adviser's perspective, LRM is understood as a shared responsibility between a legal adviser and his client (Apollon, 2015). The objective of the LRM is to help the client to better identify and manage their legal risks. It is the responsibility of the client to provide all the necessary information to his legal adviser. In this way, effective risk assessment can be done by the legal adviser whilst the client is in a better position to select the appropriate risk response (Apollon, 2015). In addition, managing the legal risk requires the legal adviser to respect the client's autonomy and decision (Apollon, 2015).

¹³⁷ Lawyering was defined as “the process of providing legal services to a person or a legal entity which includes taking instructions from the client and understanding the clients' needs, analysing the facts and applying the law in the form of legal analysis and producing the final output in the form of a legal document or representational activity” (Hamzah, 2010, p.xiii).

For LRM, legal advisers assume the dual roles of legal adviser and risk manager. According to Mahler (2010), legal advisers have been managing risk informally and without a standardized method. In assessing legal risk¹³⁸, legal advisers typically do not estimate the risk value, i.e., the likelihood of the risk and its consequences. The closest estimate made by the legal advisers is through the hypothetical application of law that estimates the likely legal output. Thus, it was suggested that the LRM must cover (Mahler, 2010):

- i. legal risk assessment from the ‘*context, target and scope*’ (e.g. of a contract);
- ii. risk identification (e.g., legal decisions¹³⁹ based on contract text);
- iii. risk estimation (i.e., likelihood on the effect of the legal decision and its consequences);
- iv. risk evaluation; and
- v. risk treatment and cost benefit.

LRM must therefore be supported with tools, for example, graphical tools such as visualization and codes (Mahler, 2010).

From the perspective of the legal advisers, LRM may also be regarded as a legal strategy, i.e., a long-term plan structured to protect legal interests through legal risk avoidance, if not mitigation, or value creation (e.g. protection of intellectual property)

¹³⁸ In the article, legal risk was restricted to “risk related to a decision in a legal case”. By risk, it means the effect of uncertainty. In his view, uncertainty could be due to the deficiency of information, understanding or knowledge of a legal decision, its consequences or likelihood (Mahler, 2010).

¹³⁹ The likely facts and subsequent decisions that may affect the clients’ objective negatively (Mahler, 2010).

(Hamzah, 2010, p.xiv). There are a few steps required in managing legal risk, as follows:

- i. The operating environment is apprehended and the legal risks are identified;
- ii. The legal risks are analyzed and ranked (in accordance to its effect and severity); and
- iii. The legal risks are mitigated or prevented through documentation prepared in advance (Hamzah, 2010, p.9).

LRM from the legal advisers' perspective can also take a proactive approach. For instance, it was said that LRM promotes the use and development of objective criteria (Apollon, 2015). In this view, it focuses on objectifying the legal issues at stake by identifying and managing legal risks proactively (Apollon, 2015). It is thus associated with strategic management to encourage strong corporate governance by reducing the negative impact of legal risk across the organization (Apollon, 2015). Additionally, LRM under this perspective also covers proactive action (e.g., preparing a contract that protects the interest of the client) as well as reactive action by the legal advisers, particularly when the clients are sued in court (Hamzah, 2010; Whalley & Guzelian, 2016).

Based on these two perspectives of LRM, it can be concluded that LRM can be perceived from two levels of management, i.e., the macro level and the micro level. The macro level consists of operational or continuous LRM, whilst the micro level consists of the pre and post management of legal risks, or proactive management and reactive management, respectively. At the macro level, LRM may be studied from the aspect of relevant strategies, techniques, and tools adopted by an organization. The micro level of LRM consists of the pre-management phase, i.e., how the appointed legal advisers

objectify relevant legal issues at stake, identify, and manage them proactively. At this point, certain strategies may be employed, such as risk avoidance, risk mitigation, etc. In the post-management phase, the legal advisers build hypothetical application of law on the relevant legal issues. At this point, the legal risks, for example legal risks in a contract, are assessed, identified, estimated, evaluated, and treated.

Thus, the following discussion will take into consideration the differences between strategies, techniques, and tools of both LRM perspectives to develop themes and codes for further analysis of LRM for *wakalah sukuk*.

5.4 LEGAL RISK MANAGEMENT (LRM) STRATEGIES

In general, risk management involves neither eradication of risk nor risk reduction (McCormick, 2013). This is because the former is impossible and the latter denies the fact that many situations faced by an institution warrant risk-taking (McCormick, 2013).

As a result, managing risk can be broken down into five strategies:

- i. Controlling situations that may cause the unwanted risk to emerge;
- ii. Minimizing the loss that may be caused by a risk that materializes;
- iii. Limiting the occurrence of loss trigger events;
- iv. Transferring risk; and
- v. Avoiding the acceptance of risk through negotiation or structuring transactions (McCormick, 2013).

Additional strategies can be adopted in the form of risk response strategies¹⁴⁰ (Trzaskowski, 2005). Trzaskowski (2005) opined that LRM involves only two risk response strategies, i.e., risk mitigation by seeking legal advice and risk avoidance to the extent that is possible (i.e., through compliance with the law). Risk acceptance as a risk response strategy is not possible because it leads to infringement of law that is unlawful (Trzaskowski, 2005). Even risk avoidance through compliance with the law is exposed to uncertainties. For instance, legal advice may be sought to comply with the law but the legal adviser may still be unable to foresee how the court will rule on his client's case (Trzaskowski, 2005). In order to manage legal risk through risk mitigation, a cost-benefit approach¹⁴¹ was suggested (Trzaskowski, 2005). Details of LRM strategies in the literature are identified as follows:

5.5 RISK MANAGEMENT STRATEGIES (OPERATIONAL)

5.5.1 Risk Identification:

5.5.1.1 Organization:

Identification of legal risk can be achieved based on the definition of legal risk and how the definition is applied in the operation of an organization (McCormick, 2013). Having an agreed definition of legal risk which is sufficiently understood and consistently applied within an organization is vital (Anderson & Black, 2013). It was argued that a successful legal risk framework is one that defines the scope and parameters of legal risk (Anderson & Black, 2013). At the same time, it was opined that legal risk can be

¹⁴⁰ Risk response strategies are the approaches that can be used when a specific risk has been identified and assessed (Azhar, Panthi, & Ahmed, 2007; Hillson, 1999).

¹⁴¹ The cost-benefit approach was defined as “the process of weighing the total expected costs against the total expected benefits of one or more actions in order to choose the most profitable option” (Trzaskowski, 2005, p.4). The implication of the approach is that it entails that a business should break the law if that would be more profitable than complying with the law.

identified where it is likely to arise, i.e., through (1) adverse claims; and (2) defective documentations (McCormick, 2013).

5.5.1.2 Legal advisers:

For a legal adviser, legal risk is identified by way of apprehending its operating environment (Hamzah, 2010). The legal adviser focuses on objectifying the legal issues at hand by identifying legal risks proactively (Apollon, 2015). The legal adviser would suggest strategic management to encourage strong corporate governance for the client by reducing the negative impact of legal risk across the client's organization (Apollon, 2015).

In identifying legal risk, the following are taken into consideration:

- i. Understanding the nature of business that the organization conducts to help identify the legal risks (Johnson & Swanson, 2007).
- ii. The loss to be prevented (i.e., financial and reputational losses), the origin, the outcome and the human behaviors that can lead to the loss (Whalley & Guzelian, 2016).
- iii. Legal consequences of the contract clauses or “how each clause could lead to a legal decision that impacts the organization's objectives or assets” (Mahler, 2010) as well as the interplay between different contract rules, which may be relevant to a legal decision (Mahler, 2010).

This risk identification also includes the scope of the risk, or the regulatory footprint. These cover the consideration for jurisdictions, countries, regulators, and

rules that may impact the organization (Cooper, 2008), the risk appetite (or preferred risk response) of the clients, the business owners¹⁴², and the upstream risks¹⁴³.

5.5.2 Risk Assessment:

5.5.2.1 Organization:

Assessment of legal risk requires a system to effectively manage the risk. Responsibility to assess must be assigned appropriately and the legal risk policies, either prescriptive or principle-based, must be appropriate.

5.5.2.2 Legal advisers:

Assessment of legal risk is to be conducted by legal advisers who are well versed with the law as well as the business so that they will be able to articulate the risk quantitatively (Anderson & Black, 2013). In assessing the risk, focus is given to factual events as well as the application of legal norms based on these factual events (Mahler, 2010). As a result, legal risk assessment must place emphasis on identification, estimation, and treatment of legal risk (Mahler, 2010).

Legal advisers have to specify the context, scope, and target of a contract. The context of the contract is related to the rules of the contract, the scope of the contract, e.g., certain types of risk of the client's interest and target of the contract, e.g. it can be the whole contract or certain parts of the contract (Mahler, 2010). The contractual risk assessment must be conducted by a multi-disciplinary team of experts. The objectives of the assessment must be specified in accordance with the client's objectives (e.g. to

¹⁴² The management of regulatory risk by Cooper (2008) focused on sustainability development consultancy. Thus, it is crucial to identify the business owners since they are the people within the business who will be responsible for the solution once the consulting engagement is completed.

¹⁴³ Regulatory risk consists of two types of risks, namely, upstream risks and downstream risks.

protect his asset). It is also vital that the assessment determines the criteria for risk evaluation that the client wishes to employ (Mahler, 2010). In assessing risk, the legal risks will be analyzed and ranked in accordance to its effect and severity. Consequently, they are mitigated or prevented (i.e., through documentation prepared in advance) (Hamzah, 2010).

5.5.3 Risk Control:

5.5.3.1 Organization:

To control its legal risk, an organization needs to develop strategies to deal with the legal risk scenarios (McCormick, 2013). Among the strategies are:

- i. To review the impact of documentation;
- ii. To establish resources to defend claims or to initiate claims and to analyze the possible financial impact of the legal risk loss (McCormick, 2013); and
- iii. To conduct continuous control of legal risk that involves periodic review of documentation, updating documentation in response to specific events and on a regular basis, conducting reviews on procedures and practices in terms of how the documentation are handled, and obtaining clarification regarding the organization's position on certain contractual issues¹⁴⁴ (McCormick, 2013).

¹⁴⁴ For instance, the legal advisers of the organisation should ensure the preferred position of the organisation in term of clauses that limit liability under warranties and indemnities, disclaimers of liability, 'changes in circumstances' clause, *force majeure* provisions, choice of law and jurisdiction clauses, conditions precedent etc (McCormick, 2013, p.406).

5.5.4 Risk Monitoring

5.5.4.1 Organization:

Monitoring of legal risk requires regular reporting of important information to departments which can assess its significance (McCormick, 2013). The effectiveness of the monitoring function, performed by the in-house legal advisers or other departments, is to be subject to internal audit by operationally independent personnel (McCormick, 2013). Monitoring of legal risk also demands procedures that are built from appropriate risk indicators. Some of the risk indicators are new law, new case law, significant changes in market practice and documentation, change of personnel, feedback from regulators, legal action on other market participants, political changes, etc. (McCormick, 2013).

5.5.5 Risk Response

5.5.5.1 Organization:

5.5.5.1.1 Risk Mitigation

Risk mitigation is meant to reduce risky behaviors by the organization and to lay off the consequences of the risks to a third party, i.e., transfer of risk through insurance and to reduce the likelihood of criticism and sanction without necessarily changing the underlying behaviors of the organization (Moorhead & Vaughan, 2012).

Risk mitigation lies between the extreme ends of acceptance and avoidance. If acceptance is unlawful and avoidance is impossible, then the proper solution to LRM must be found in risk mitigation (Trzaskowski, 2005). In other words, risk mitigation is also risk avoidance (i.e., through compliance with the law for matters other than

contractual relations) to the extent that is possible. One form of risk mitigation is risk avoidance by seeking legal advice (Trzaskowski, 2005).

5.5.5.2 Legal advisers:

From a legal adviser's perspective, risk mitigation is a preventive step that typically concerns the legal documentation prepared upfront. Sometimes, risk mitigation can also be a reactive step, e.g., the mitigation techniques are designed after measuring the elements of probability and severity of the risk after a client has been sued (Hamzah, 2010).

5.5.5.2.1 Risk Acceptance

LRM involves neither risk eradication nor risk reduction, but merely the controlling, minimizing, limiting, and transferring of risk (McCormick, 2013). It was argued that risk acceptance may be problematic because it inevitably entails an acceptance of infringing the law (Trzaskowski, 2005).

5.5.5.2.2 Risk Avoidance

Risk avoidance is a part of risk mitigation (Trzaskowski, 2005). It is among the objectives of a legal adviser's work, i.e., legal risk avoidance and creating value for his individual or organizational client (Hamzah, 2010).

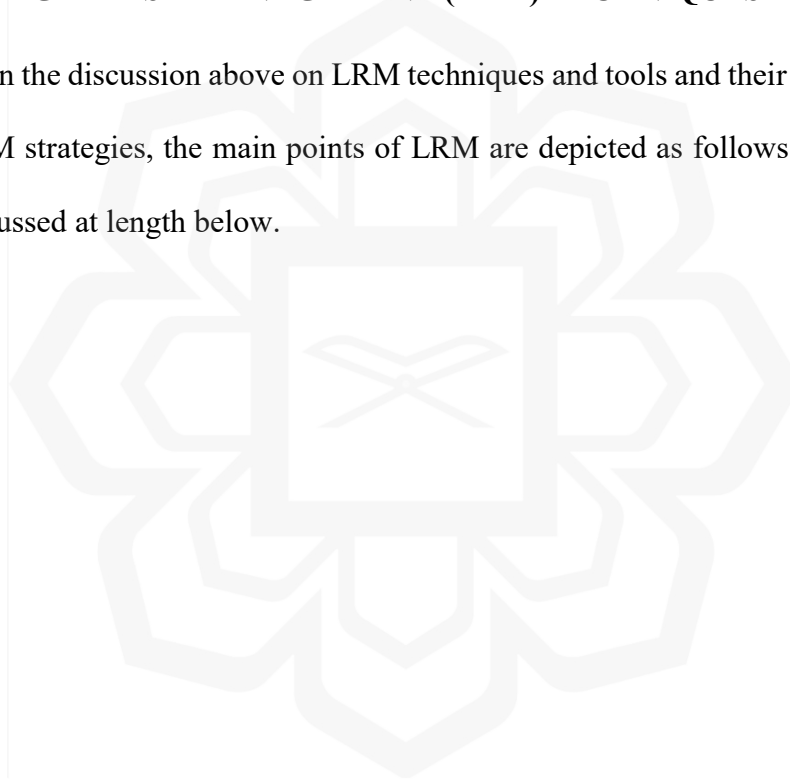
5.5.5.2.3 Risk Transfer

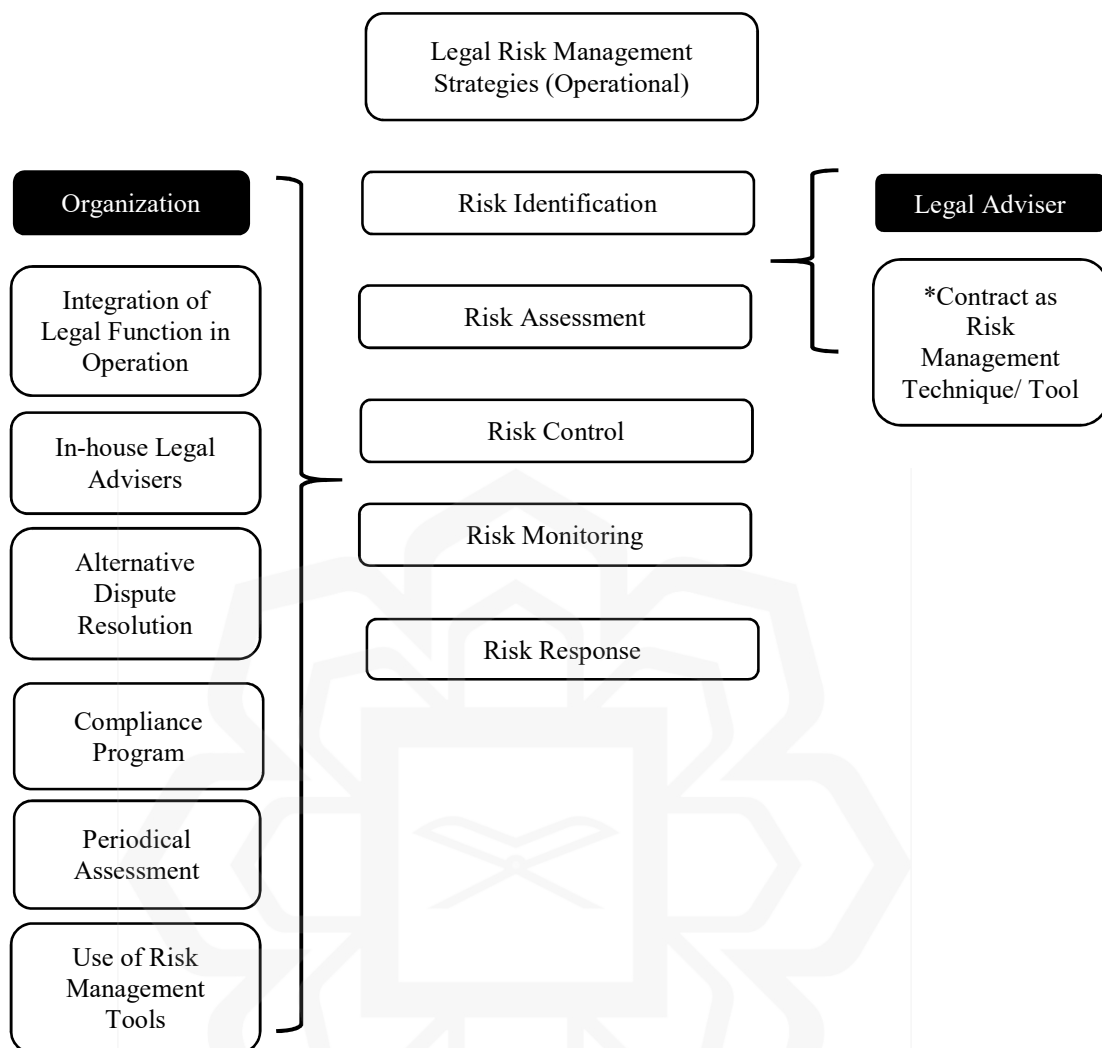
Transfer of risk may be done through insurance, appropriate derivative instruments, and also by avoiding the acceptance of risk through negotiation and structuring transactions

(McCormick, 2013). Commercial insurance is the obvious instrument to mitigate loss caused by legal risk (McCormick, 2013). But it is unlikely to be available to cover all types of legal risk. Similar mitigation instruments may have issues of their own and give rise to another type of risk (McCormick, 2013). Transfer of legal risk through insurance was not considered a mechanism to manage the said risk because it is likely to conflict with public order (Trzaskowski, 2005).

5.6 LEGAL RISK MANAGEMENT (LRM) TECHNIQUES AND TOOLS

Based on the discussion above on LRM techniques and tools and their relationship with the LRM strategies, the main points of LRM are depicted as follows. Details of these are discussed at length below.





*It was also opined that the use of fintech, e.g. blockchain and smart contract protocols, can improve three aspects of *sukuk* i.e., the traceability of underlying assets, the traceability of cash flows, and the traceability of investors. (S&P Global Ratings, 2020). For the first two aspects, it was opined that the use of fintech can help to understand the risks involved in the underlying assets and cash flows, as well as to prompt corrective action in case of underperformance.

Figure 5.1 Summary of LRM Strategies, Techniques, and Tools

5.6.1 Organization

5.6.1.1 Integration of Legal Function in Operation

Integration of legal function within wider risk management system is an operational technique for LRM (Anderson & Black, 2013). However, this technique is difficult, either because of the sweeping categorization of legal risk or because it may lead to

circulation of information that will otherwise be privileged to the legal teams (Anderson & Black, 2013). There must be a clear allocation of responsibilities between the legal department and the compliance department. In some organizations, the legal department has the responsibility of advising the management of applicable laws, rules and standards and preparing guidance for the staff. Meanwhile, the compliance department has the responsibility of monitoring compliance with policies and procedures and to report the compliance to the management (McCormick, 2013).

5.6.1.2 In-House Legal Advisers

According to the report by EY (2016), most of the respondents agreed that the ownership of legal risk goes to the in-house legal advisers. It was shown that the in-house legal advisers were the most confident in their level of understanding of legal risk. As the need to identify and quantify the legal risk exposure is a crucial first step, then the in-house legal advisers are expected to take the lead due to their legal expertise. The in-house legal advisers in an organization must provide proactive legal support, ensure legal approval is sought for the organization's projects, and provide contingency planning (Whittaker, 2003). In order to do these, they must have sufficient independence within the organizational structure to allow a rigorous approach to the relevant procedures and to have access to the necessary information (McCormick, 2004, 2013; Whittaker, 2003).

5.6.1.3 Alternative Dispute Resolution (ADR)

ADR is a technique used in legal risk communication to improve LRM by uncovering the real issues and interests at play. This is done by probing and incorporating the client's wishes with the best legal risk responses (Apollon, 2015).

5.6.1.4 Compliance Programme

An effective compliance program is needed to execute risk oversight, particularly legal and regulatory violations (Collins, 2010). The compliance program is designed to prevent and detect such violations. This tool is, however, confined to compliance risk management as part of LRM. The program helps to gather information in order to evaluate the effectiveness of each scattering or separated compliance activity and report the assessment directly to the board (Collins, 2010). It involves assessing and coordinating self-assessment on risk-specific compliance activities, initiating improved effectiveness in risk specific compliance activities, reporting assessment to senior leadership and board of directors, coordinating with investigative functions, and working on preventive efforts (Collins, 2010)

5.6.1.5 Periodical Assessments

Regular reporting of material information to those who can assess its significance and ultimately to senior management is considered one of the LRM techniques (McCormick, 2004). One of the tools is a quarterly self-assessment (QSA), i.e., a risk management assessment measure to evaluate the level of an organization's compliance program. It assists in identifying risk exposure by examining the following eight fundamental components of compliance risk management: policy and procedure,

performance and management, identification and prioritization of risk, monitoring and tracking of compliance issues, reporting and communication, training programs and professional proficiency, management commitment, and infrastructure effectiveness. To achieve successful risk management, assessing the management of risk is as important as the assessment of risk itself (Kelsey & Matossian, 2004, p.9). This tool is designed to manage the compliance risk.

5.6.1.6 The Use of Risk Management Tools

According to Kelsey and Matossian (2004), there are numerous tools used to manage compliance risk. Some compliance risk officers measure compliance risk (as part of legal risk) on a periodic basis, some flag the changes to the business profile based on key business developments, and some use general business risk profiles as risk management tools for assessing all categories of risk throughout the organization. Quantification of risk was a tool suggested by Johnson and Swanson (2007) for LRM in value-chain companies. This tool requires identification of risk, description of risk, understanding of risk, evaluation of risk, and quantification of risk. These procedures will enable the company to produce a worksheet to identify and quantify the legal risks and separate the LRM into different aspects of the business's activities. It also constitutes part of compliance planning (Johnson & Swanson, 2007).

Other LRM tools may comprise a guide for LRM assessment techniques that includes a glossary for LRM standard vocabulary and answers to frequently asked questions (FAQs) (Apollon, 2015). In the Department of Justice of Canada, the LRM Initiative has been implemented since 2003. The LRM Initiative involves a list of LRM activities. For legal risk assessment, LRM Grid is employed to assess the adverse

outcome and impact of each case upon the government and its agencies¹⁴⁵. The assessment will be input in an iCase (computer-based) program to analyze the level of risk in the case. It is a quantitative assessment of legal risk in the department. Any case with a risk level of 7-9 is considered high risk and the case will be reported to the senior management. In the LRM Initiative, several tools have also been employed for risk communication/reporting such as Early Warning Notes System, Early Warning Report, Radar Screen, Scanning News, Summary of High Impact Litigation, Forward Agenda, etc. (Evaluation Division, 2008).

5.6.2 Legal Adviser

5.6.2.1 Contract as a Risk Management Tool

This refers to a risk-based approach contract. This tool helps in LRM. According to BLP (2014), there are three types of contracts and each has a different risk perspective:

- i. Entirely standard contracts: Contracts that employ entirely standard legal terms. The risk perspectives of this type of contract are the value and volume of the contract used, the potential impact of changes in the market and legal positions on their contractual enforceability, and their ability to manage changes to terms and conditions when required.
- ii. Largely standard contracts: These refer to negotiated contracts that are based on standard template, usually with pre-defined negotiation positions.

The risk perspective of this type of contract is the variation in commercial

¹⁴⁵ LRM Initiative by the Department of Justice of Canada is “the process of making and carrying out decisions that reduce the frequency and severity of legal problems that prejudice the government’s ability to meet its objectives successfully”.

terms and technical language that are approved by the negotiating teams without legal input (merely to get the contract concluded).

- iii. Heavily negotiated contracts: Contracts where legal advisers are made involved in the day-to-day negotiations, or contracts of high-value/high complexity. The risk perspectives of this type of contract are the key clauses that may trigger financial and reputational loss and compare the individual clauses to acceptable or standard industry wording. A legal team must be employed to analyze the risk perspectives of this type of contract.

In view of the above, to regard a contract as a risk management tool requires identification of the type of contract involved. In other words, if the contract is heavily negotiated, the function of the legal team is heightened compared to a contract which is entirely standard.

Other than the above, it was found in the relevant literature that the use of certain techniques or clauses in the contract is vital. This will be elaborated as follows:

5.7 OTHERS

5.7.1 Disclosure of Material Information

One of the techniques used in the contract is disclosure of material information. This disclosure is an important tool, particularly when it is required by law. This tool was mentioned by Barnes and Bagley (1994) to be significant in managing litigation risk. Apart from this, the allocation of risk management in a contract is also imperative (Prosidian Consulting, 2011) because the risk can be allocated to a party/parties who is in the best position to manage it. Recently, Tawfik and Elsayed Ghazi (2023) discussed

the disclosure of risk framework for *sukuk* in accordance with the requirements set by the international bodies, e.g., IFSB and AAOIFI. The risk disclosures made by the Qatari Islamic banks as *sukuk* issuers have also been investigated. The findings indicate that disclosure of the risks of *sukuk*, not limited to legal risks, were very minimal.

5.7.2 Disclaimer

The Black Law Dictionary defines ‘disclaimer’ as:

“The repudiation or renunciation of a claim or power vested in a person or which he had formerly alleged to be his. The refusal, or rejection of an estate or right offered to a person. The disavowal, denial, or renunciation of an interest, right, or property imputed to a person or alleged to be his. Also the declaration, or the instrument, by which such disclaimer is published.” (Black’s Law Dictionary, 2004; Schain, 1985)

In view of this, the use of a disclaimer by a party is to indicate that it renounces a claim against him regardless of the fact that the original liability lies on him. With the exception of negligence, fraud, misrepresentation, or other deceptive actions, a disclaimer is a valid risk control technique (Duesenberg, 1964). Its use, according to Eörsi (1975), must always be subject to certain rules prevailing in the legal system where the clause is being used.

In the Malaysian context, particularly in regards to *sukuk*, it was found that disclaimer is a common and acceptable practice in the capital market. Its effect was also agreed upon since its use in the *sukuk* documents is considered due to the fact that it is meant for sophisticated investors and experienced financial institutions. These were noted from the case of *CIMB Bank Bhd v Maybank Trustees Bhd and other appeals* [2014] MLJU 117.

5.7.3 Risk Transfer

In the previous section, risk transfer was regarded as a valid risk mitigation technique (Moorhead & Vaughan, 2012; Trzaskowski, 2005). According to them (Moorhead & Vaughan, 2012; Trzaskowski, 2005), risk transfer is evident when the organization transfers their risk to a third party, e.g., lawyers and insurance companies. However, the risk transfer is only restricted to credit risk. For instance, credit risk transfer to an insurance company, including financial loss arising from legal risk. Legal risk *per se* is not necessarily appropriate to be managed by risk transfer (McCormick, 2013; Trzaskowski, 2005). Nonetheless, initial analysis on the selected *wakalah sukuk* indicated that there was a wide use of ‘transfer of risk’ to manage legal risk. Thus, its applicability as an LRM technique will be discussed further in Chapter 7.

5.7.4 Waiver and Indemnity Clause

Another widely discussed risk management clause in the literature are waivers and indemnity clauses. A waiver has been defined as:

“A promise or permission express or implied in fact, supported only by action in reliance thereon, to excuse performance in the future of a condition, or to give up a defence not yet arisen, which would otherwise prevent recovery on an obligation”. (Ewart, 1927).

Waiver originates from a party’s consent. In other words, if a person consents to be searched, he waives his right to privacy (Ware, 2004). Similarly, a consent to marriage waives one’s right to deny the validity of the marriage. It requires unilateral action from a party against whom the waiver operates and requires no action from another party who will be in favor of the waiver (Duval, 2005). This waiver may be verbal, written, or conduct-based. The essential part of a waiver is the ‘knowing’, i.e.,

the party waiving his rights is aware of its legal implications; and the ‘voluntariness’, i.e., led by the knowledge, the party has agreed to the waiver without any force or protest. (Duval, 2005).

In the Malaysian context, in the case of *Tahan Steel corp Sdn. Bhd. v Bank Islam Malaysia Bhd* [2005] 1 SHLR 117, the High Court held that the waiver employed by the defendant was a valid clause. In view of the facts of the case, the waiver of conditions have set the defendant to be in a position where it can waive, wholly or partly, any conditions in the contract for its benefit. The waiver was prevalent in an *al-Istisna*’ purchase agreement for conditions to be met by the plaintiff before full disbursement of financing amount is made. The waiver was solely for the interest of the defendant and the court held that it gives leverage to the latter. In the case of *Acoustic & Lighting System Sdn. Bhd. v Golden Affinity Development Sdn. Bhd.* [2017], MLJU 2283, the plaintiff made late payments to the defendant. The plaintiff argued that there was a verbal waiver of the late payment interest by the defendant, and acquiescence of the latter. The court found that there was no verbal waiver evident and no-waiver effect of the defendant’s acquiescence as stipulated in Clause 33 of the Sales and Purchase Agreement. Although these cases were in relation to financing/loan agreements, the use of waiver and its applicability in *sukuk* documents as a risk management tool may be perceived in a similar way. However, further discussion on this will be provided in Chapter 7.

In sum, LRM as discussed above can be depicted in the following Figure:

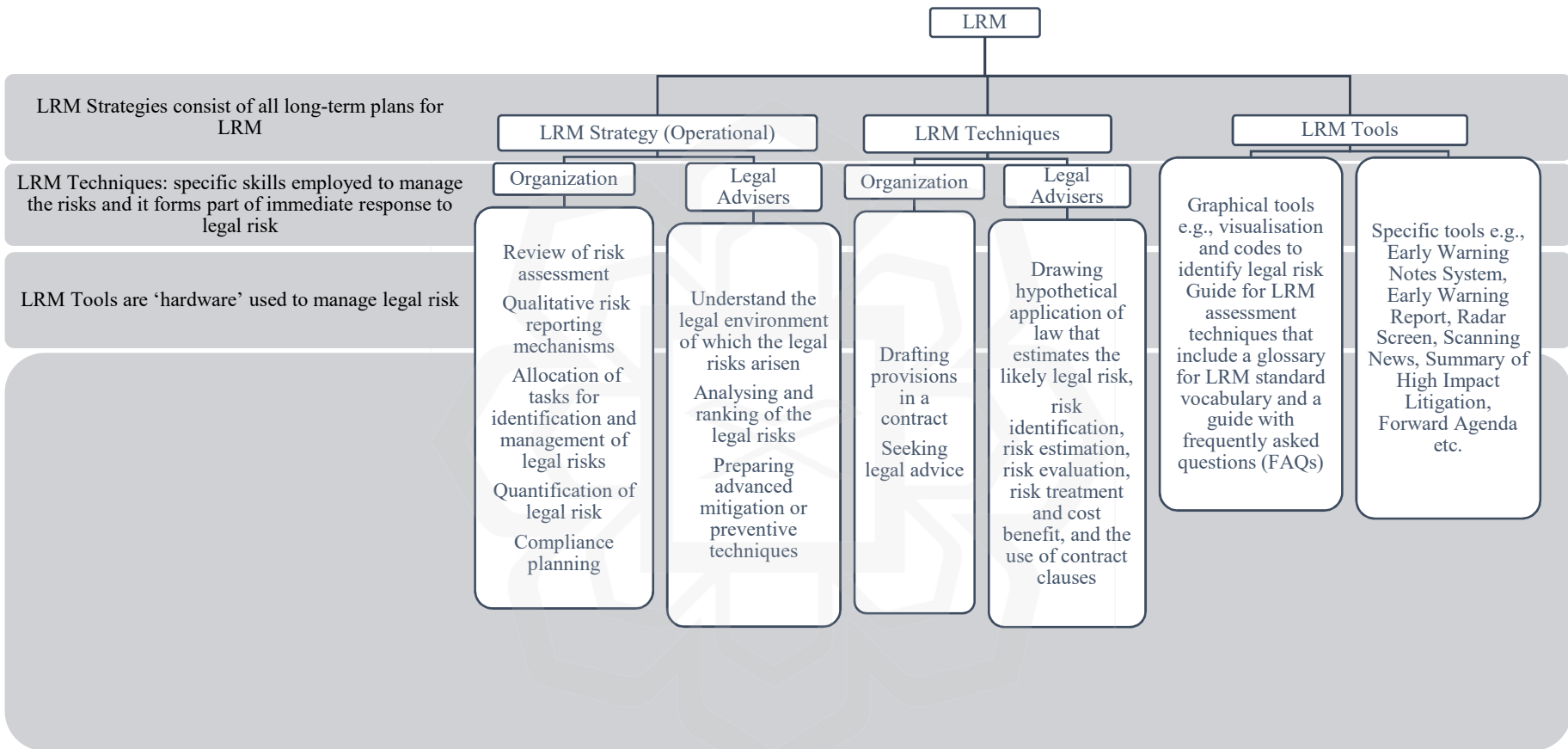


Figure 5.2 LRM Strategies, Techniques, and Tools from Two Perspectives (Summary of the Relevant Literature)

5.8 LEGAL RISK MANAGEMENT IN *SUKUK*

Past studies have discussed LRM in *sukuk* using two approaches. First, the studies have discussed the risk management in *sukuk* generally where management of legal risk was included. Secondly, management of legal risk was discussed in the context of specific legal issues of *sukuk* or legal issues in Islamic finance. In other words, management of legal risk was discussed impliedly through the legal issues.

The LRM in *sukuk* using the first approach was exhibited by a few studies (Al-sayed, 2013; Haider & Azhar, 2010; Najeeb, 2013). In these studies, it was evident that there were different uses of the term ‘legal risk’. While Al-sayed (2013) and Haider and Azhar (2010) treated legal risk and regulatory risk equally and use them interchangeably, Najeeb (2013) differentiated between legal risk and regulatory risk. Regulatory risk was described as:

“lack of harmonization in regulations among major players-heterogeneity in terms of laws and regulatory principles... variations in local laws which may adversely affect *sukuk* that are structured to be non-compliant with the varying regulatory requirements.”

Meanwhile, legal risk was described as:

“the absence of proper legislative bases that may govern disputes between *sukuk* investors and issuers”.

While regulatory risk is linked to lack of standardization of laws, legal risk is linked to conflict between conventional law and the Shariah principles. Nevertheless, the studies on LRM have highlighted certain areas such as: (1) the roles played by central banks and regulators (Al-sayed, 2013; Haider & Azhar, 2010); (2) international bodies for the purpose of harmonization of laws; and (3) the roles played by arbitration

forums (Najeeb, 2013). Unfortunately, in depth discussion with empirical data was not presented in these studies.

The second approach of management of legal risk in *sukuk* was adopted by a few studies (Abdul Khaleq et al., 2007; Bälz, 2008; Colon, 2011; McMillen, 2007; Oseni & Hassan, 2015) where the legal risks in *sukuk* were discussed based on the researchers' perceived legal issues in *sukuk*. Thus, the LRM was discussed in detail. For internationally rated *sukuk*, there are several legal issues pertaining to the *sukuk*, namely the applicability of Shariah, the true sale position, bankruptcy remoteness, collateral security structure, choice of law, enforceability of transactional documents, and judicial judgements. McMillen (2007) discussed a range of enforceability issues in *sukuk* including true sale of assets and several bankruptcy issues. One of the mechanisms to manage legal risk is by acquiring legal opinions (McMillen, 2007). The mechanism he suggested, i.e., acquiring legal opinion on the said matters, is beneficial for the management of legal risk in *sukuk*.

The importance of seeking legal advice was mentioned in another study (Abdul Khaleq et al., 2007). Abdul Khaleq et al.(2007) explained the legal issues faced by *sukuk* issuers in a non-Shariah jurisdiction. Among the issues are the difficulty to secure a Shariah-compliant underlying asset, complicated structuring and documentation of asset-backed *sukuk* due to the application of local laws regarding bankruptcy, trust, taxation, securities regulation, real property, and secured transactions. Other areas where legal issues may arise are taxation, bankruptcy laws, securities laws, and investment laws. Thus, *sukuk* promoters (e.g. *sukuk* principal advisers, lead arrangers etc.) must be well-versed with the regulatory and compliance requirements of the jurisdiction where the *sukuk*'s underlying asset is located or where the *sukuk* is issued. In addition, legal advice must be sought in relation to the governing law for the *sukuk*

documentation and the alternative forum for dispute resolution, as well as the regional aspects of the related jurisdiction. Cautious selection of Shariah advisers who are equipped with knowledge of conventional financial and economic concepts and have the ability to communicate and review English documents are also necessary to mitigate the legal issues in relation to *sukuk* issued in non-Shariah jurisdictions (Abdul Khaleq et al., 2007).

Another recommended mechanism is to resort to ADR and use a combined-law clause¹⁴⁶ (Colon, 2011). This is to manage the enforceability of choice of law in a non-Shariah jurisdiction and to curb the problem of conflict of laws. This recommendation was nonetheless confined to the choice of law of arbitration or ADR for Islamic financial contracts in general. A similar discussion was provided on the issue of choice of law by Junius (2007). He contemplated that the choice of law to incorporate Shariah must be made so specific that the Shariah will not be regarded as another set of law governing the contract (Junius, 2007). His discussion was nevertheless made in the context of German laws applying Islamic laws as the choice of law.

Mohammad (2010) highlighted the importance of heightened disclosure of information on the rights of investors, particularly in the offering circular, since the investors' concern is more on the purchase undertaking ability of the originator instead of the credit value of the underlying asset. The study contended that international rated *sukuk* could have analyzed the Shariah applicability through the legal opinions sought during the rating process. The legal opinions must have addressed the following matters as output of the documentation review: the 'true sale' position, bankruptcy remoteness, collateral security structure, choice of law by parties, and enforceability of transactional

¹⁴⁶ Pairing a state or national law with Shariah principles. Thus, a contract will be governed by the state law, but when conflict arises, the Shariah will prevail (Colon, 2011, p.6).

documents and judicial judgments. Summarizing the study with proposing a Shariah Act model and empowering the function of IFSB, the study placed emphasis on analyzing legal risks from the perspectives of legal opinions on the applied documentation in order to reduce the severity of legal risk in *sukuk*, provided that the *sukuk* is internationally rated.

Legal risk may arise from unenforceable contracts. As mentioned previously, legal risk in *sukuk* may arise from ambiguity and voidability issues, e.g., issues of Shariah non-compliance. Thus, Shariah non-compliance is among the issues to be discussed in the management of *sukuk* legal risk. Shariah non-compliance defense waiver is one of the management mechanisms used (Bälz, 2008). The waiver is a particular provision in the contract that waives the rights of the parties to later question the Shariah non-compliance issues of the agreed contract or structure (Bälz, 2008). The provision may also contain the explicit statement of the Shariah-compliant matters that have been approved by the relevant Shariah advisers or that the parties acknowledge that they have had the opportunity to seek Shariah advice on. Nevertheless, the Shariah non-compliance defense waiver was discussed in the context of Islamic financing facilities, not *sukuk*.

Generally, there are two types of *sukuk* ratings, namely the issuer credit rating, i.e., rating designed for specific *sukuk* issuance in the *sukuk* market and default *sukuk* rating (Huang, 2004). The former is based on the likelihood of an investor receiving the promised principal and the profit, while the latter is based on the overall creditworthiness of the *sukuk* issuer through its future cash flow to cover the cost of debt services and the principal promised. In the Malaysian context, all *sukuk* issuance are required to be accompanied with credit ratings. The credit rating agency is the third party that assesses the probability of default by the issuer. Among the international

sukuk rating agencies are Standard & Poor's and Moody's Investor Services, and in Malaysia, the Rating Agency Malaysia (RAM) and the Malaysian Rating Corporation Berhad (MRCB) (A. Elhaj, 2015; Zakaria, 2012; Ab Majid, 2011). According to Arnott (2004), credit agencies also bear certain roles in LRM, stating as follows:

“By publishing rating, they in effect permit investors and collateral takers to delegate some legal risk assessment on them.”

The roles played by the credit rating agencies in LRM must also be highlighted (Arnott, 2004). The function of the credit rating is to give clear information on the originator's creditworthiness and prediction of default. By being rated, the *sukuk* has undergone the 'legal opinions' stage, and as for MARC and RAM, they also provide additional assessment of Shariah compliance (Chew, 2010) to mitigate the risk of contract voidability due to Shariah non-compliance. Although credit rating looks at the financial viability of the *sukuk*, MARC credit rating, for instance, considers some legal analysis (legal perfection in the underlying asset, insulation of the assets from insolvency, or reorganization of the originator of the underlying asset) of the *sukuk* (Noor & Shahimi, 2013). Additionally, Shariah related matters were also analyzed through the *sukuk* ratings as much as the Shariah related issues have financial impact or any bearing on the *sukuk* (ISRA, 2017, p.561). This signals some LRM through the ratings since Shariah issues of a *sukuk* may be linked to legal risk.

Based on the existing literature, there are many techniques that have been suggested to manage legal risks or legal issues in *sukuk*. Various studies have made suggestions on LRM based on different aspects, e.g., legal aspect, contractual aspect, rating aspect, etc. The suggestions are all beneficial, except for the fact that they are scattered. In addition, it was also found that most of the literature were theoretical

studies, with only a few studies having embarked on empirical research, e.g., based on case studies.

5.9 EVALUATING THE LEGAL RISK MANAGEMENT (LRM) STRATEGIES, TECHNIQUES, AND TOOLS

Based on the literature of LRM from the perspectives of both the organization and legal advisers, there are various LRM strategies, techniques, and tools. Unfortunately, the differences between such strategies, techniques, steps, and tools cannot be found in the literature on risk management. For the purpose of this study, LRM is apprehended in three aspects, i.e., LRM strategies, techniques, and tools. LRM strategies consist of all long-term plans for LRM. The **LRM strategies** form part of the operational LRM either for an organization or a legal adviser. For an organization, LRM strategies cover a review of risk assessment, qualitative risk reporting mechanisms (Moorhead & Vaughan, 2012), allocation of tasks for identification and management of legal risks (Berwin Leighton Paisner (BLP) 2013), quantification of legal risk and compliance planning (Johnson & Swanson, 2007), and others. For a legal adviser, LRM strategies are to understand the legal environment in which the legal risks arise, analyzing and ranking of the legal risks, and preparing advanced mitigation or preventive techniques (Hamzah, 2010). At this point, the LRM strategy can be apprehended as proactive actions. The proactive nature of LRM was mentioned by Reid and Clark (1996) and Trzaskowski (2006).

Meanwhile, **LRM techniques** are specific skills employed to manage risks. The techniques form part of the immediate response to legal risk. For instance, an organization utilizes certain techniques like highlighting provisions in a contract

(Mahler, 2010) and seeking legal advice¹⁴⁷ (Hamzah, 2010). For a legal adviser, the LRM techniques cover drawing hypothetical application of law that estimates the likely legal output through legal risk assessment, risk identification, risk estimation, risk evaluation, risk treatment, and cost benefit (Mahler, 2010). These techniques may be performed during pre-trial (or its equivalent, e.g., arbitration session) and trial sessions in court. In view of these, the LRM techniques are proactive actions, e.g., preparing a contract that protects the interest of the clients, as well as reactive actions by the legal advisers, particularly when the clients are sued in court (Hamzah, 2010; Whalley & Guzelian, 2016).

LRM tools are ‘hardware’ used to manage legal risk. For instance, graphical tools like visualization and codes to identify legal risk (Mahler, 2010), guide for LRM assessment techniques that includes a glossary for LRM standard vocabulary and answers to FAQs (Apollon, 2015) and specific tools like Early Warning Notes System, Early Warning Report, Radar Screen, Scanning News, Summary of High Impact Litigation, Forward Agenda, etc. (Evaluation Division, 2008).

5.10 CONCLUSION

This chapter has shown that there are abundant risk management strategies, techniques and tools employed in LRM. They range from the operational approach to specific tools like the quantification of risk. What is still lacking in the literature discussed above is a focused discussion on LRM in a project or in a specific organization. Since LRM techniques may differ by organization, there can be other techniques employed in the organization that may be beneficial to the LRM literature and development. Besides

¹⁴⁷ This technique can also be apprehended as an LRM strategy if the function of legal advisors is placed within the chain of the organization’s risk management plans.

these, without empirical data on LRM as applied by an organization, it can be argued that the suggested risk management techniques are vague.

In this chapter, LRM in the context of *sukuk* has been presented. There were two types of LRM found, i.e., the general recommendations on how to manage legal risks (macro-level) and the specific recommendations (micro-level). For the former, the recommendations are to enhance the roles played by: (1) central banks and regulators (Al-sayed, 2013; Haider & Azhar, 2010); (2) international bodies for the purpose of harmonization of laws; and (3) arbitration forums (Najeeb, 2013). For the latter, recommendations found in the literature are concerned with: (1) acquiring legal opinion particularly on issues of regulatory and compliance requirements, the effects of governing law, jurisdiction clause, and alternative forums for dispute resolution (Abdul Khaleq et al., 2007; McMillen, 2007); (2) having competent *sukuk* promoters who are well-versed in regulatory and compliance requirements (Abdul Khaleq et al., 2007); (3) having competent Shariah advisors who are well-versed in conventional financial and economic concepts and have the ability to communicate and review English documents (Abdul Khaleq et al., 2007); (4) the use of ADR; (5) adequacy of disclosure of material information particularly in the offering circulars (Barnes & Bagley, 1994; Mohammad, 2010); (6) Shariah waivers (Bälz, 2008); (7) the use of choice of law to ensure the applicability of Shariah law especially in non-Shariah law jurisdiction (Colon, 2011); and (8) the use of credit ratings or highlighting the roles played by credit rating agency in assessing legal risk (Arnott, 2004). Considering the findings of this chapter, the two types of LRM suggested in the literature will be embedded in the three themes found, i.e., LRM strategies, LRM techniques, and LRM tools.

For the purpose of this study and discussion in the next chapters, **LRM Strategies** refer to the general strategies employed by the *sukuk* parties or the DDWG.

These include the principal adviser/ lead arranger, legal adviser, Shariah adviser, and *sukuk* trustee. It is essential to determine how the LRM was conducted, i.e., in identifying, assessing, monitoring, controlling as well as responding to the legal risks in the *wakalah sukuk*. From the aspect of legal analysis, further enquiries will be made on how the LRM in *wakalah sukuk* is conducted by them in general. These are in line with the suggestions made in the literature on the important roles played by each party involved.

In terms of **LRM Techniques**, they refer to the techniques used in the *wakalah sukuk* contract/documents. For this, all the suggested LRM techniques found in the literature will be determined. They include the use of governing law and jurisdiction clause, the use of ADR clause, the use of Shariah waiver, adequate disclosure of material information, and the use of any provision employed to manage legal risks in the *wakalah sukuk*, either generally or specifically. This will be done through a document analysis on selected *wakalah sukuk*. At the same time, further enquiries will be made to the principal adviser/lead arranger (since the *wakalah sukuk* documents are the issuers' documents), legal adviser, or the DDWG in general on the use of these provisions as LRM techniques.

In terms of the **LRM Tools**, it will be determined whether or not there are additional tools employed by the *sukuk* parties in managing the legal risks in *wakalah sukuk* in Malaysia. Unlike LRM strategies and techniques, LRM tools refer to the use of additional 'hardware' by the *sukuk* parties to manage legal risk. Details of these will be provided in Chapter 7.

CHAPTER SIX

RESEARCH METHODOLOGY

6.1 INTRODUCTION

This chapter elaborates on the methods to be employed in order to identify the legal risks in *wakalah sukuk* issued in Malaysia, determine how such legal risks are currently managed, and find ways to further improve the management of the said legal risks. This chapter is organized into three main sections: i.e. 1) Research Design; 2) Data Collection; and 3) Data Analysis.

6.2 RESEARCH DESIGN

A research design refers to “a procedural plan that is adopted by the researcher to answer questions validly, objectively, accurately, and economically” (Kumar, 2005). The research design can help a researcher by conceptualizing the operational plan to complete the research and to answer the research questions validly, objectively and accurately.

This research is designed to answer three essential questions:

1. What are the legal risks in *wakalah sukuk* in Malaysia?
2. How are the legal risks in *wakalah sukuk* in Malaysia managed?
3. How can the management of legal risks in *wakalah sukuk* in Malaysia be improved?

To answer these questions, this research employs multiple approaches, i.e., exploratory, qualitative, and inductive methods.

6.2.1 Exploratory Research

Exploratory research or exploration has been described in four senses, i.e., investigative exploration, innovative exploration, exploration for discovery, and limited exploration (Stebbins, 2001, p.2). It was claimed that exploratory research consists of exploration of discovery (Stebbins, 2001, p.3). When a researcher explores to discover, he aims for the research to be as broad and as thorough as possible. The researcher also explores because he has little or no scientific knowledge about the group, process, or events of the research, but believes that the research has elements worth to be discovered (Stebbins, 2001, p.6). The exploratory research also aims at generating new ideas and weaves them together to form or generate theories that emerge directly from the data (Stebbins, 2001, p.9). In the process of exploration, the researcher needs to follow certain flows. Firstly, the researcher needs to search for generalizations leading to in-depth and profound details. Secondly, the researcher needs to explore through observation/ interviews/ documents and finally, answering the 5Ws, of *who*, *what*, *whom*, *when* and *where* while alternatively searching for “categories” (Stebbins, 2001).

In this study, exploratory research is conducted to identify the legal risks in *wakalah sukuk* and to determine its management. It is exploratory because it aims to be as broad as possible to include all the possible and actual legal risks in the *wakalah sukuk*. In addition, it has been shown that past literature on legal risks in *sukuk* and its management are still lacking and did not involve empirical data or field studies (Abdul Khaleq et al., 2007; Al-sayed, 2013; Balz, 2010; Colon, 2011; Haider & Azhar, 2010;

McMillen, 2007; Naim, 2013; Najeeb, 2013), except for a few (Oseni & Hassan, 2015; Salah, 2010; Sole, 2008).

As suggested by Stebbins (2001), the first step in these research activities is to search for general concepts. When applied to this research, general concepts are explored pertaining to legal risk and LRM. These concepts will then lead to more detailed discussions on legal risks in *wakalah sukuk* and its management. Subsequently, more data will be explored through document analysis and interviews. This exploratory method is used to answer the questions of *what* and *how* and the information gathered are then used to build “categories” in answering the research questions.

6.2.2 Qualitative Research

This study is also a qualitative research that employs data primarily from documents and interviews. Qualitative research is a type of:

“social action that stresses on the way of people interpret, and make sense of their experiences to understand the social reality of individuals” (Mohajan, 2018).

A study is considered a qualitative research because there are some salient features inherent in it, e.g., analyzing experiences of individuals, analyzing communication and interaction involved in the research, as well as analyzing documents (Flick, 2007). These salient features are inherent in this research.

According to Knafl and Howard (1984), there are a few objectives of qualitative research. Depending on the aims of a research, its purposes range from refining instruments used in quantitative research, sensitizing research, illustration of theories, and finally, conceptualization (Knafl & Howard, 1984). These purposes are of

importance since they could affect the interpretation and reporting of qualitative research. Looking at the objectives of this research, they apparently fall under the primary aim of qualitative research, namely:

“to gain a better understanding of phenomenon through the experiences of those who have directly experienced the phenomenon, recognizing the value of participants' unique viewpoints that can only be fully understood within the context of their experience and worldview” (Castleberry & Nolen, 2018).

As a result, the interpretation and reporting of the findings of this research will consider the practical insights of the legal risks in *wakalah sukuk* and its management from the lenses of the selected participants.

6.2.3 Inductive Approach

Inductive method is the approach that generates and justifies a general explanation based on the accumulation of certain circumstances that have similarities between them (Gibbs, 2007). There are a few objectives of employing inductive approach in research; primarily, it is to allow research findings to flow from the raw data unrestrained. In other words, it is to enable the findings to “emerge from the frequent, dominant, or significant themes inherent in raw data, without the restraints imposed by structured methodologies” (Thomas, 2006) such as in deductive approach. The second objective of the inductive approach is to enable the researcher to condense raw textual data into brief, summarized, and formatted forms of data. Consequently, it enables the researcher to build clear relationships between the research objectives and the findings gathered from the raw data. In this way, the research will be able to develop a framework of the

underlying structure of experiences or processes that are evident in the raw data (Thomas, 2006).

This research is an inductive, qualitative, and exploratory research. It employs an inductive approach because qualitative research is itself inductive in nature (Mohajan, 2018). This means that an inductive approach in qualitative research is inevitable due to the nature of the research that usually explores meanings and insights in given situations (Mohajan, 2018). Legal risk in *wakalah sukuk* or its management is a rather under-discussed topic compared to other risk management topics such as financial risk. In this research, a new theory or new explanation regarding legal risk and LRM of *wakalah sukuk* are to be sought. Therefore, the inductive approach is used in a way that the data to be collected are raw textual data, i.e., content analysis from past literature and document analysis on *sukuk* documents, particularly *sukuk* offering circulars. In addition, primary data will also be gathered from interviews. These data will be condensed into brief, summarized, and formatted forms of data using a set of codes and themes. Consequently, the formatted data from interviews will be used to verify the formatted data obtained from the document analysis. Later, the verified findings and additional findings will be interpreted and reported based on themes mapped on the research objectives.

6.3 RESEARCH INSTRUMENTS

There are a few common methods used in qualitative research. These methods are interview, observation, survey, case study, historical analysis, and document analysis (Mohajan, 2018). As a result, there are numerous theoretical perspectives or designs employed in qualitative research such as narrative research, phenomenology research,

grounded theory research, action research, case study¹⁴⁸, ethnographical research, historical research, and content analysis (Mohajan, 2018). Some have expanded the designs to oral history¹⁴⁹, focus groups/ group interviews, participant observation, holistic research¹⁵⁰, community discussion forums, and reflective journal logs (Kumar, 2011).

Considering the objectives of this research, the design employed is content analysis¹⁵¹. The research objectives seek to explore the practical insights, particularly human knowledge and experiences, on LRM in *sukuk*. According to Erlingsson and Brysiewicz (2017), human experiences can adequately be studied through textual data such as individual interviews, focus groups, documents, or documented observations.

Based on these, this research employs document analysis and interview as its data collection methods. These methods have been selected due to the nature of the data to be collected, i.e. the data is not confined to predetermined categories of analysis, except for general concepts. Moreover, the use of qualitative methods such as interview may contribute to the depth and details of the collected data (Patton, 1987).

¹⁴⁸ It is based on the assumption that the selected case is atypical of cases of a certain types. In this view, the selected case can provide some insights on events or situations that are prevalent in the group of which the case has been selected (Kumar, 2011, p.126).

¹⁴⁹ Originally, it was a data collection method. In qualitative research, this method has been regarded as a research design used to study perceptions, experiences, and accounts of an event (Kumar, 2011, p.127).

¹⁵⁰ It is considered more as a philosophy in qualitative research (Kumar, 2011, p.129). When applied in qualitative research it may refer to the use of multi-dimensional perspectives to understand an event, i.e. as a holistic way of understanding.

¹⁵¹ Content analysis was conventionally used to analyse written or verbal communication messages by way of counting the occurrence of specific words in the messages (Mohajan, 2018, p.14). In the current context, the general strategies of content analysis are building initial coding based on past literature, coding categories directly from text and summative analysis is used when counting categories precedes the interpretation (Mohajan, 2018, p.15).

6.3.1 Document Analysis

Document analysis refers to a systematic procedure to review and evaluate both printed and electronic data (Bowen, 2009). This method involves certain activities such as skimming¹⁵², reading, and interpretation (Bowen, 2009). It was claimed that this method involves both elements of content analysis¹⁵³ and thematic analysis (Bowen, 2009). Content analysis is a technique used to analyze ‘open-ended’ data to be structured for diagnosis (Harwood & Garry, 2003). Thus, it is a process of organizing information into categories related to the central questions of the research. On the other hand, thematic analysis refers to a method of identifying, analyzing, and reporting themes inherent in the texts (Castleberry & Nolen, 2018). Both forms of document analysis are the methods through which documents are evaluated in a way that empirical knowledge is produced and understanding is developed (Bowen, 2009).

This research employs qualitative document analysis both as data collection as well as data analysis methods. Qualitative data analysis acts as both a data collection method for the *wakalah sukuk* documents, as well as a data analysis method for data retrieved from both the documents and the semi-structured interviews. At the end of the data collection process, certain codes, code groups, and themes will be highlighted. As indicated by Bowen (2009), document analysis is often used as a means of triangulation. In this view, the document analysis is used together with other qualitative data collection methods (for example, interview such as in this study) to corroborate the findings of the other methods. In this study, data on legal risks and LRM to be collected

¹⁵² This refers to superficial examination of the documents.

¹⁵³ By this, the author means “first-pass document review, in which meaningful and relevant passages of text or other data are identified”(Bowen, 2009, p. 32).

from the interviews will be corroborated with the data and findings of the document analysis.

6.3.1.1 Doctrinal Legal Analysis

This study adopts doctrinal legal analysis (DLA) which analyze legislation, legal documents (e.g. legal contract), and case reports to derive conclusions (M.D., 2019). Unlike socio-legal research analysis, doctrinal legal analysis “concerns itself with rhetorical practices that are internal to law, avoiding reliance on extralegal normative considerations” (Wendel, 2011). In doctrinal legal analysis, general steps are required, namely: 1) identification of research problem; 2) identification and compilation of the legal sources; 3) evaluation and analysis of the legal sources; and finally 5) synthesizing and applying the legal principles (Neel, 2023).

This study is a socio-legal research that inquires into the social context of the *sukuk* legal risk and LRM, especially with the use of interviews with wider participants who are both legal and non-legal practitioners. Nonetheless, the identification of legal risk and LRM directly from the *sukuk* documents demand a doctrinal legal analysis. For these, several legislation and case reports have been referred to and embedded in the analysis. DLA is a two-steps process, that it involves locating the case or the law and analyzing them (Hutchinson & Duncan, 2012). In applying DLA, relevant cases and relevant legislation that are used are as follows:

The cases are: *Pesaka sukuk, CIMB Bank Bhd v Maybank Trustees Bhd and other appeals* [2014] MLJU 117 and *Maybank Trustees Bhd (formerly known as Aseambankers Malaysia Bhd) v Amtrustee Bhd & Ors* [2020] 4 MLJ 405 (in relation to legal risks in *sukuk*/ bonds); *Acoustic & Lighting System Sdn. Bhd. v Golden Affinity Development Sdn. Bhd.* [2017], MLJU 2283 and *Tahan Steel corp Sdn. Bhd. v Bank*

Islam Malaysia Bhd [2005] 1 SHLR 117 (in relation to waivers); *CIMB Bank Bhd v Maybank Trustees Bhd and other appeals* [2014] MLJU 117 (in relation to disclaimer); *Arch Reinsurance Ltd v Akay Holdings Sdn Bhd* [2019] 1 CLJ 305 (in relation to dispute arbitrability).

The legislations are: CMSA 2007; The Guidelines on Unlisted Capital Market Products under the Lodge and Launch Framework (LOLA framework) and Guidelines on Issuance of Private Debt Securities and Sukuk to Retail Investors (Retail PDS and *Sukuk* Guidelines) which are used to determine the legal requirement of *sukuk*.

The analysis of the cases and legislations were based on the researcher's understanding after reading the cases' reports and through delineation provided in supporting literature.

6.3.1.2 Wakalah Sukuk Documents

Technically, a *sukuk* issuance involves several documents, as follows (Hegazy, 2016):

1. Agreement between the investor and the SPV;
2. Agreement between the SPV and the originator;
3. Agreement between the SPV and third parties (which may be the *wakil*, supplier, seller, etc.);
4. Agreement between the originator and third parties;
5. Supporting documents that state details on the conditions of the *sukuk* (either for legal or tax purposes); and

6. *Wakalah sukuk* prospectus or offering circular¹⁵⁴.

Unfortunately, the documents (i.e., the Transaction Documents) are subject to confidential policy. The only available documents on *sukuk* are the *sukuk* Information Memorandum (IM), Trust Deeds (TD), Principal Terms and Conditions (PTC) and Other Terms and Conditions (OTC). Upon further survey on these documents (which are available for public viewing through bixmalaysia website), it was found that the PTC and OTC form part of the IM. Only for some *wakalah sukuk* issuers, where the IM is not available, the document analysis will be conducted on the PTC.

According to Hegazy (2016), the offering circular or IM provides details of the *sukuk*, e.g., the percentage of the issue price, the (check) maturity of the *sukuk*, descriptions of the SPV, issuer, bank, assets, principal shareholders (check), the issuing country's financial system for foreign investors, tax considerations, conditions of subscription and sale, etc. In addition, it provides potential investors with information regarding risks of the *sukuk* and some indication on how the risks are reduced. At the same time, it gives a summary of all relevant documents pertaining to the transaction, e.g., the trust deed, purchase undertaking deed, obligations of each party, and particulars of all relevant parties in the offering document (Hegazy, 2016). As indicated in the case of *Pesaka sukuk, CIMB Bank Bhd v Maybank Trustees Bhd and other appeals* [2014]

¹⁵⁴ Information Memorandum is also called offering circular or offering memorandum. See [https://uk.practicallaw.thomsonreuters.com/5-3823356?transitionType=Default&contextData=\(sc.Default\)&firstPage=true](https://uk.practicallaw.thomsonreuters.com/5-3823356?transitionType=Default&contextData=(sc.Default)&firstPage=true).

Bursa Malaysia offers three types of listing, i.e., Main Market, ACE Market, and Leading Entrepreneur Accelerator Platform (LEAP) Market for listed companies in Malaysia. It was noted that these three listings are designed for different companies (Bursa Malaysia, 2020). Each listing requires a disclosure document. If the company intends to be listed on the Main Market or the ACE Market, the disclosure document is called 'prospectus', and if the company intends to be listed in the LEAP Market, the disclosure document is called 'information memorandum' (Bursa Malaysia, 2020, p.72). LEAP Market is a listing accessible only to Sophisticated Investors. Any company that seeks to be listed on the LEAP Market must be assessed by a Principal Adviser (PA) registered with Bursa Malaysia's Register of Advisers (Bursa Malaysia, 2020, p.71).

MLJU 117, IM was a document heavily referred to by the Court and the legal effects of some provisions in the IM have been recognized by the Court, e.g., Important Notice in the IM¹⁵⁵. Thus, legal risks within the IM are important and they need to be highlighted.

Therefore, for the purpose of data collection, only the IM, TD, PTC, and OTC will be analyzed. The selection of the *wakalah sukuk* documents was done purposively, i.e., by those that employ *wakalah bi al-istithmar* contract. At the same time, variation in terms of the background of issuers and advisers of the selected *wakalah sukuk* is anticipated to present different outputs to be analyzed from the *wakalah sukuk* documents, e.g., different types of legal risks involved and variation on LRM strategies and techniques.

The *wakalah sukuks* that have been selected for the purpose of this document analysis are corporate *sukuks* that were issued from 2016-2021 (Details of the *sukuk* Issuers are provided in Appendix I). Sovereign *sukuks* were neglected partially because a significant number of legal risks due to multiple jurisdictions could be anticipated. This may render the analysis to become too extensive. From 2016 to July 2021, there were 393 corporate *sukuk* issuances made under the Lodge and Launce Framework of the Securities Commission (SC) of Malaysia (SC, 2021). Within these issuances, 32 *wakalah sukuks* have been issued. These *wakalah sukuks* were issued in various types. Some of the types are *Sukuk Wakalah*, *Sukuk Wakalah Programme*, *Additional Tier 1 Sukuk Wakalah Programme*, *Green Sustainable and Responsible Investment Sukuk*, *Senior Sukuk Wakalah Programme*, *Senior Sukuk Wakalah* and/or *Subordinated Sukuk*

¹⁵⁵ For instance, the Court said, “It would appear that Important Notice is a common practice not only in this country but also in more established capital markets. Therefore, Important Notice cannot just be brushed aside. It has to be given effect. After all, it cannot be denied that the bondholders in the present case are sophisticated investors and experienced financial institutions. They have vast experience in bonds and are expected to act on independent and professional advice from their own sources in respect of the contractual obligations in the light of the disclaimer as contained in the Important Notice.” (p.8)

Wakalah Programme, *Sukuk Wakalah* MTN Programme, *Sukuk Wakalah* CP Programme, and Multi-Currency *Sukuk Wakalah* Programme (SC, 2021).

However, it was found that within the 32 *wakalah sukuk*s issued between the years of 2016 until July 2021, only 24 *wakalah sukuk* documents were available for further analysis. Out of 24 *wakalah sukuk* that were issued, 10 were arranged by Maybank Investment Bank Berhad, seven were arranged by CIMB Investment Bank Berhad, six were arranged by AmInvestment Bank Berhad and the other issuances were arranged by other institutions, e.g., RHB Investment Bank Berhad, BNP Paribas Malaysia Berhad and Standard Chartered Saadiq Berhad, Bank Muamalat Malaysia Bhd. and others, either solely or jointly. Meanwhile, the trustees appointed for the 32 *wakalah sukuk* issuance were Malaysian Trustees Berhad, Mayban Trustees Berhad, Pacific Trustees Berhad, AmanahRaya Trustees Berhad and AmTrustees Berhad. Legal advisers employed for these issuances were mainly Zaid Ibrahim & Co. and Adnan Sundra & Low. The legal advisers employed were either acting for all the parties (issuer and the DDWG) or acting for either one of the parties. Shariah advisers appointed were mainly the Islamic banks and there were only two issuances that employed individual advisers, namely Dr. Mohd Daud Bakar and Assoc. Prof. Dr. Aznan Hasan, as the Shariah advisers. The credit rating agencies which rated the *wakalah sukuk* were either the RAM Rating Agency or MARC. Two of the 24 *wakalah sukuk* issuances were unrated. Details and coding of the documents are as follows. Further details on the selected *sukuk* can be referred to in Appendix A.

Document analysis on these documents was employed to collect data on legal risk and LRM in the *wakalah sukuk*. This study posits that when a legal risk is disclosed in the *wakalah sukuk* documents, it shows that the legal risk is prevalent in the *sukuk*. Similarly for LRM, when a technique is disclosed in the *wakalah sukuk* documents, it

shows that the technique forms part of the LRM. These data were collected using data coding. As indicated in Lewis (2016), data coding using Atlas.ti may be done in three or more stages. He demonstrated the first data coding using open data coding or *in vivo*. Later, the second stage data coding was implemented by grouping similar codes and merging them into higher code categories. At this stage, renaming some of the codes to include similar codes in one category is necessary. In the third stage, the list of codes is revisited and the search for appropriate themes begins.

Coding in this study has been conducted in similar ways. Using the first stage coding, 269 codes have emerged. After a few checks, the number of codes have been reduced to 114 codes. In the final stage of coding, 13 code groups, six group families, and three themes have been maintained. Details of these are provided in Chapter 7, as part of the study's findings.

Table 6.1 List of Wakalah Sukuk Documents for Document Analysis

| NO. | ISSUER CODE | DOC | CODE | ISSUER | AVAILABILITY | | | | ISSUER'S MAIN BUSINESS/ INDUSTRY |
|-----|-------------|-----|------|-----------------------------------|--------------|----|-----|-----|--|
| | | | | | IM | TD | PTC | OTC | |
| 1. | 1 | IM | 1.A. | Tadamun Services Berhad | √ | √ | √ | √ | The issuer is a Special Purpose Vehicle (SPV) incorporated in Malaysia in 2008. The obligor is the Islamic Development Bank, a supranational organization operating as a multilateral development body to foster the economic growth of its member countries. (SUPRANATIONAL BODY) |
| | | TD | 1.B. | | | | | | |
| | | PTC | 1.C. | | | | | | |
| | | OTC | 1.D. | | | | | | |
| 2. | 2 | IM | 2.A. | Lebuhraya DUKE Fasa 3 Sdn Bhd | √ | √ | √ | √ | The issuer is a Private Limited Company (PLC) incorporated in Malaysia. The issuer was incorporated for the sole purpose of designing, constructing, managing, operating, and maintaining the Expressway pursuant to the Concession Agreement in the <i>sukuk</i> . (CONSTRUCTION & MANUFACTURING INDUSTRY) |
| | | TD | 2.B. | | | | | | |
| | | PTC | 2.C. | | | | | | |
| | | OTC | 2.D. | | | | | | |
| 3. | 3 | IM | 3.A. | Southern Power Generation Sdn Bhd | √ | √ | X | √ | The issuer is a Private Limited Company (PLC) incorporated in Malaysia. The issuer was formed by SIPP and later jointly owned by SIPP and TNB to undertake a project to develop a combined-cycle gas turbine electricity generating facility located at Pasir Gudang, Johor, Malaysia. (POWER GENERATION INDUSTRY) |
| | | TD | 3.B. | | | | | | |
| | | PTC | - | | | | | | |
| | | OTC | 3.D. | | | | | | |
| 4. | 4 | IM | 4.A. | Edra Energy Sdn Bhd | √ | √ | X | √ | The issuer is a Private Limited Company (PLC) incorporated in Malaysia. The issuer was granted an award to undertake a project to develop a combined cycle gas turbine electricity generating facility located at Alor Gajah, Melaka, Malaysia. (POWER GENERATION INDUSTRY) |
| | | TD | 4.B. | | | | | | |
| | | PTC | - | | | | | | |
| | | OTC | 4.D. | | | | | | |

| | | | | | | | | | |
|----|----|-----|-------|---|---|---|---|---|--|
| 5. | 5 | IM | 5.A. | SHC Capital Sdn. Bhd. | √ | √ | √ | √ | The issuer is a Private Limited Company (PLC) set up as an SPV by TCE. The principal activity of the issuer is investment holding. (POWER GENERATION INDUSTRY) |
| | | TD | 5.B. | | | | | | |
| | | PTC | 5.C. | | | | | | |
| | | OTC | 5.D. | | | | | | |
| 6. | 6 | IM | 6.A. | Lafarge Cement Sdn Bhd | √ | √ | √ | √ | The issuer is a subsidiary company of Lafarge Malaysia Bhd. The issuer's principal activities are manufacturing of cements, sale of cement, clinker, and other related products. (CONSTRUCTION & MANUFACTURING INDUSRTY) |
| | | TD | 6.B. | | | | | | |
| | | PTC | 6.C. | | | | | | |
| | | OTC | 6.D. | | | | | | |
| 7. | 9 | IM | 9.A. | Projek Lintasan Sungai Besi-Ulu Klang Sdn Bhd | √ | √ | X | √ | The issuer is a Private Limited Company (PLC) incorporated in Malaysia. It is a subsidiary of PNB. The issuer was incorporated to undertake the construction, operations, maintenance, and collection of tolls of the expressway. (CONSTRUCTION & MANUFACTURING INDUSRTY) |
| | | TD | 9.B. | | | | | | |
| | | PTC | - | | | | | | |
| | | OTC | 9.D. | | | | | | |
| 8. | 11 | IM | 11.A. | BGRB Venture Sdn Bhd | √ | √ | X | √ | The issuer is a Private Limited Company (PLC) set up as an SPV by Berjaya Golf Resort Sdn. Bhd. The principal activities of the obligor are property investment, property management services and operations of recreation and golf club. (PROPERTY AND RECREATIONAL RELATED INDUSTRY) |
| | | TD | 11.B. | | | | | | |
| | | PTC | - | | | | | | |
| | | OTC | 11.D. | | | | | | |
| 9. | 12 | IM | 12.A. | Perbadanan Kemajuan Pertanian Negeri Pahang | √ | √ | √ | √ | The issuer is a statutory body. Its principal activities cover palm oil plantation, investment holding, and real estate development. (AGRICULTURE INDUSTRY) |
| | | TD | 12.B. | | | | | | |
| | | PTC | 12.C. | | | | | | |
| | | OTC | 12.D. | | | | | | |

| | | | | | | | | | |
|-----|----|-----|-------|----------------------------------|---|---|---|---|--|
| 10. | 13 | IM | 13.A. | Bank Pembangunan Malaysia Berhad | X | √ | √ | X | The issuer is a development bank. Its principal activities cover infrastructure project financing that focuses on maritime, advanced manufacturing industry as well as high technology and export related industries. (FINANCIAL INSTITUTION) |
| | | TD | 13.B. | | | | | | |
| | | PTC | 13.C. | | | | | | |
| | | OTC | - | | | | | | |
| 11. | 14 | IM | 14.A. | Guan Chong Berhad | √ | √ | √ | √ | The issuer is a Public Limited Company. Its principal activities are investment holding and provision of management services to its subsidiaries which are involved in the manufacturing of cocoa products. (CONSUMER GOODS INDUSTRY) |
| | | TD | 14.B. | | | | | | |
| | | PTC | 14.C. | | | | | | |
| | | OTC | 14.D. | | | | | | |
| 12. | 15 | IM | - | Padiberas Nasional Berhad | X | √ | √ | √ | The issuer is a Public Limited Company. Its principal activities involve the procurement, collection, import, export, purchase, and distribution of rice, paddy and other grains. (AGRICULTURE INDUSTRY) |
| | | TD | 15.B. | | | | | | |
| | | PTC | 15.C. | | | | | | |
| | | OTC | 15.D. | | | | | | |
| 13. | 16 | IM | 16.A. | Sunsuria Berhad | √ | √ | √ | √ | The issuer is a Public Limited Company incorporated in Malaysia. Its principal activities are investment holding and provision of management services to its subsidiaries which are involved in various industries, e.g., education, healthcare, investment holding, etc. (PROPERTY AND RECREATIONAL RELATED INDUSTRY) |
| | | TD | 16.B. | | | | | | |
| | | PTC | 16.C. | | | | | | |
| | | OTC | 16.D. | | | | | | |
| 14. | 17 | IM | 17.A. | Evyap Sabun Malaysia Sdn. Bhd. | √ | √ | √ | √ | The issuer is a Private Limited Company (PLC) incorporated in Malaysia. The issuer is jointly owned by two Turkish companies. The principal activities of the issuer are manufacturing of various types of soaps, oleochemical, and personal hygiene and care products. (CONSUMER GOODS INDUSTRY) |
| | | TD | 17.B. | | | | | | |
| | | PTC | 17.C. | | | | | | |
| | | OTC | 17.D. | | | | | | |

| | | | | | | | | | |
|-----|----|-----|-------|------------------------------------|---|---|---|---|---|
| 15. | 18 | IM | 18.A. | Bermaz Auto Berhad (IMTN & ICP) | √ | √ | √ | √ | The issuer is a Public Limited Company incorporated in Malaysia. It is an investment holding company for businesses that are involved in the distribution, retail, and after-sales services of Mazda vehicles. (AUTOMOTIVE INDUSTRY) |
| | | TD | 18.B. | | | | | | |
| | | PTC | 18.C. | | | | | | |
| | | OTC | 18.D. | | | | | | |
| 16. | 19 | IM | 19.A. | Maybank Islamic Berhad | √ | √ | √ | √ | The issuer is a wholly owned subsidiary of Maybank Bhd. Its principal activities are deposit taking and financing for retail and non-retail customers. It offers diversified Shariah compliant products to its customers. (FINANCIAL INSTITUTION) |
| | | TD | 19.B. | | | | | | |
| | | PTC | 19.C. | | | | | | |
| | | OTC | 19.D. | | | | | | |
| 17. | 20 | IM | 20.A. | Sinar Kamiri Sdn Bhd | √ | √ | X | √ | The issuer is a limited liability company incorporated in Malaysia. It is wholly owned by Madujaya Sdn. Bhd to undertake the project to of power generation of the power plant located in Sungai Siput, Perak. (POWER GENERATION INDUSTRY) (*green <i>sukuk</i>) |
| | | TD | 20.B. | | | | | | |
| | | PTC | - | | | | | | |
| | | OTC | 20.D. | | | | | | |
| 18. | 21 | IM | 21.A. | Leader Energy Sdn Bhd | √ | √ | X | √ | The issuer is a Private Limited Company (PLC) incorporated in Malaysia. It is an investment holding company owned by HNG Capital. Two project companies i.e., LSE I and LSE II, were incorporated by the issuer to undertake the projects of constructing and maintaining solar photovoltaic power plants and electric energy generation, respectively. (POWER GENERATION INDUSTRY) |
| | | TD | 21.B. | | | | | | |
| | | PTC | - | | | | | | |
| | | OTC | 21.D. | | | | | | |
| 19. | 22 | IM | 22.A. | CIMB Islamic Bank Berhad | √ | X | √ | √ | The issuer is a wholly owned subsidiary of CIMB Bank Bhd. Its principal activities are deposit taking and financing for retail and non-retail customers. It |
| | | TD | - | | | | | | |
| | | PTC | 22.C. | | | | | | |

| | | | | | | | | | |
|-----|----|-----|-------|-----------------------------------|---|---|---|---|--|
| | | OTC | 22.D. | | | | | | offers diversified Shariah compliant products to the customers. (FINANCIAL INSTITUTION) |
| 20. | 24 | IM | - | Alliance Islamic Bank Berhad | X | √ | √ | √ | The issuer is a wholly owned subsidiary of Alliance Bank Bhd. Its principal activities are deposit taking and financing for retail and non-retail customers. It offers diversified Shariah compliant products to its customers. (FINANCIAL INSTITUTION) |
| | | TD | 24.B. | | | | | | |
| | | PTC | 24.C. | | | | | | |
| | | OTC | 24.D. | | | | | | |
| 21. | 25 | IM | 25.A. | MBSB Bank Berhad | √ | √ | √ | √ | The issuer is a wholly owned subsidiary of MBSB Bhd. Its principal activities are deposit taking and financing for retail and non-retail customers. It offers diversified Shariah compliant products to its customers. (FINANCIAL INSTITUTION) |
| | | TD | 25.B. | | | | | | |
| | | PTC | 25.C. | | | | | | |
| | | OTC | 25.D. | | | | | | |
| 22. | 27 | IM | 27.A. | Dialog Group Berhad | √ | √ | X | X | The issuer is a Public Limited Company incorporated in Malaysia. It is an investment holding company that manages various subsidiaries mainly involved in oil, gas, and petrochemical industry. (OIL, GAS AND PETROCHEMICAL INDUSRTY) |
| | | TD | 27.B. | | | | | | |
| | | PTC | - | | | | | | |
| | | OTC | - | | | | | | |
| 23. | 30 | IM | 30.A. | Putrajaya Holdings Sdn. Bhd. | √ | X | √ | √ | The issuer is a Private Limited Company (PLC) incorporated in Malaysia. It is a subsidiary of KLCC Holdings Sdn. Bhd, which is a subsidiary of PETRONAS, CIMB Group Nominees, and Khazanah. The issuer's principal activities are investment holding, property development, and buildings' leasing. (PROPERTY AND RECREATIONAL RELATED INDUSTRY) |
| | | TD | - | | | | | | |
| | | PTC | 30.B. | | | | | | |
| | | OTC | 30.D. | | | | | | |
| 24. | 32 | IM | 32.A. | Eco World Capital Services Berhad | √ | √ | √ | √ | The issuer is a Public Limited Company incorporated in Malaysia. It is a wholly owned subsidiary of Kafalah Provider. The issuer was incorporated principally to issue notes under the |
| | | TD | 32.B. | | | | | | |
| | | PTC | 32.C. | | | | | | |

| | | | | | | | | | |
|--|--|-----|-------|--|--|--|--|--|---|
| | | OTC | 32.D. | | | | | | Islamic MTN programme. (PROPERTY AND RECREATIONAL RELATED INDUSTRY) |
|--|--|-----|-------|--|--|--|--|--|---|



Details of the analyzed documents are provided in the following sections:

6.3.1.2.1 Wakalah Sukuk Information Memorandum (IM)

Wakalah sukuk IM contains important information for potential *sukuk* holders. In general, it contains information about the *sukuk*, the issuer, and other important considerations to be noted by the potential *sukuk* holders. IM is arranged from the executive summary of the issuer, the executive summary of the *wakalah sukuk* and the programme (if applicable), information on the issuer that includes corporate history, principal activities, shareholdings, profiles of the Board and profiles of the Senior Management Team of the issuer, principal terms and conditions of the *wakalah sukuk* and the programme (if applicable), the business overview of the issuer, investment considerations, overview of the industry related to the issuer, and other information and considerations. In order to obtain approval from the SC for the *sukuk* issuance, the issuer must provide an IM as stipulated in para 11.03 (b)(iii) of CBSR 2017. However, IM is only required from a qualified issuer, besides a set of documents including financial report, supporting documents, and a Product Highlight Sheet (PHS).

6.3.1.2.2 Wakalah Sukuk Trust Deed (TD)

The TD Guidelines sets out minimum requirements, covenants, and provisions required for a TD. A TD is arranged in a few sections, particularly sections on the Declaration of Trust, covenant to pay by the issuer, information relating to the *wakalah sukuk* and *wakalah sukuk* issuance, details and covenants that relate to the payments of the *sukuk*, duties and liabilities of the parties in the TD, as well as provisions in regards to the appointment, powers of the trustee, etc. Since the TD constitutes the contractual relationship between the issuer, the trustee and the *sukuk* holders, legal risks embedded

in the TD may be anticipated, particularly legal risks that relate to the duties and liabilities of the parties.

6.3.1.2.3 Wakalah Sukuk Principal Terms and Conditions (PTC) and Other Terms and Conditions (OTC)

In general, PTC presents important information of the *sukuk* in a standard format. It starts with the basic information of the *wakalah sukuk*, description of the *sukuk*, covenants of the issuer, representations and warranties, and other material conditions of the *sukuk*, e.g., events of default, governing laws, redemption, early redemption, voting, *ta'widh*, and *ibra'*. The PTC will be preceded by OTC. OTC includes details of the proceeds utilization, redemption, and details on the profit, e.g., periodic distribution rate and periodic distribution frequency, taxation, jurisdiction, status of issuer's obligations, etc.

6.3.2 Semi Structured Interviews

Interview is considered the most common and effective way to understand human behaviors (Fontana & Frey, 2003). This data collection method was selected due to its ability to comprehend a flow of human behaviors. This was echoed as:

“Increasingly, qualitative researchers are realizing that interviews are not neutral tools of data gathering but active interactions between two (or more) people leading to negotiated, contextually based results. Thus the focus of interviews is moving (check) to encompass the hows of people's lives (the constructive work involved in producing order in everyday life) as well as the traditional whats (the activities of everyday life)” (Fontana & Frey, 2003).

There are a few types of interviews. They are: 1) structured interviews; 2) group interviews;¹⁵⁶ 3) unstructured interviews; and 4) semi-structured interviews. This research employs the semi-structured interview method.

Within the field of Islamic finance, the studies on legal risk and LRM of *wakalah sukuk* are still lacking. Thus, the semi-structured interview is a suitable method for this research because it allows the interviewer to seek more elaboration, particularly on how the legal risks are currently managed and how LRM can be improved. The semi-structured interview lies in between the structured¹⁵⁷ and unstructured interviews¹⁵⁸ (Piaw, 2012). Using this interview method, the researcher is allowed to ask questions other than those prepared in order to further explore answers given by the interviewee (Piaw, 2012). Nonetheless, the interviewer is required to have a clear idea about the data that he wants to obtain when putting forward his research questions (Piaw, 2012).

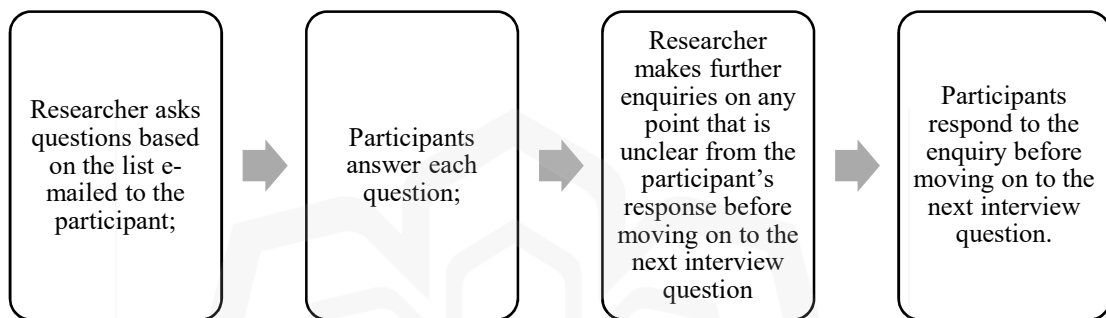
The semi-structured interviews were conducted via either physical or online meetings. This was determined by the participants based on their convenience. The

¹⁵⁶ Group interview refers to “a qualitative data gathering technique that relies upon the systematic questioning of several individuals simultaneously in a formal or informal setting” (Fontana & Frey, 2003, p.71). In a group interview, the interviewer will direct the responses and interactions between the group members as respondents in either structured or unstructured manner. The purpose of employing the group interview is to explore the responses of the respondents. Other than that, the group interview will be beneficial when used in order to assist the respondents to recall certain events or experiences (Fontana & Frey, 2003, p.71).

¹⁵⁷ Some characteristics of structured interview are, 1) same set of questions asked on all respondents, 2) there could be limited response categories unless open-ended questions are employed, 3) there is a certain control played by the interviewer and 4) there is less flexibility in term of the questioning as well as answering of the interview questions. The disadvantages of structured interview are, 1) response effects or non-sampling errors are potential, 2) there could be errors in the nature of the task, such as in questioning, sequence and wording of the questions, 3) error in term of the interviewer who does not possess the questioning techniques or in term of his characteristics (Fontana & Frey, 2003, p.69).

¹⁵⁸ Unstructured interview is differentiated from structured interview based on the fact that the former “... attempts to understand the complex behaviour of members of society without imposing any priori categorization that may limit the field of inquiry” (Fontana & Frey, 2003, p.75). Generally, when framing unstructured interview, a few elements have to be considered due to the informal nature of the interview. Those elements depend on the nature of the setting and heightened due to the use of certain pre-established set of techniques. Among the elements are the selection of specific terms as well as non-verbal techniques, e.g., *proxemic*, *chronemics*, *kinesis* and *paralinguistic* communication that need to be noted and recorded (Fontana & Frey, 2003, p.87).

interview starts with the participant's agreement to participate after the interview questions and the information sheet of the research (containing the research background and research objectives) have been e-mailed to the participants. Subject to the internal procedures of each participant's organization, the interviews are arranged to be conducted as follows:



Each interview was conducted for about one hour to three hours depending on the participant's convenience. During the interview, the researcher is allowed to record and make notes.

6.4 SAMPLING METHOD

This study has selected the purposive sampling method. Sampling is a technique that seeks to achieve analytic generalizability (Gentles, Charles, Ploeg, & McKibbin, 2015). In simple words, reasonable generalization can be made on the samples selected. In a qualitative research, selection of participants must be based on certain rationale and purpose. Thus, purposive sampling technique can adequately fulfil the need to select the participants for this research. The selection of participants for this research is made with certain justifications, which will be elaborated on in the next sub-section.

6.4.1 List of Participants

Participants selected for this research came from different institutions and backgrounds. The initial list of participants consisted of 10 participants, namely: (1) *sukuk* principal advisors/ lead arrangers; (2) legal advisers; (3) securities commission representatives; (4) credit agency representatives; (5) *sukuk* trustee; and (6) Shariah advisers for the *wakalah sukuk*. However, only seven participants ultimately agreed to participate in the interviews. Interview with a representative from the SC was not secured throughout the data collection period. In addition, the SC informed that the interview questions would be best answered by the advisers. Hence, the policy maker's perspectives are not represented. Within these seven interviews, five were conducted online and two were conducted face-to-face, as preferred by the participants. However, the interview with PA/LA1 was conducted in writing. The participant had requested for the interview questions to be e-mailed to her as she was not able to participate in a face-to-face or online interview session. After two days, the participant replied to the e-mail with answers to each of the interview questions.

The remaining seven participants were experienced players in *sukuk* and they have been selected for specific purposes. The participants' profiles and the specific purposes for their selection are outlined below:

Table 6.2 List of selected participants

| No. | Name, Position and Company's Address | Code |
|-----|---|--------|
| 1. | Deepak Sadasivan Managing Partner Adnan, Sundra and Low (Advocates & Solicitors) Level 25, Menara Etiqa, 59000 Kuala Lumpur | LA1 |
| 2. | Madzlan Mohamad Hussain Senior Partner CSQ Law (Advocates & Solicitors) No. 22 Lorong 2C, Taman Hillview, 68000 Ampang, Selangor | LA2 |
| 3. | Nur Hidayah Salim Manager of Corporate & Investment Banking Maybank Islamic Berhad, Malaysia Maybank Tower, 100, Jalan Tun Perak, Bukit Bintang, 50050 Kuala Lumpur | SA1 |
| 4. | Dr. Ayaz Ismail Associate Director Wholesale Banking CIMB Bank Berhad 11, Jln Raja Laut, City Centre, 50350 Kuala Lumpur | SA2 |
| 5. | Siew Suet Ming Chief Rating Officer RAM Rating Services Level 8, Mercu 2, No.3, Jalan Bangsar, KL Eco City, 59200 Kuala Lumpur | CRA1 |
| 6. | Hafizul Hassan Senior Vice President, Legal MTrustee Berhad Level 15, Menara AmFirst No. 1, Jalan 19/3 46300 Petaling Jaya, Selangor | ST1 |
| 7. | Salina Burhan Islamic Markets, Debt Markets AmInvestment Bank Berhad Level 23, Bangunan AmBank Group, 55 Jalan Raja Chulan, 50250 Kuala Lumpur | PA/LA1 |

Table 6.3 List of Participants Selected using Purposive Sampling

| No. | PARTICIPANTS | Roles | Purposes |
|-----|--|--|--|
| 1. | Principal Advisor/ Lead Arranger (PA/LA) | To advise on all aspects of <i>sukuk</i> issuance to ensure compliance with regulatory requirements, market conditions, and other compliance requirements. He is responsible to manage the issuance process of the <i>sukuk</i> (Wan Mohamed Ali, 2014). | <p>This participant is directly involved in the issuance process of a <i>sukuk</i>, responsible for the book-building process as well as compliance with regulatory requirements. As stated in the Guidelines on Due Diligence Conduct for Corporate Proposals (SC, 2008) (DDG) Appendix 3.0 (g), the PA has the responsibility to review all aspects of the <i>sukuk</i> including the material legal risks which may have a material impact on the corporate proposal. In this regard, the PA is required to undertake a detailed risk analysis of the applicant/issuer and ensure the adequacy of the risk disclosures, particularly in the offering document.</p> <p>Thus, his knowledge, experiences, and views are crucial towards identifying the legal risks in <i>wakalah sukuk</i>, the current LRM of <i>wakalah sukuk</i>, and ways to improve the latter.</p> |
| 2. | Legal Advisor (LA) | To advise on all legal aspects of <i>sukuk</i> issuance to ensure compliance with regulatory requirements. His scope of responsibilities lies in advising on the legal implications and drafting of issuance documents, acting as secretary to DDWG as well as improvising due diligence planning memorandum and verification notes and providing advice in terms of | <p>As the participant poses vast knowledge on <i>sukuk</i> legal aspects and whose advices are sought, this participant must have practiced certain legal risk management for the <i>sukuk</i>.</p> <p>Thus, his knowledge, experiences and views are crucial towards identifying the legal risks in <i>wakalah sukuk</i>, the current legal risk management of <i>wakalah sukuk</i> and ways to improve the latter.</p> |

| | | | |
|----|---------------------------|--|--|
| | | the <i>sukuk</i> asset transfer and status of trust entity in a particular jurisdiction (Wan Mohamed Ali, 2014). | |
| 3. | Shariah Advisor (SA) | To examine and ensure valid application of Shariah principles in the <i>sukuk</i> structure, documentation, investment of assets, | <p>Shariah non-compliance in <i>sukuk</i> is part of legal risk in <i>sukuk</i>. In order to ascertain the Shariah compliance, the Shariah advisor is required to make Shariah disclosures (ISRA, 2016).</p> <p>Ascertaining Shariah compliance also warrants continuous review of the Shariah matters. For instance, Shariah-compliant utilization of <i>sukuk</i> proceeds (Para 6.16 and 13.15 of the LOLA framework and CCSR 2017 respectively).</p> <p>Hence, the participant's knowledge, experiences and views are significant towards identifying the legal risks in <i>wakalah sukuk</i>, particularly those arising from Shariah issues and compliance, its management, and ways to improve the latter.</p> |
| 4. | <i>Sukuk</i> Trustee (ST) | A <i>sukuk</i> trustee is entrusted by the <i>sukuk</i> investors to undertake diligent action to protect the latter's rights (R. Hassan, Yaman, Othman, & Yusoff, 2012). The relationship between the investors and their trustee is not only regulatory, but also contractual and fiduciary. | <p>The primary duty of a <i>sukuk</i> trustee is to undertake diligent action to protect the rights of the investors. These duties are entrusted to them by Chapter 19, Para 19.01 and 19.01 of the Guidelines on Trust Deed. Therefore, in discharging their duties, for instance to ensure minimum content of the trust deed is met, they must be involved in managing risks. These risks may fall under contract risk or compliance risk. Thus, they are involved in the management of legal risk.</p> <p>Hence, the participant's knowledge, experiences, and views are significant towards identifying the legal risks in <i>wakalah sukuk</i> particularly those arising from Shariah issues and compliance, its management, and ways to improve the latter.</p> |

| | | | |
|----|--|---|---|
| 5. | Credit Rating Agency (CRA) representatives | The credit agency improves the investors with assurances through information notification regarding the quality of the <i>sukuk</i> underlying asset (Wan Mohamed Ali, 2014) or the quality of the issuer of the <i>sukuk</i> . | <p>The responsibility of this participant is to provide disclosures of all the pre-conditions, relevant risk factors, and all material information relating to all parties of the <i>sukuk</i> (Wan Mohamed Ali, 2014). The disclosure is also submitted to the regulatory bodies in order to seek approval for the <i>sukuk</i> issuance (Wan Mohamed Ali, 2014). Even though the mandatory credit rating has been removed by the government in June 2014, the mandatory requirement was initiated in 2017 since the SC has relaxed the rule in 2015. As per current amendments towards a few <i>sukuk</i> guidelines, the importance of credit rating agency rises again when the qualified issuer is required to maintain a minimum credit rating of AA- (or its equivalent) of its corporate <i>sukuk</i> to be offered (Chapter 22, Guidelines on Issuance of Corporate Bonds and Sukuk to Retail Investors) (Kok, 2018).</p> <p>Therefore, this participant's insights on legal risks and LRM are important, particularly when credit rating monitoring runs throughout the tenure of the <i>sukuk</i>.</p> |
|----|--|---|---|

Summary of the data and data collection methods employed in this research are as follows:

1. Document Analysis: Data collected from publicly available Transaction Documents, i.e. Information Memorandum (IM), Principal Terms and Conditions (PTC) and Trust Deeds (TD) of selected *wakalah sukuk* issued through the Malaysian SC. Documents were obtained from official website of Securities Commission of Malaysia at www.sc.com.my and Bond and *Sukuk* Information Platform Sdn. Bhd at bixmalaysia.com.
2. Interviews: Data collected from interviews with seven participants: Principal Advisor/ Lead Arranger (PA/LA1), Legal Advisers (LA1 & LA2), Shariah Advisers (SA1 & SA2) and Credit Rating Agency Representative (CRA1), and Trustee (ST1).

6.5 Data Analysis

In theory, data collection and data analysis in qualitative research are inseparable. As the data is collected, it is also analyzed (Gibbs, 2007). This is particularly true for raw data collected through document analysis and interview. In terms of qualitative research, data analysis is defined as:

“... the classification and interpretation of linguistic (or visual) material to make statements about implicit and explicit dimensions and structures of meaning-making in the material and what is represented in it. Meaning-making can refer to subjective or social meanings... is applied to discover and describe issues in the field or structures and processes in routines and practices. Often, qualitative data analysis combines approaches of a rough analysis of the material (overviews, condensation, summaries) with approaches of a detailed analysis (elaboration of categories, hermeneutic interpretations or identified structures). The final

aim is often to arrive at generalizable statements by comparing various materials or various texts or several cases (Flick, 2013).”

It is notable that procedures for handling such qualitative data analysis are still lacking (Bowen, 2009; Woodrum, 1984). However, there are some guidelines provided by researchers in the past literature on how to conduct the analysis. For instance, Castleberry and Nolen (2018, p.808) highlighted five major procedures in thematic analysis, i.e., compiling, disassembling, reassembling, interpreting, and concluding. Thomas (2006) explained on general inductive approach for analyzing qualitative data with illustrations, while Knafl and Howard (1984) emphasized on research purposes to interpret and report qualitative data.

In order to analyze the data in this research, certain procedures have been identified and employed. These procedures are aligned with a specific approach in qualitative research, i.e.; generic inductive approach. The purpose of identifying certain procedures and approach for this research is to assist the researcher in following certain flows in analyzing, interpreting, and reporting the data. Within the flows, certain activities need to be conducted to ensure the validity, reliability, and objectivity of the data.

6.5.1 Data Analysis Approach

According to Thomas (2006), there is a wide range of literature that documents approaches to analyze qualitative data. They typically range from grounded theory, phenomenology, discourse analysis, and narrative analysis (Thomas, 2006). Nonetheless, there are two main approaches in analyzing qualitative data. The first approach aims at reducing data into categories while the second aims at expanding data by offering more interpretations in the data (Flick, 2013). Qualitative content analysis

and grounded theory fall under the first approach. Phenomenological method, documentary method, and hermeneutic method form the second approach (Flick, 2013,). On the other hand, some literature contain discussions on generic analytic approach (Kahlke, 2014; Liu, 2016; D. R. Thomas, 2006). The generic analytic approach is also known as general inductive approach (Thomas, 2006) or generic inductive approach (Kahlke, 2014; L. Liu, 2016). For the purpose of this research, the generic inductive approach is utilized to analyze the data.

6.5.1.1 Generic Inductive Approach

Generic inductive approach in a qualitative research method, which analyzes:

“people’s reports of their subjective opinions, attitudes, beliefs, or reflections on their experiences, of things in the outer world” (Percy, W.H.; Kostere, K.; Kostere, 2015).”

It was claimed that this approach is suitable in a research where ethnography, case study, and grounded theory approaches are inappropriate (Percy, W.H.; Kostere, K.; Kostere, 2015). This approach is also advisable if the researcher has prior knowledge in order for him to understand the respondents’ perspectives (Percy, W.H.; Kostere, K.; Kostere, 2015).

Based on this approach, the data analysis is guided by the research objectives (Thomas, 2006). Firstly, specific domains/topics as intended in the research objectives are identified (Thomas, 2006). The domains/topics, also known as themes, will guide the analysis, particularly in developing categories from the raw data. The categories will form a model or a framework for the research (Thomas, 2006). Still, the data analysis is conducted based on the assumptions and experiences of the researcher who conducted

and analyzed the research himself. Thus, this approach warrants a few techniques for trustworthiness of the analysis to be assessed. The techniques are discussed under section 6.5.2 of this Chapter.

6.5.1.2 Content Analysis and Thematic Analysis

As elaborated in section 6.3.1, content analysis and thematic analysis form part of document analysis. While document analysis has been utilized as a data collection instrument, this research has also employed it as a method of data analysis. Considering the types of data collected, i.e., data from documents and data from interviews, the utilization of content analysis and thematic analysis are distributed among these types of data.

For the purpose of this research, data analysis using the generic inductive approach and document analysis (*wakalah sukuk* documents and interviews' transcription) is illustrated below based on the research objectives. Both content analysis and thematic analysis involve coding and developing code groups and themes processes. Initially, the codes and code groups are developed from the data. It was noted by Mohamad, Hamin, Md Nor, Kamaruddin, and Nizam Md Radzi (2020) that the coding process involves building the codes based on the researcher's understanding, the literature review, and the data itself. At the same time, Fereday and Muir-Cochrane (2006) asserted that a code template which has been developed a priori can be used to assist in the coding process. Even though this study does not use any template, the findings from the literature review contributed to the analysis. For instance, in answering the RQ1, the definition and scope of legal risk developed in Chapter 3 and Chapter 4 have been used to help with the identification of legal risk and its coding from the interviews. Similarly, to answer RQ2, the LRM strategies, techniques, and tools as

discussed in Chapter 5 have been used to determine them in the documents' analysis. These also contributed towards developing the code groups and themes. To validate the coding, peer-briefing was used. This is to ensure reliability of the codes (Fereday & Muir-Cochrane, 2006). After the interview data were coded by a peer, the results were compared. Where there is a difference in the coding, modifications were made or further discussion was carried out to reach mutual understanding on the data coding. An example of the peer-briefing of an interview data is as follows:

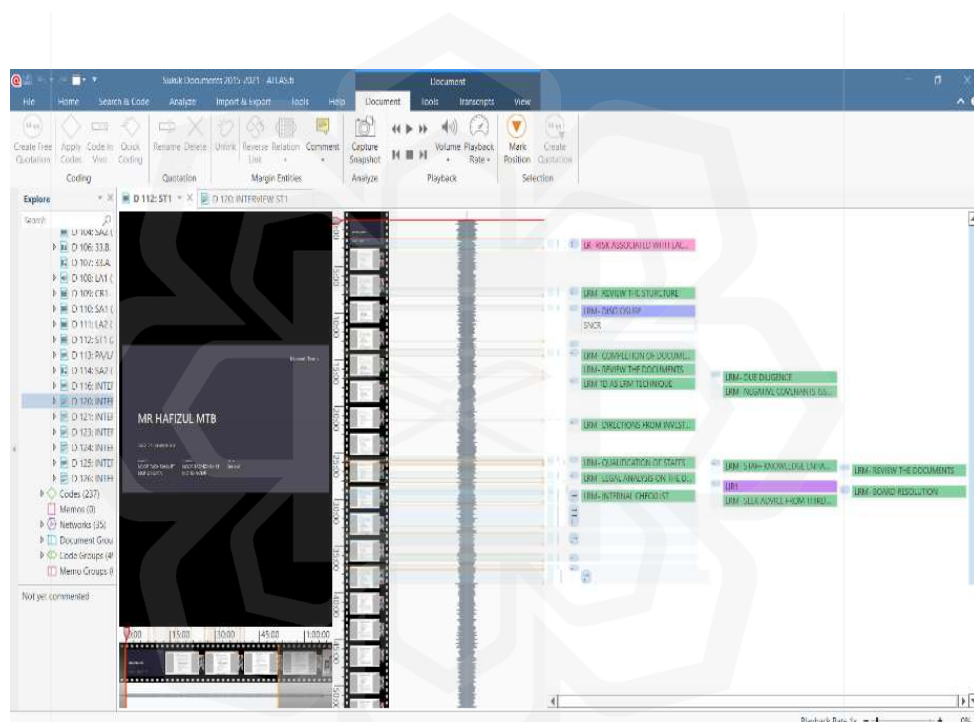


Figure 6.1 Interface of Coding of the Interview Data by a Peer (the peer used a different code (different code name) to avoid redundancy in the code frequency produced in Atlas.ti)

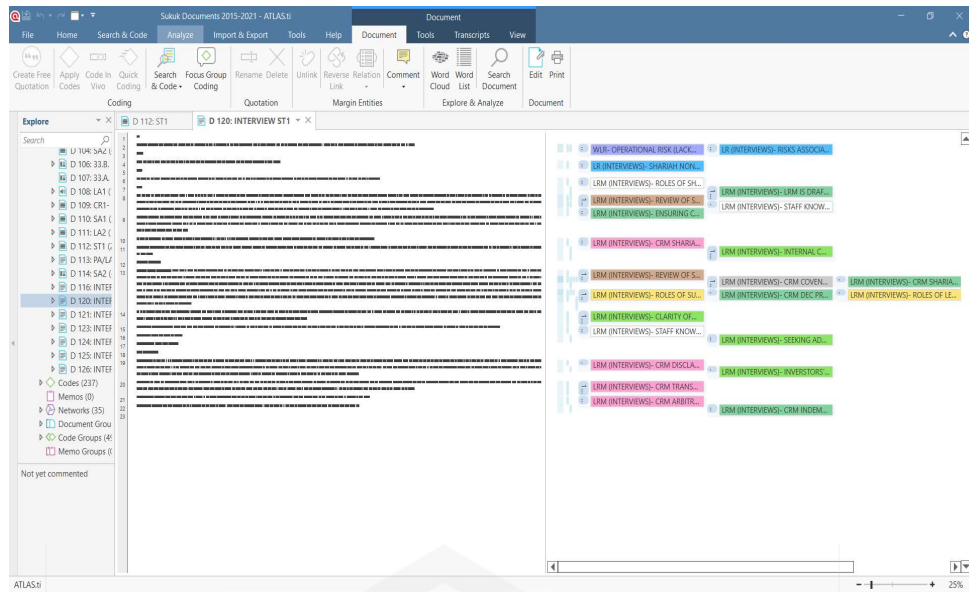


Figure 6.2 Interface of Coding of the Interview Data by Researcher

Later, these codes and code groups were categorized under a set of themes. Some of them were also grouped under group family before being categorized under the themes. The use of the group family was evident in the study of Choe, Lee, and Lee (2022). In terms of the themes, their identification is made through reading and re-reading of the data (Fereday & Muir-Cochrane, 2006). However, in this study, the themes were also built based on the three aspects of legal risk as found in Chapter 3 and Chapter 4. Although some studies indicated that thematic analysis should not involve pre-existing themes (Alhojailan & Ibrahim, 2012), it was noted by Vaismoradi, Jones, Turunen, and Snelgrove (2016) that the benefits of pre-existing themes gathered from literature review can outweigh threats to the prior theme development because they may allow researchers to make inferences from the data beyond what has been made. In other words, the pre-existing themes may assist the researchers to explain more on the data as compared to what was studied in the literature.

In relation to the presentation of findings, the findings from the content analysis and thematic analysis have been presented differently. Employing Atlas.ti for the

content analysis has allowed the analysis to produce descriptive tables, co-occurrence analysis, as well as visualization of findings using Sankey diagram. The use of these in the content analysis was also evident in previous studies (Adelowotan, 2021; Choe et al., 2022; Saad, Udin, & Hasnan, 2014). However, instead of using correlation coefficient in the co-occurrence analysis, frequencies were used. This was due to weak correlation coefficient values found in the findings that may be attributed to the large sample used in this study.

In addition, employing Atlas.ti for thematic analysis has allowed the analysis to produce a network diagram. According to Lewis (2016), network diagram is a “qualitative visual representations of the data”. In this study, network diagram has helped in identifying patterns in the data when the data is visualized and the occurring codes emerged in the visualization. The relationship between the data can also be well explained using hyperlinks, e.g., “is associated with”, “a part of”, “a cause of”. However, these hyperlinks were built based on the researcher’s understanding of the findings.

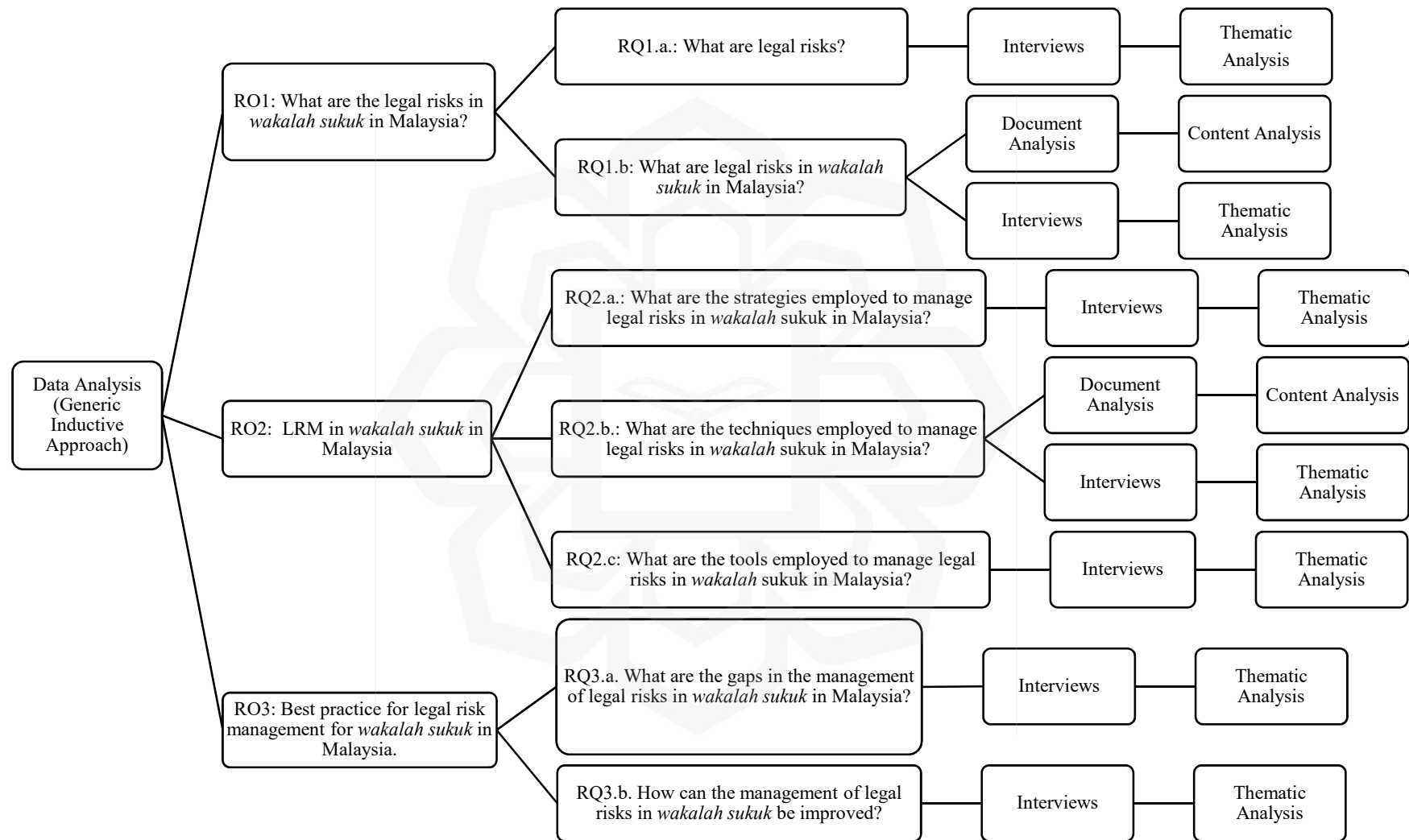


Figure 6.3 Summary of Research Methodology (Data Collection and Data Analysis)

6.5.2 Flow of Data Analysis

In a general qualitative research analysis, there are three concurrent flows of activity. The first flow is the data reduction, followed by data display, and finally data verification (Miles & Huberman, 1994). In data reduction activity, the data is processed in a way that it is reduced and transformed. The process involves selecting, focusing, simplifying, abstracting, and transforming the data into transcriptions. This process runs throughout the duration of the data collection. This process also forms part of data analysis (Miles & Huberman, 1994). This is because analytic choices are made to decide on the selection of data to be coded and patterns of data to be followed.

The second flow of activity in qualitative data analysis is the data display. For this activity, the data that has been reduced will be displayed in certain forms using matrices, graphs, charts, and even networks. This is considered part of data analysis because when a researcher designs specific displays of his data, he has to employ analytic activities (Miles & Huberman, 1994).

Finally, the third flow of activity in the analysis is drawing conclusions and verification of the conclusion. This is done by way of testing the data for their plausibility, sturdiness, and confirmability.

Since this research has employed Atlas.ti 9 as a research analysis tool, published works using similar tools were referred to. Based on these publications, the data analysis includes at least two rounds of data coding (Mohamad, Hamin, Md Nor, Kamaruddin, & Nizam Md Radzi, 2020; Mohamad, 2014; Saad, Udin, & Hasnan, 2014). In the first round of data coding, the data were coded based on the sentence or terms used in the sentence of a document. In the second round, some of these codes were merged, thus reducing the number of codes. After that, these codes were grouped into family codes or themes. These publications used both content analysis, i.e., presenting the findings

based on the count or frequency of the codes (Choe et al., 2022; Mohamad, 2014) and code occurrence analysis (Choe et al., 2022), as well as thematic analysis, i.e., presenting the findings based on family codes/themes using network analysis (Choe et al., 2022; Mohamad, 2014; Mohamad et al., 2020; Saad et al., 2014).

For this research, the interface of the data, i.e., codes and code groups, is as follows:

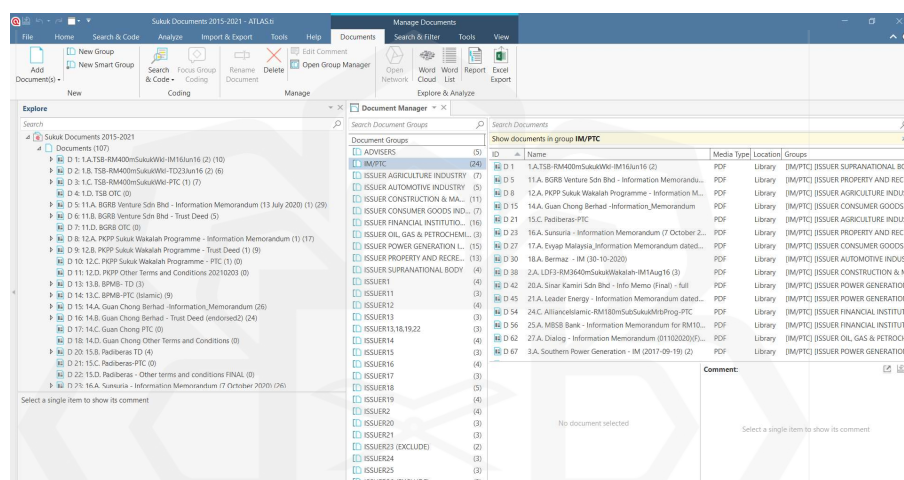


Figure 6.4 Interface of Document Code and Document Code Groups

The initial documents employed in this research totaled to 107 documents (IM, TD, PTC and TD). However, some of these documents were excluded from the data analysis because they were incomplete. These documents were categorized into several groups, e.g., industry group, document type group, etc. These groupings have helped with the presentation of findings in Chapter 7.

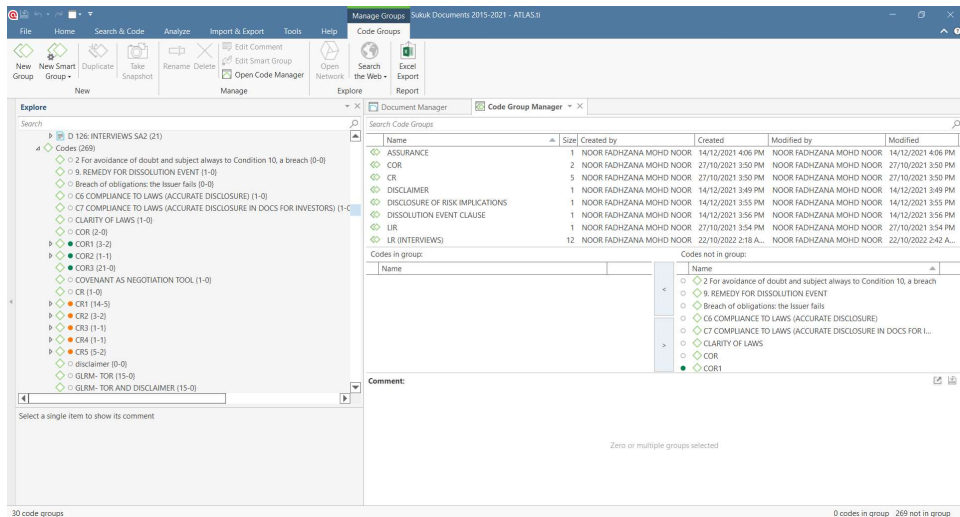


Figure 6.5 Interface of Codes and Code Groups

The initial codes in this research were 269 codes gathered from IM, TD, PTC, and TD, including those from the interviews. However, some of these codes were merged into several groups, e.g., legal risk code groups, legal risk management codes groups, etc. These groupings have helped with the presentation of findings in Chapter 7. Summary of codes, code groups, group family, and themes to describe the findings will also be presented in Chapter 7.

6.5.3 Validity, Reliability, and Objectivity of Data

Among the challenges faced in conducting qualitative research is lack of certainty of hard numbers to foster confidence in the research (Pandey, S. C. & Patnaik, 2014). It was claimed that specific research settings chosen by a qualitative researcher has caused the research to be inapplicable for wider world generalization. The researcher's closeness to his research settings may cause biasness and subjectivity in the interpretations of the research data (Pandey, S. C. & Patnaik, 2014). Thus, there must be certain tests undertaken to reduce the biasness and subjectivity. In quantitative research, these issues are reduced through validity, reliability, and objectivity tests.

Discussions on the validity, reliability, and objectivity of qualitative data have been drawn by some scholars¹⁵⁹. It was asserted that whenever qualitative researchers discuss reliability and validity, they are basically referring to the credibility of the data (Pandey, S. C. & Patnaik, 2014). ‘Credible’ is the operational term to achieve trustworthiness of a qualitative research, as described by Lincoln and Guba (1985). It was suggested that the credibility of data is to replace the test of internal validity of data (Lincoln & Guba, 1985).

In order to do this, it was suggested that the researcher conduct the research in a way that would enhance the probability of the findings being credible. There is a need for the researcher to demonstrate the credibility of the findings by having them approved by constructors of the multiple realities being studied (Lincoln & Guba, 1985). The constructors are stakeholders who are involved in the field of the research conducted, and their approvals constitute the conduct of member checking process¹⁶⁰.

Simultaneously, the credibility of the findings also depends on the efforts and ability of the researcher (Pandey, S. C. & Patnaik, 2014). To enhance the credibility and trustworthiness of the research, it was suggested that a few techniques be considered throughout the research (Lincoln & Guba, 1985):

¹⁵⁹ For instance, reliability of qualitative data was analysed from the traditional empirical angles, i.e., through validity, reliability, and objectivity (consistency of data). Nonetheless, they found the analysis to be useless in assessing qualitative data (Flick, 2007, p.15). Validity of data was also analysed. It was found that to validate a quantitative data, the researcher has to ensure internal validity within the context of the study. To do that, the researcher must maintain certain standards in data collection and data analysis processes. To apply these on qualitative data is not possible because “the necessary standardization is not compatible to qualitative methods” (Flick, 2007, p.15). Efforts to determine objectivity of qualitative data also resulted in disappointment since very few attempts were made to objectivate qualitative data.

¹⁶⁰ It refers to “direct test of findings and interpretations with the human sources from which they have come”... “The member check, whereby data, analytic categories, interpretations, and conclusions are tested with members of those stakeholding groups from whom the data were originally collected, is the most crucial technique for establishing credibility. If the investigator is to be able to purport that his or her reconstructions are recognizable to audience members as adequate representations of their own (and multiple) realities, it is essential that they be given the opportunity to react to them” (Lincoln & Guba, 1985, p.314).

1. To conduct activities that will produce credible data. These activities include prolonged engagement, persistent observation, and triangulation. The purpose of having prolonged engagement is to expose the researcher to other sources of information or multiple influences (the mutual shapers and contextual factors) that may affect the studied area (Lincoln & Guba, 1985). On the other hand, the purpose of persistent observation is to identify other characteristics and elements in the studied area that are most relevant to the problem studied (Lincoln & Guba, 1985). While prolonged engagement provides scope, persistent observation provides depth (Lincoln & Guba, 1985).
2. To conduct peer debriefing. This refers to a “process of exposing oneself to a disinterested peer in a manner paralleling an analytic session and for the purpose of exploring aspects of the inquiry that might otherwise remain only implicit within the inquirer’s mind” (Lincoln & Guba, 1985). Besides giving peace of mind to the researcher, other purposes of conducting peer debriefing are to keep the researcher genuine in finding answers to his research question, to give the researcher a chance to test his initial interpretations of the findings by having consistency with the interpretations of the debriefer or a person without interest and finally to provide the researcher with the opportunity to develop appropriate methodological designs for the research (Lincoln & Guba, 1985, p.308).
3. To determine negative case analysis: Negative case analysis amounts to a process whereby research hypothesis is refined at a point where there is no exception to be found. It is said to be a “process of revising hypotheses with hindsight”.

4. To have referential adequacy: By this, the researcher may attempt to have other sources of data, instead of the intended raw data to support the findings of the research. It is to complement the intended raw data.
5. To do members checks: In terms of the research data, checking by members of the stakeholding groups (authorities relevant to the data and the research) is considered the most crucial technique for establishing credibility (Lincoln & Guba, 1985). Member checking can be conducted either informally or formally, and it must be done continuously.

Based on the above suggestions, this research employed peer-debriefing and triangulation techniques. Peer-debriefing was conducted by qualified research colleagues neutral to this research who has experience using Atlas.ti. Transcripts of all interviews were given to the colleague and she was entrusted to code the data completely independently, without the researcher's intervention or participation. Afterwards, the researcher and the colleague made a comparison check on the coded categories/ themes.

Triangulation technique was also conducted in this research to control bias in the data collected and analyzed. Triangulation was employed to address the internal validity issue of the data¹⁶¹ or the credibility of the data. Triangulation refers to an attempt to obtain a "true" fix on a situation by way of combining different ways of looking at it or different findings (Silverman & Marvasti, 2005). In view of this, participants were selected from different institutions and backgrounds. In this way, credible data may be obtained by combining different outputs from different people or sources. This

¹⁶¹ Internal validity "in conventional terms (is referred) as the extent to which variations in an outcome (dependent) variable can be attributed to controlled variation in an independent variable. A causal connection between independent and dependent variables is usually assumed". (Lincoln & Guba, 1985, p.290)

triangulation is called triangulation of sources (Pandey, S. C. & Patnaik, 2014). There are two advantages to this: 1) interviewees from different institutions and backgrounds will provide multiple angles of data on legal risk and LRM in *wakalah sukuk* that will lead to rich data; and 2) triangulation of data will be successfully done so that biases within the data can be controlled.

Besides credibility of data, Lincoln and Guba (1985) also discussed the transferability of data¹⁶², dependability of data¹⁶³, as well as confirmability of data. By these, they meant external validity, reliability, and objectivity of data, respectively (Lincoln & Guba, 1985, p.300). As echoed in Lincoln and Guba (1985), transferability as in external validity of qualitative data is not within the responsibility of the researcher. As a matter of fact, future researchers who seek to use data from the existing qualitative data have to ensure that there are sufficient similarities between their research and the existing data. By this, the burden of transferability of data ends when sufficient descriptive data (also called thick description) are provided to future researchers to make such similarities possible. Thus, this research provides sufficient description of the analyzed data by way of building codes and themes that are then mapped to the research objectives.

In terms of the dependability of the data, this refers to the ability of the research to be replicated by other research. In this study, inquiry audit is used, whereby a person is appointed to examine the flow of the research, determine its acceptability and examine the research data, findings, interpretations, and recommendations (Pandey, S. C. & Patnaik, 2014). In addition to the peer briefing, the supervisors of this research

¹⁶² Refers to the domain in which the findings of a research can be generalized (Pandey, S. C. & Patnaik, 2014, p.5745).

¹⁶³ Illustrates that the operations of a study can be repeated, with the same results generalized (Pandey, S. C. & Patnaik, 2014, p.5745).

also act as auditors who inquire on the process as well as the data and findings of the research. In view of these, the qualitative data may avail the data dependability test.

Finally, qualitative data also need to undergo a confirmability test. This is comparable to the objectivity of data test for quantitative data (Pandey, S. C. & Patnaik, 2014). The purpose of ascertaining the objectivity or confirmability of data is to ensure that the findings of the research are free from the researcher's personal preferences and biases (Pandey, S. C. & Patnaik, 2014). In regards to this research, the confirmability of the data is ascertained through the audit trail. Audit trail refers to:

“the whole procedure of data gathering and analysis is documented, including both raw data material, categorized data material, and the findings” (Akkerman, Admiraal, Brekelmans, & Oost, 2008).

I procedures of an audit in research are employed throughout the research period, i.e., from the origination of research objectives until the assessment by the auditor. These are done between the researcher and the supervisors.

In sum, there are several techniques employed in this research to comply with the quality standard of qualitative research. As mentioned earlier, this research employs peer-briefing and triangulation of sources to enhance the credibility (internal validity) of its data. It also utilizes thick description to enhance the transferability (external validity) of its data. For the purpose of enhancing the dependability (reliability) and confirmability (objectivity) of the data, inquiry auditor and auditor trails are employed in the research.

6.6 CONCLUSION

As indicated above, this research employs exploratory, qualitative, and inductive methodological approaches. Document analysis and semi-structured interviews are the methods used for data collection. The details of the documents are presented in Table 3 above. More details on the *wakalah sukuk* issued from 2016-2021 are presented in Appendix A. In terms of interview, initially ten participants from different backgrounds and institutions were selected for this research. However, only seven participants have agreed and voluntarily participated in the interviews. This has been mentioned as a research limitation. The selection of these participants was based on certain purposes as delineated in Table 4.

Data analysis in this research employs the generic inductive approach. Within this approach, the data analysis is conducted based on the research objectives where the researcher has identified the themes to be studied. In this approach, both content analysis and thematic analysis were conducted. These analyses involved several processes, i.e., the coding and the development of code groups, group families, and themes. Peer-briefing has been used to help with the validity of the coding process. For the content analysis, the findings are presented using descriptive tables, co-occurrence analysis (using frequencies), and Sankey diagrams. The purpose of these presentation tools are to present the LR and LRM that have been identified and determined from the *wakalah sukuk* documents. For the thematic analysis, network diagrams have been used to produce better visualization of the findings, in addition to detailed discussion of every code, code group, group families and theme emerging from the interview data. In terms of validity and reliability, peer-briefing, triangulation of sources, inquiry audit, as well as audit trail are techniques used to ensure the validity, reliability, as well as objectivity of the data analysis.

CHAPTER SEVEN

DISCUSSION AND ANALYSIS OF RESEARCH FINDINGS

7.1 INTRODUCTION

This chapter presents, discusses, and analyzes the findings of this study. Presentation of the findings is arranged in accordance with the research objectives and questions. It begins with the findings on legal risk in *wakalah sukuk* in Malaysia based on document analysis and interviews. This is followed by findings on legal risk management (LRM) in *wakalah sukuk* in Malaysia based on document analysis and interviews. Later, findings on gaps and improvements to the existing LRM based on interview data are discussed. In the final section, in-depth discussion and critical analysis of the findings are provided.

7.2 OVERVIEW OF FINDINGS

7.2.1 Legal Risks of Wakalah Sukuk as Disclosed in the Information Memorandum (IM)

Technically, the disclosure of legal risk in the IM are made in two manners:

- i. scattered within the IM Important Notice (IN); and
- ii. focused within a specific section under the IM, e.g., Investment Consideration (IC) and Dissolution Event Clause (DEC).

7.2.2 Legal Risks of Wakalah Sukuk as Disclosed in Trust Deed (TD)

Based on the document analysis, it was found that there is no specific section that deals with risks associated with the *wakalah sukuk*. Nonetheless, the risks are mentioned indirectly in relation to the duties and liabilities of the contracting parties, either the trustee, the issuer, or the *sukuk* holders.

Details of the legal risks within the TD are presented in the following Table 5.

7.2.3 Legal Risks in Wakalah Sukuk's Principal Terms & Conditions (PTC) and Other Terms and Conditions (OTC)

The PTC forms part of IM except for some cases where the PTC was lodged separately from the IM. Based on the document analysis, it was found that PTC and OTC do not have specific provisions on legal risk. PTC and OTC merely provide descriptive information on the *wakalah sukuk*. However, the risks were impliedly mentioned in terms of how they are managed, i.e., in the Representations and Warranties and Covenants. In other words, the risks are acknowledged in the form of representation¹⁶⁴ and warranty¹⁶⁵ by the issuer as well as issuer covenants¹⁶⁶. As a result, findings from PTC and OTC will only be discussed under the section of LRM of *wakalah sukuk* in Malaysia.

¹⁶⁴ Representation is a type of “statement made to induce another to enter into a contract” and warranty is “a promise that a proposition of fact is true” (Peterson, n.d.). The functions of representation and warranty in a contract between a seller and a purchaser is to make the former reveal facts about the contract, i.e., by way of disclosing risks within the contract that can be assessed by the purchaser as well. The facts and risks are to assist the purchaser to make informed decisions (Peterson, n.d.).

¹⁶⁵ “An express or implied promise that something in furtherance of the contract is guaranteed by one of the contracting parties; esp., a seller's promise that the thing being sold is as represented or promised” (Black's Law Dictionary, 2004). It was also delineated that warranty forms an essential part within a contract, while a representation is usually employed as a collateral inducement, it is also usually in the written form in a contract (Black's Law Dictionary, 2004).

¹⁶⁶ Covenants refer to a formal agreement in a contract... obliges a party to do something” (Black's Law Dictionary, 2004)

7.2.4 Code, Code Groups, and Themes

The initial analysis has resulted in 269 codes for both legal risks (LR) and legal risk management (LRM). After the data has been cleaned, merged, and deleted, only 114 codes remained. The deletion and merging of codes were due to redundancy or due to their incompatibility with the definition and scope of LR and LRM in this research. Finally, there are only 13 code groups, 6 group families, and 3 themes, i.e., legal risk, LRM, and Legal Risk Management Best Practices (LRMBP). Details of these are provided as follows:

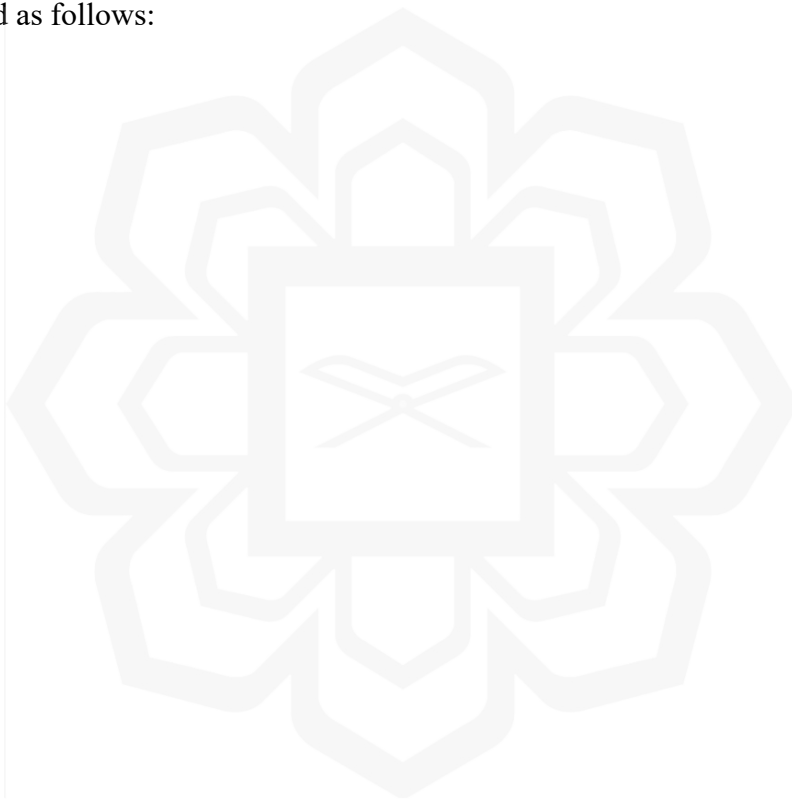


Table 7.1 List of Codes, Code Groups, Group Family and Themes

| Codes | Code Groups | Group Family | Themes |
|--|---|---|--------|
| Regulatory risk (1-0) Liability risk (1-0) Contract risk (documentation) (3-0) Contract risk (unenforceability) (2-0) Operational risk (lack of knowledge) (1-0) Compliance risk (1-0) Related to credit risk and business risk (1-0) | | Legal risk arising from law Legal risk arising from a contract Legal risk arising from operation | LR |
| LR (Interviews)- Risks associated with <i>sukuk</i> legal framework (3-1) LR (Interviews)- Tax risk (1-0) LR (Interviews)- Risks associated with <i>sukuk</i> documentation/ transaction (5-1) LR (Interviews)- Risks associated with <i>sukuk</i> enforceability (3-1) LR (Interviews)- Risks associated with investors' protection (2-1) LR (Interviews)- Risks associated with <i>sukuk</i> structure (2-1) LR (Interviews)- Shariah non-compliance risk (6-0) LR (Interviews)- Business risk (1-0) LR (Interviews)- Default risk (2-0) LR (Interviews)- Credit risk (1-0) | RR Contract risk (CoR) CR (SNCR) Financial risk (FR) | LR arising from the Malaysian legal environment LR arising from the legal perspectives of <i>sukuk</i> contract. LR arising from the <i>sukuk</i> operation | |

| Codes | Code Groups | Group Family | Themes |
|---|---|--|--------|
| <p>*<i>Wakalah sukuk</i> legal risk (WSR)</p> <p>WSR (Interviews)- Contractual relationship between <i>wakil</i> and <i>muwakkil</i> (1-0)</p> <p>WSR (Interviews)- Enforceability risk (1-0)</p> <p>WSR (Interviews)- Purchase undertaking risk (2-0)</p> <p>WSR (Interviews)- Risks associated with <i>wakalah sukuk</i> framework (1-0)</p> <p>WSR (Interviews)- Negligence risk (1-0)</p> | WSR | <p>LR arising from the legal perspectives of <i>sukuk</i> contract.</p> <p>LR arising from the law (Malaysian legal environment)</p> <p>LR arising from the <i>sukuk</i> operation</p> | |
| <p>RR1 (8-1)</p> <p>RR2 (14-3)</p> <p>RR3 (18-7)</p> <p>RR4 (2-3)</p> <p>RR5 (2-1)</p> <p>RR6 (42-4)</p> <p>RR7 (12-3)</p> <p>RR8 (36-4)</p> <p>RR9 (18-4)</p> <p>RR10 (29-3)</p> <p>RR11 (1-1)</p> <p>RR12 (14-3)</p> <p>LU1 (6-1)</p> <p>LU2 (3-2)</p> <p>SNCR1 (24-6)</p> <p>SNCR2 (41-5)</p> | <p>Regulatory risk (RR)</p> <p>Legal uncertainty (LU)</p> <p>Shariah non-compliance risk (SNCR)</p> | <p>LR arising from the law (Malaysian legal environment)</p> | |

| Codes | Code Groups | Group Family | Themes |
|--|----------------------|---|---------------|
| SNCR3 (1-1) CR1 (14-5) CR2 (3-2) CR3 (1-1) CR4 (1-1) CR5 (5-2) | Compliance risk (CR) | LR arising from the operation of the <i>sukuk</i> | |
| Review of <i>sukuk</i> documents (4-0) Recourse/ Purchase Undertakings (2-0) Ensuring compliance with related regulatory requirements (2-0) Shariah confirmation/ pronouncement (3-0) Clarity of laws and regulations (3-0) Review on Shariah compliance (3-0) Standardization of documentation (4-0) Staff knowledge enhancement (3-0) Assessing the investment implications (1-0) Clarity of trust deed (1-0) Due diligence practices (7-0) Following precedents (4-0) Investors' own assessment (1-0) Negotiation (2-0) Rechecking with Shariah advisers (1-0) Review by the securities commission (2-0) Seeking advice from legal advisers (1-0) Shariah audit (1-0) Surveillance exercise/ ratings update (1-0) | LRM strategies | | LRM |
| Assurance (22-10) Contingency fund (2-1) | LRM techniques | | |

| Codes | Code Groups | Group Family | Themes |
|--|-------------|--------------|--------|
| <p>Contract adjustment (4-1) Corporate guarantee (2-1) Disclaimer (115-15) Disclaimer by DDWG including SA (6-2) Disclaimer by issuer, DDWG except SA (20-2) Disclaimer by way of immunity (1-1) Disclaimer of inapplicability of governing law clause (1-1) Disclosure (5-2) Disclosure of risk implications (51-13) Dissolution events clause (25-7) Exemption of laws (5-2) Fair market compensation (2-1) Force majeure (8-1) Government guarantee (1-1) Relocation/ adjustment of sources (2-1) Shariah waiver (18-2)</p> <p>*Contract risk management (CRM) from interviews</p> <p>CRM Arbitration clause for foreign <i>sukuk</i> (3-0) CRM Assurance (2-1) CRM Assurance not LRM technique (2-1) CRM Condition precedent (1-0) CRM Contractual obligation (2-0) CRM Covenants (7-0) CRM Dissolution Event Clause (DEC)(6-0) CRM Dissolution Event Procedures (2-0) CRM Disclosure of Risk Implication not LRM technique (2-0)</p> | | | |

| Codes | Code Groups | Group Family | Themes |
|--|--------------------|---------------------|------------------------------------|
| CRM Disclaimer (6-1) CRM Disclaimer not LRM technique (1-1) CRM Governing law and jurisdiction (3-0) CRM Indemnity clause (1-0) CRM Litigation disclosure (1-0) CRM Minimum content under the trust deed (1-0) CRM Payment obligation (1-0) CRM Recourse/ Purchase undertaking clauses (4-0) CRM Shariah pronouncement(1-0) CRM Shariah waiver (4-1) CRM Shariah waiver not LRM technique (1-1) CRM Transfer of risk to investors (5-0) CRM Utilization conditions (1-0) | | | |
| Compliance statement from issuer (1-0) Credit ratings of the <i>sukuk</i> (1-0) Internal checklist (1-0) Planning memorandum (3-1) Planning memorandum not LRM tool (1-1) <i>Sukuk</i> holders' resolutions (1-0) Trust deed as LRM tool (2-0) | LRM tools | | LRM |
| Competitiveness Non-uniformed understanding between advisers | LRM Gaps | | LRM Best Practice (LRMBP) |
| Preferred <i>sukuk</i> issuance country Training | LRM Improvements | | |

**The numbers in the column, e.g. SNCR1 (24-6), indicate that there are 24 data that have been coded as SNCR1 and six times that the data co-occurred with other codes. The co-occurrence will be discussed in the LRM section.

7.3 FINDINGS

7.3.1 Legal Risks

Although the definition and scope of legal risk have been discussed in Chapter 3 and Chapter 4, the perspectives of the participants on legal risk and legal risks in *wakalah sukuk* were also investigated through the interviews. The perspectives of the participants on legal risk are vital in explaining the LRM strategies, techniques, and tools employed by them. This is particularly true when each of the participants in the interviews may perceive the legal risk from different angles, e.g., Shariah advisers from their position as advisers towards an issuer, or as advisers towards an investor. Similarly, legal advisers may perceive legal risk differently from their positions as advisers towards an issuer than as advisers towards a *sukuk* trustee. In view of this, it can be anticipated that there may be some disagreements among the participants on the LRM strategies, techniques, and tools.

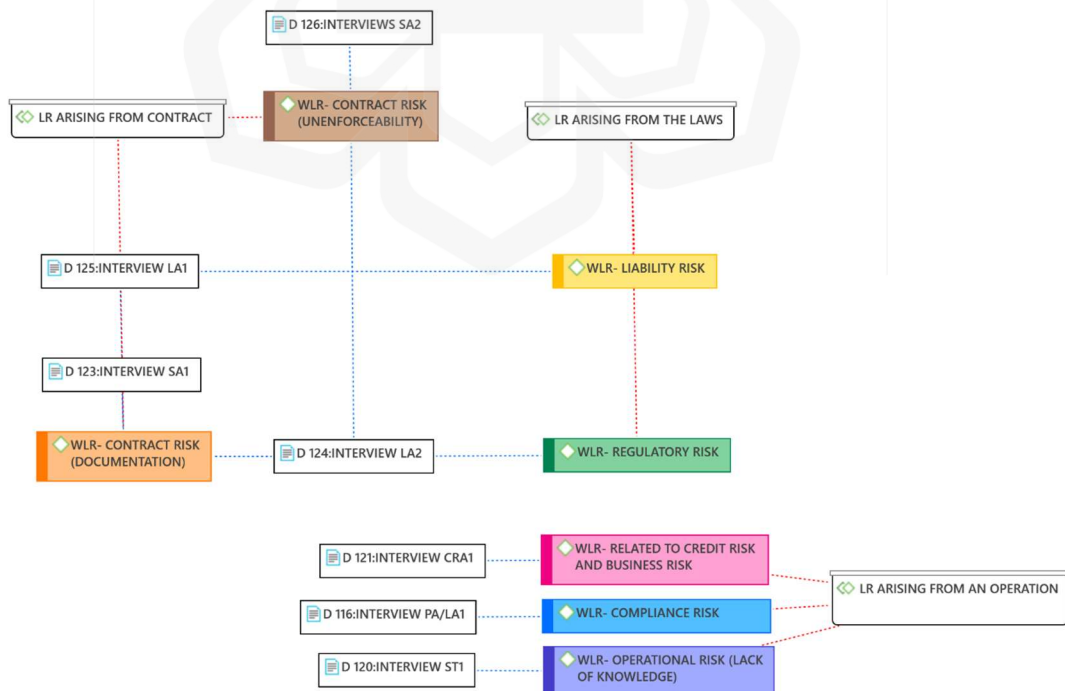


Figure 7.1 Legal Risk from the Perspectives of the Participants

As indicated in Figure 15, seven types of legal risk have been identified. These seven types of legal risk are categorized into three aspects/ group family considering their similarities, as follows:

- 1) Legal risk arising from the law: regulatory risk and liability risk;
- 2) Legal risk arising from a contract: contract risk (unenforceability risk) and contract risk (documentation);
- 3) Legal risk arising from an operation: compliance risk, operational legal risk (lack of knowledge of legal aspects of *sukuk*) and credit risk/ business risk.

Under the first aspect, the participants have perceived legal risk as regulatory risk and liability risk. These are evident in the responses of LA2 and LA1, respectively. Based on the responses of LA2, legal risks are risks arising from the laws. He specifically mentioned the *sukuk* framework that gives rise to legal risks. In a similar vein, LA1 expressed quite similar views but he emphasized the legal obligations that give rise to legal risks. He said:

“Legal risks are the risks related to the legal obligations of the parties involved in the transaction, so that is the first one that I mentioned just now, those under the, provided in the CMSA, e.g. if you don’t have accurate disclosure, there’s penalties ...”.

Under the second aspect, legal risk was perceived as contract risk by most of the participants, i.e. LA1, LA2, SA1, and SA2. LA2 and SA2 mentioned that legal risk is risk of unenforceability. For instance, SA2 said:

“Based on the work that I have been doing, legal risk is something that doesn’t work from the legal aspect, something wrong with the terms of the document, so on and so forth”.

In a similar vein, LA2 elaborated that besides the risks arising from the laws, there are also transactional legal risks, i.e., the ex-ante and ex-post risks. He deliberated on these by referring to the ex-ante legal risks as risks relating to the documentation and ex-post risks as risks relating to unenforceability of the documents. On the other hand, LA1, LA2, and SA1 have associated legal risk with contract risk in relation to the documentation. Both SA1 and LA1 stated that legal risk is the risk that documentation of a contract has not been able to allocate the desired intentions. Nonetheless, based on the responses of both SA2 and LA1, they were more focused on explaining the legal risk in *sukuk* instead of the nature of legal risk as perceived by them.

Under the third aspect, it was found that three participants have perceived legal risk differently. In the case of PA/LA1, she said:

“In my view, legal risk is a risk arising from failure to comply with statutory/ regulatory requirements or obligations”.

Thus, she perceived legal risk as compliance risk. Meanwhile, CRA1 and ST1 have expressed different views of what constitutes a legal risk. For CRA1, legal risk was perceived as that relating to credit risk and business risk. She mentioned that her position required her to analyze the implications of risk from the credit side. However, she discussed further on these in relation to *sukuk* instead of the nature of legal risk itself.

For ST1, legal risk is a risk relating to lack of knowledge of legal perspectives. In his view, legal risk is operational in nature. The way he perceived the risk may be influenced by his work experience as a trustee. Unlike legal advisers, *sukuk* trustees are not involved in the *sukuk* document drafting. However, the trustee is entrusted with the

document review and it requires vast knowledge on legal matters. Therefore, he said that legal risk is:

“Anything associated with potential loss arising from no knowledge or lack of knowledge of the legal perspectives. Risk is about potential loss for the business, from legal perspectives, I mean, lack of legal knowledge or anything related to legal matters, that can lead to loss.”

In sum, there are seven types of risk associated with legal risk. Generally, they were discussed in the previous chapters and they constitute important elements in the definition and scope of legal risk, e.g. regulatory risk, compliance risk, and contract risk. Risks that were not included were liability risk, credit risk, business risk, and operational legal risk. The risks were not included because they are indirect legal risks. As elaborated above, these risks were perceived by the participants as legal risk due to the nature of work they have been doing, with the assumption that these risks fit in the scope of legal risk. However, only a few of these participants (LA2, CRA1, and ST1) mentioned the effects of legal risk, i.e., loss and liability arising from the laws. Others have focused on the source of the risks, i.e., laws, such as in the case of regulatory risk; contract, in the case of contract risk; and conduct of the parties (operational side) in the case of compliance risk.

Other than that, the themes developed for these findings were also found to be in line with those found in the literature. As elaborated in Chapter 2, legal issues/ legal risks in *sukuk* have been discussed based on three aspects: 1) legal issues/risks associated with the regulatory framework or law; 2) legal issues/risks associated with *sukuk* document/contract; and 3) legal issues/risks associated with other aspects of *sukuk*. These three aspects were later refined in Chapter 4 to: 1) legal risks arising from the law; 2) legal risks arising from a contract; and 3) legal risks arising from a *sukuk*

operation. In the findings, the seven types of legal risk were found to fit in similar themes.

7.3.2 Legal Risks in Wakalah Sukuk in Malaysia

In addition to the above, the participants were also asked about legal risks in *wakalah sukuk*. As illustrated in Figure 16 below, there were ten codes generated for the legal risks in *wakalah sukuk*. The ten codes were also grouped under four code groups, i.e., regulatory risk, contract risk, compliance risk (including Shariah non-compliance risk), and financial risk. At the same time, these code groups were also grouped under three group family as indicated below:

- 1) Legal risks arising from the Malaysian legal environment:
 - a. Risks associated with *sukuk* legal framework; and
 - b. Taxation law risk, particularly change of law risk.
- 2) Legal risks arising from the legal perspectives of *sukuk* contract/document:
 - a. Risks associated with *sukuk* documentation/ transaction;
 - b. Risks associated with *sukuk* enforceability (unenforceability risk);
 - c. Risks associated with investors' protection; and
 - d. Risks associated with *sukuk* structure.
- 3) Legal risks arising from *sukuk* operation:
 - a. Shariah non-compliance risk;
 - b. Business risk;
 - c. Default risk; and
 - d. Credit risk.

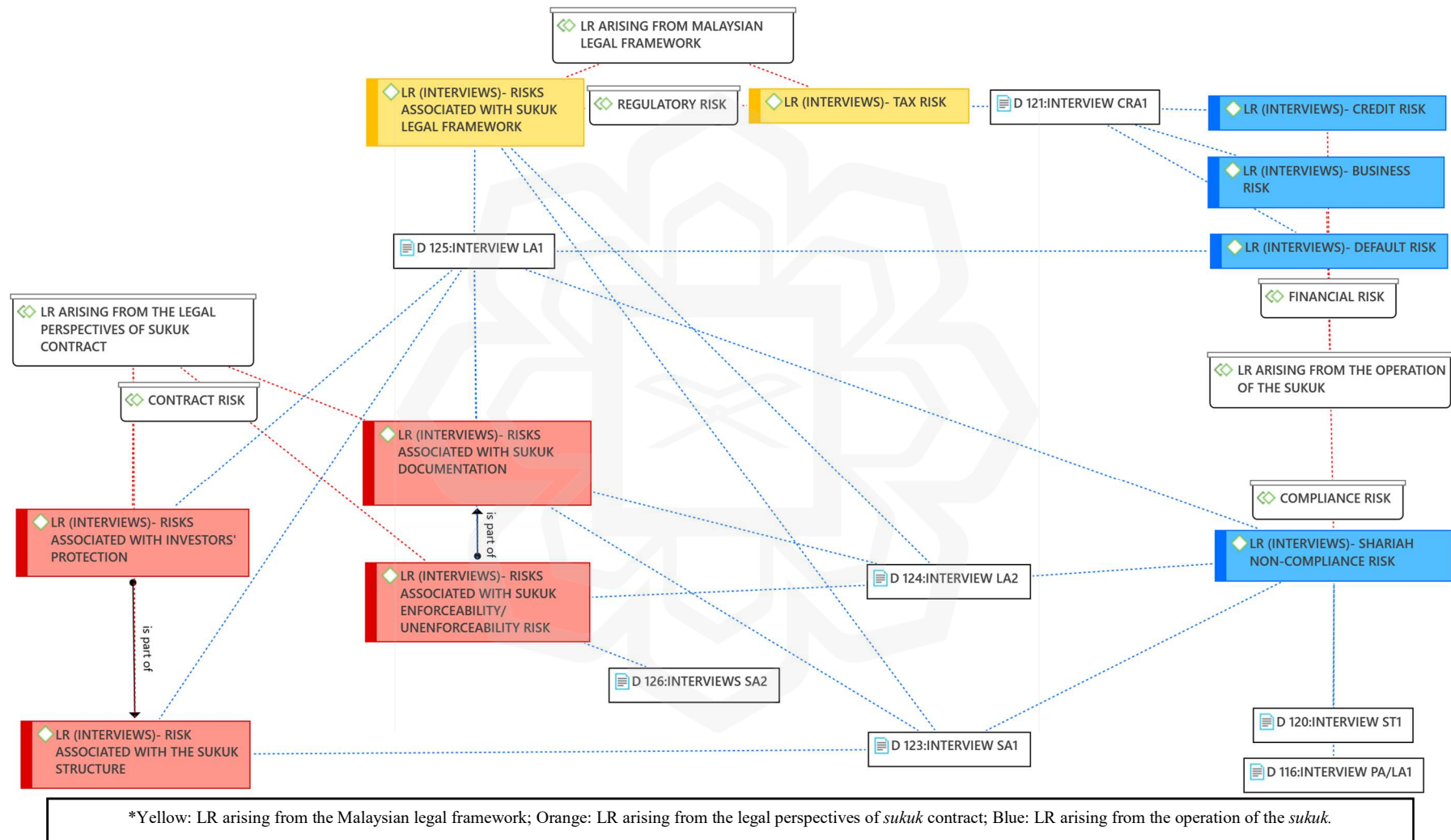


Figure 7.2 Legal Risks in Wakalah Sukuk from the Perspectives of the Participants

Under the first aspect, i.e. legal risks arising from the law, namely the Malaysian legal framework, it was found that four of the participants perceived the legal risks in *sukuk* as those originating from the laws. According to them, legal risks are those risks associated with the *sukuk* legal framework (LA1, LA2 and SA1). For LA1 and LA2, these were in line with how they perceived legal risk. LA1 stated:

“Not just *sukuk wakalah*, any type of *sukuk* is a capital market instrument, because as a capital market instrument, they come under the Capital Market Services Act and then they come under the jurisdiction of the Securities Commission. So that be the case, there are a few risks associated with the instrument”.

This view was similar to the views of LA2 and SA1. On the other hand, CRA1 was of the view that legal risks are risks associated with taxation laws (CRA1). She said:

“... a sudden legal risk or a tax risk that comes out, right?”

Tax rulings that are absolutely unanticipated, so, for most instances, even for bond holders, there will be a cross in the bond debenture, or the *sukuk* documents that actually say any changes in tax ruling it is an event of default.”

The *sukuk* legal framework consists of the main legislation, i.e., CMSA or subsidiary legislations such as SC guidelines that include the LOLA Framework. Based on the interviews, the participants were of the opinion that since *sukuks* are instruments that originated from the laws, the laws give effect to the *sukuk* and give rise to duties and liabilities towards the *sukuk* parties. This includes the duty to adhere to the regulatory requirements and liabilities arising from earlier failure to adhere to them.

SA1 further explained that the risks may also be associated with how the laws will give effect to the structure of the *sukuk* and the intended recourse in the *sukuk*.

In addition to this, CRA1 as a credit rating agency representative considered that any changes in taxation laws or rulings may create legal risks to the *sukuk*. In her response, she explained that ‘changes in taxation law’ is one of the standardized dissolution events provided in the *sukuk* documents. Therefore, it may give rise to legal risks in the *sukuk*. Nonetheless, this was not found from the analysis of the 24 documents. Only ‘changes in laws’ was found to be included under the DEC in 6.B. Other than this, changes in taxation laws were also included in the disclosure of compliance risk (CR1) as seen in 17.A. These will be elaborated in the next section.

Under the second aspect, i.e., legal risks arising from the legal perspectives of *sukuk* contract, there are four types of legal risks in *wakalah sukuk* according to the participants. The legal risks are those associated with the *sukuk* structuring, documentation (*ex ante*), enforceability (*ex post*), and investors’ protection. For *sukuk* structuring, LA1 and SA1 were of the opinion that the risks are those related to the ‘workability’ of the structure. In view of these, SA1 has emphasized on the risks that the structure may not allocate the intended interests of the parties, e.g. the profits, recourse etc. In a similar vein, LA1 also emphasized the risk that the structure may not work or there could be legal issues surrounding the structure. As part of these risks, LA1 explained that the risks may also be those related to the investor’s protection, that the *sukuk* structure has not been able to secure the interests of the investors.

In addition, LA1, LA2, and SA1 were of the view that legal risks in *wakalah sukuk* were also those risks associated with the documentation of the *sukuk*. LA1 explained further by underscoring the risk of inaccurate disclosure particularly of the documents issued to the investors.

“Even apart from the substantive legal risks. The first one is the risk of accurate disclosure to documents that go out to the investors. And then, the risk of Shariah compliance a, and then the substantive legal risks with the documents themselves, meaning the structure, how the structure works and what are legal issues that come along with the structure. And then, with instrument like this, there a risk of default. The issuer’s default and how the documents protect the investors, what sort of recourse they have, you know, and whether there will be any issue at the enforcement of the documents, especially the securities documents. So, those are legal risks associated with *sukuk*, I mean any type of *sukuk* including *sukuk wakalah*”.

SA1 also shared similar views when she highlighted the risk that the *sukuk* documents do not capture the intended structure of the *sukuk* and the intended recourse. LA2 employed the term ‘transactional legal risk’ to underline the legal risks associated with the documentation of the *sukuk*. However, according to him, the risks are not just those related to documentation of the *sukuk*, e.g., failure to capture the intended recourse, profit amount, etc., but also the risk that the provisions in the *sukuk* documents may become unenforceable. The unenforceability of the *sukuk* documents as part of the *sukuk* legal risk was also mentioned by LA1, LA2, and SA2. This type of risk was also evident in the literature as noted by Djojosedjito (2008c).

As indicated in Chapter 5, some legal risks are operational in nature. These refer to the risks that stem from poor organizational management that give rise to legal issues. Based on Figure 14, there are four types of legal risks perceived by the participants. They fall under the third aspect, i.e., legal risks arising from the operation of the *sukuk*. They are Shariah non-compliance risk, default risk, business risk, and credit risk. According to LA1, LA2, SA1, and PA/LA1, legal risks are risks related to Shariah non-compliance of the *sukuk*. They perceived SNCR as legal risks of *sukuk* because failure to comply with Shariah will bring legal implications. For instance, it can cause the contract to be void (PA/LA1) and may lead to legal suits (ST1). However, LA2

elaborated that there could be situations where SNCR can be a legal risk, and other situations where SNCR is not a legal risk. He said:

“However, factually and operationally, SNCR and legal risk are intertwined, related. This means, theoretically they are not related but in practice, they can be related.”

Legal risk in *sukuk* was also associated with default risk (CRA1, LA1). In supporting her view, CRA1 stressed on the difference between payment obligation arising from *sukuk* contract and those arising from a regular loan or financing contract. According to her, timeliness in the payment obligation in *sukuk* is very important because failure to meet the payment timeline may result in *sukuk* default. Legal risk was also associated with credit risk and business risk of the issuer (CRA1). She explained further by stating that some legal risks may manifest into credit risk. Besides this, she was also of the view that business risk is one of the legal risks in *sukuk*. She said:

“How will legal risk manifest into credit risk? There are a few ways. I think typically we will take the recent COVID as an example, right? And you have overarching regulations, you know, suddenly MCO and moratorium on loans, that it [*they*] affected the credit, so it depends on what credit you are looking at. One, of course, it is a business risk, an external risk that how it fits into the credit that we are looking at, right? One is, stop work order, .. in those kind of scenarios, what is critical is the balance sheet of the company, are they able to ride through that period of uncertainty or the standstill, for them to be able to do that? Of course when it comes to certain legal requirements, for example, what happens after the extension of time, particularly for projects under construction? Then it becomes the question of what are my remedies.”

Thus, she considered both credit risk and business risk to be types of legal risk. Based on previous discussion in Chapter 3, Rubock (2010) has mentioned this as well. He has assumed the creditworthiness of contracting parties, i.e., credit risk, to be part of legal risk. The view of CRA1 was plausible since she was of the opinion that default

risk was a legal risk in *sukuk*. Considering her position as a credit rating agency representative who evaluates the credibility of an issuer based mostly on its financial position, the inclusion of these risks as legal risks in *wakalah sukuk* is plausible.

Based on these findings, it can be concluded that several participants shared similar views on legal risks in *wakalah sukuk*. They can be summarized into five types of risks:

- 1) risks associated with *sukuk* legal framework (LA1, LA2 and SA1);
- 2) risks associated with *sukuk* structure (LA1 and SA1);
- 3) risks associated with *sukuk* documentation (LA1, LA2 and SA1) including unenforceability risk (LA1 and SA2);
- 4) SNCR (LA1, LA2, SA1, ST1, PA/LA1); and
- 5) default risk (LA1 and CRA1).

The other four legal risks were perceived individually by the participants. These were changes in taxation law risk (CRA1), credit risk (CRA1), business risk (CRA1), and risks associated with investor protection (LA1). These findings indicated that there was more consensus among the views of the legal advisers and the Shariah advisers (internal advisers) about legal risks in *sukuk* than the views of principal advisers, *sukuk* trustees and credit rating agency representatives. This may be due to the fact that the former are more involved in the structuring and documentation of *sukuk* compared to the latter. It may be assumed that more similar views could have been sought from the *sukuk* principal adviser/ lead arranger. However, the interview with the PA/LA was conducted in written form, thus only written responses were obtained for each interview question. Hence, the findings are limited.

However, most importantly, the findings revealed that most of the participants have perceived legal risks in *wakalah sukuk* as similar legal risks prevalent in any type of *sukuk*. For instance, it was noted from LA1's responses that these legal risks are prevalent in any type of *sukuk*. Based on these responses, it was also noted that the legal risks mentioned were not distinguished between those prevalent in *wakalah sukuk* and those prevalent in any other *sukuk*. Therefore, the following section will discuss only legal risks that are specifically prevalent or associated with *wakalah sukuk* in Malaysia.

7.3.3 Legal Risks Specifically Associated with *Wakalah Sukuk* in Malaysia.

While two of the participants perceived the legal risks to be similar for any *sukuk* structure, four other participants have elaborated on another four types of legal risks:

- 1) purchase undertaking risk;
- 2) risk associated with *wakalah sukuk* framework (including unenforceability risk);
- 3) risk associated with the principal-agent relationship; and
- 4) negligence risk.

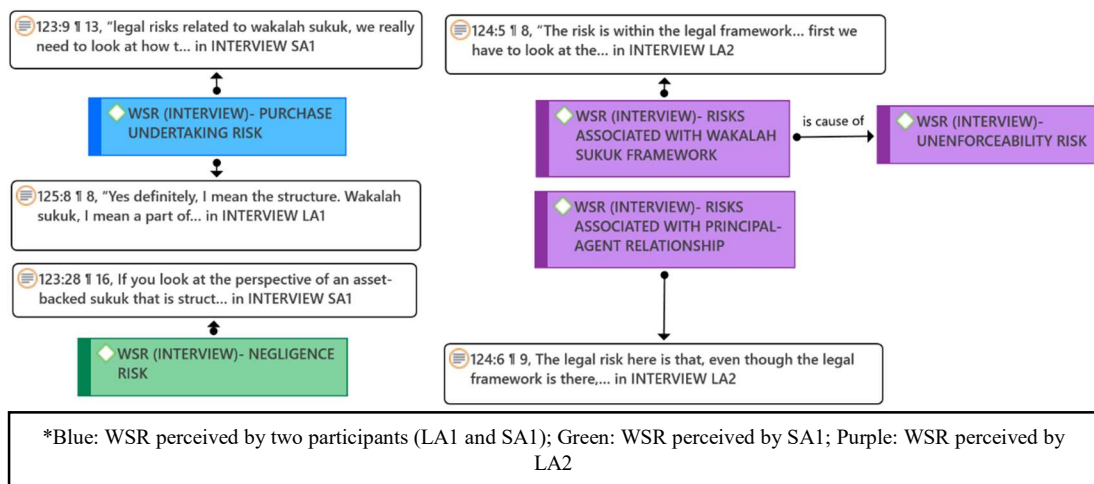


Figure 7.3 Legal Risks Specific to Wakalah Sukuk

Based on Figure 17 above, the first legal risk was the purchase undertaking risk (SA1 & LA1). As pointed out by SA1, the risk is concerned with whether the investors have a recourse against the issuer for the exercise price. While emphasizing the risk, LA1 explained that this risk is linked to the pricing of the underlying asset for purchase undertaking, mechanisms that are available should the asset no longer exist, the effects of the issuer company's liquidation, and the pricing of the underlying assets that are affected by the liquidation. In his response, LA1 gave an example of transaction risk, i.e., purchase undertaking document that is not signed by the investors. He said:

"Yes definitely, I mean the structure. *Wakalah sukuk*, I mean a part of the structure is the purchase undertaking, the buying back of the Shariah compliant business or the asset that you have purchased right, so there are risks associated with it... how do you price that, what happens if the asset doesn't exist anymore, what happens if the company goes into liquidation, would that mean that the business value should be zero, or should be fire sale value, in which case how would the investors be able to prove that debt for the full amount they want to get, the possibility of the purchase undertaking to be at a fixed price, in and out loud, so how do I provide investors' recourse la, and the purchase undertaking if he does not sign the document at that time, because in a default situation, it would not be helpful la, most likely."

In addition to these, LA2 perceived two types of legal risks specifically associated with *wakalah sukuk*. The first risk is the risk that originated from the *wakalah sukuk* legal framework. According to LA2, the legal framework for *wakalah sukuk* is quite loose that it can create confusion among the practitioners of the very nature of the structure employed by the issuer. For instance, in the case of *wakalah sukuk* using the structure of *wakalah* and *murabahah*, the structure is merely called a *wakalah sukuk* structure. As a result, practitioners may draft the documents differently or wrongly.

LA2's view on this was further elaborated pursuant to risks related to the contractual obligations of the parties in the *sukuk*. In delineating this risk, LA2 said that the contractual obligations arising from *wakalah* contract is a principal-agent relationship. However, the embedment of *murabahah* contract within the *wakalah* structure may blur the relationships. Furthermore, it was also contended by LA2 that the intentions of the parties (e.g., bank as principal and issuer as agent) are not to undertake all the fiduciary duties arising from the *wakalah* contract even though that is what the *wakalah* contract entails. In his view, he doubted that the banks are ready to undertake all the fiduciary duties arising from the contract. He pinpointed that the legal framework is silent on the matter. He further expressed his concern on the subsequent legal risk, i.e., unenforceability risk. He said:

“...other than that, all actions that carry liabilities, triggered by the *wakil*, he must take responsibility, and unfortunately all of these are not covered under the legal framework. These are legal risks, in fact they are commercial risks... If we don't manage these risks, they become financial risks. ...later when it can't be enforced, they will be mad at me (laughing). Enforceability is a legal risk, I have settled the documentation, but I can't guarantee its enforceability because it is influenced by the legal framework... the framework is there but it is quite loose.”

Another type of legal risk specifically associated with *wakalah sukuk* was underscored by SA1. She said, from the perspective of asset-backed *sukuk*, where the recourse is the underlying asset, there is a possibility of negligence risk. This risk may arise when the agent/issuer mismanages the investment portfolio that results in non-performance of the portfolio. SA1 said:

“If you look at the perspective of an asset-backed *sukuk* that is structured under *wakalah*, you rely solely on the performance of the underlying asset, because it’s a true sale, in that respect, if the *wakil*, in the event of negligence or underperformance, that legal risk (negligence) is possible... it could be a situation where the *wakil* mismanage the investment portfolio, or there is negligence that resulted in non-performance of the asset.. in ABS, the *wakil*’s roles in managing the *wakalah* portfolio is critical.”

In Chapter 4, under Section 4.4.4, negligence risk was discussed as one of the legal risks in *wakalah sukuk* as well. However, the gist of the discussion was heavily focused on the amount of indemnity to be borne by the parties involved in case of negligence, who will be liable to pay the indemnity, as well as what proportions of indemnity to be decided. With reference to the *Pesaka sukuk* case (*murabahah sukuk*), the questions of liabilities and indemnity may be more significant for *wakalah sukuk* where the relationship between the investors and the issuer is of principal-agent that carry beyond contractual obligations. Other than these, in a similar section, one of the hypothetical *wakalah sukuk* legal risks also highlighted the unique relationship of the parties in *wakalah sukuk*, namely that of *wakil* and *muwakkil*. This was supported by LA2’s responses, that their relationship may create legal risk specifically for *wakalah sukuk*.

In view of these findings, it was found that there are a few legal risks that are specifically associated with *wakalah sukuk*. In sum, these legal risks are those arising from:

- 1) the nature of *wakalah* contract that establishes the principal-agent relationship;
- 2) the structure of *wakalah sukuk* that provides purchase undertaking arrangement; and
- 3) *Wakalah sukuk* regulatory framework (regulatory risk).

In addition, not only was the legal risk specifically associated with *wakalah sukuk* not acknowledged by all participants, similar views among those who do acknowledge it cannot be determined. Each of the participants held different opinions in regards to legal risks in *wakalah sukuk*.

7.3.4 Legal Risks in Wakalah Sukuk Documents

Table 7.2 Descriptive Analysis of Legal Risks in Wakalah Sukuk Documents

| | IM/PTC* Gr=491; GS=24 | | TD Gr=183; GS=22 | | Totals | |
|-------------------------------|--------------------------|------------------|---------------------|------------------|----------|------------------|
| | Absolute | Row- relative | Absolute | Row- relative | Absolute | Row- relative |
| SNCR Gr=64; GS=3 | 46 | 71.87% | 18 | 28.13% | 64 | 100.00% |
| RR Gr=193; GS=12 | 171 | 88.60% | 22 | 11.40% | 193 | 100.00% |
| CR Gr=24; GS=5 | 21 | 87.50% | 3 | 12.50% | 24 | 100.00% |

| | IM/PTC* Gr=491; GS=24 | | TD Gr=183; GS=22 | | Totals | |
|----------------------------|--------------------------|------------------|---------------------|------------------|----------|------------------|
| | Absolute | Row- relative | Absolute | Row- relative | Absolute | Row- relative |
| LU Gr=9; GS=2 | 9 | 100.00% | 0 | 0.00% | 9 | 100.00% |
| Totals | 248 | 85.17% | 43 | 14.83% | 290 | 100.00% |

*For Issuer13, Issuer15 and Issuer24, the IMs were not available. As a result, document analysis was conducted on their PTCs.

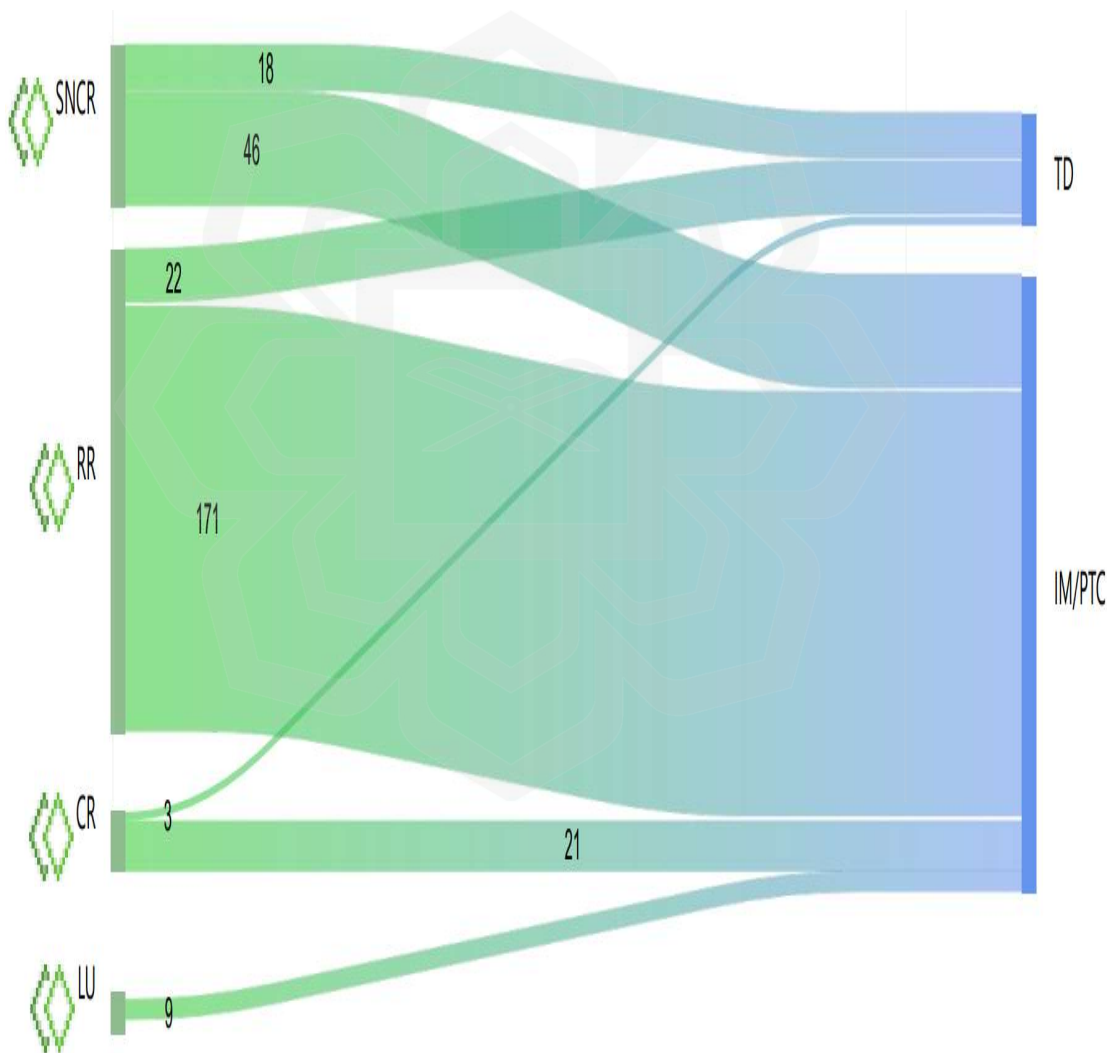


Figure 7.4 Code Document Analysis of Legal Risks in Wakalah Sukuk Documents

Table 7.3 Legal Risks Disclosed by 24 Issuers

| NO. | | SNCR | | RR | | CR | | LU | | Totals | |
|-----|-----------------|-------------|--------------|---------------|--------------|-------------|--------------|------------|--------------|----------|--------------|
| | | Gr=64; GS=3 | | Gr=193; GS=12 | | Gr=24; GS=5 | | Gr=9; GS=2 | | | |
| | | Absolute | Row-relative | Absolute | Row-relative | Absolute | Row-relative | Absolute | Row-relative | Absolute | Row-relative |
| 1. | ISSUER1 | 1 | 20.00% | 4 | 80.00% | 0 | 0.00% | 0 | 0.00% | 5 | 100% |
| 2. | ISSUER2 | 1 | 8.30% | 10 | 83.30% | 1 | 8.30% | 0 | 0.00% | 12 | 100% |
| 3. | ISSUER3 | 3 | 20.00% | 11 | 73.30% | 1 | 6.70% | 0 | 0.00% | 15 | 100% |
| 4. | ISSUER4 | 3 | 18.80% | 12 | 75.00% | 1 | 6.30% | 0 | 0.00% | 16 | 100% |
| 5. | ISSUER5 | 2 | 20.00% | 7 | 70.00% | 1 | 10.00% | 0 | 0.00% | 10 | 100% |
| 6. | ISSUER6 | 1 | 11.10% | 7 | 77.70% | 1 | 11.10% | 0 | 0.00% | 9 | 100% |
| 7. | ISSUER9 | 2 | 28.57% | 5 | 71.43% | 0 | 0.00% | 0 | 0.00% | 7 | 100% |
| 8. | ISSUER11 | 2 | 15.38% | 9 | 69.23% | 2 | 15.38% | 0 | 0.00% | 13 | 100% |
| 9. | ISSUER12 | 4 | 33.33% | 7 | 58.33% | 1 | 8.33% | 0 | 0.00% | 12 | 100% |
| 10. | ISSUER13 | 4 | 44.40% | 4 | 44.44% | 0 | 0.00% | 1 | 11.11% | 9 | 100% |
| 11. | ISSUER14 | 5 | 27.78% | 11 | 61.11% | 2 | 11.11% | 0 | 0.00% | 18 | 100% |
| 12. | ISSUER15 | 2 | 100.00% | 0 | 0.00% | 0 | 0.00% | 0 | 0.00% | 2 | 100% |
| 13. | ISSUER16 | 4 | 23.53% | 11 | 64.71% | 2 | 11.76% | 0 | 0.00% | 17 | 100% |
| 14. | ISSUER17 | 0 | 0.00% | 5 | 83.30% | 0 | 0.00% | 1 | 16.70% | 6 | 100% |
| 15. | ISSUER18 | 2 | 20.00% | 6 | 60.00% | 0 | 0.00% | 2 | 20.00% | 10 | 100% |

| NO. | | SNCR | | RR | | CR | | LU | | Totals | |
|-----|-----------------|-------------|---------------|---------------|---------------|-------------|--------------|------------|--------------|------------|--------------|
| | | Gr=64; GS=3 | | Gr=193; GS=12 | | Gr=24; GS=5 | | Gr=9; GS=2 | | Absolute | Row-relative |
| | | Absolute | Row-relative | Absolute | Row-relative | Absolute | Row-relative | Absolute | Row-relative | | |
| 16. | ISSUER19 | 4 | 33.30% | 6 | 50.00% | 0 | 0.00% | 2 | 16.70% | 12 | 100% |
| 17. | ISSUER20 | 1 | 3.30% | 27 | 90.00% | 2 | 6.70% | 0 | 0.00% | 30 | 100% |
| 18. | ISSUER21 | 4 | 16.70% | 17 | 70.80% | 3 | 12.50% | 0 | 0.00% | 24 | 100% |
| 19. | ISSUER22 | 3 | 37.50% | 4 | 50.00% | 1 | 12.50% | 0 | 0.00% | 8 | 100% |
| 20. | ISSUER24 | 0 | 0.00% | 0 | 0.00% | 0 | 0.00% | 0 | 0.00% | 0 | 100% |
| 21. | ISSUER25 | 2 | 20.00% | 5 | 50.00% | 1 | 10.00% | 2 | 20.00% | 10 | 100% |
| 22. | ISSUER27 | 4 | 26.70% | 9 | 60.00% | 1 | 6.70% | 1 | 6.70% | 15 | 100% |
| 23. | ISSUER30 | 2 | 28.60% | 2 | 28.60% | 3 | 42.90% | 0 | 0.00% | 7 | 100% |
| 24. | ISSUER32 | 8 | 34.80% | 14 | 60.90% | 1 | 4.30% | 0 | 0.00% | 23 | 100% |
| | Totals | 64 | 22.07% | 193 | 66.55% | 24 | 8.28% | 9 | 3.10% | 290 | 100% |

* For Issuer 24, document analysis was conducted on the TD and PTC. However, there is no disclosure of risk. Most legal risks grounded from TD were those disclosed under the Dissolution Event Clause (DEC). Nonetheless, the DEC for Issuer 24 is not evident but the DEC was replaced with Enforcement Events Clause that had no legal risk disclosure.

Table 7.4 Legal Risks Disclosed by 24 Issuers by Year

| | SNCR | | RR | | CR | | LU | | Totals | |
|---------------------------|-------------|------------------|---------------|------------------|-------------|------------------|------------|------------------|----------|------------------|
| | Gr=64; GS=3 | | Gr=193; GS=12 | | Gr=24; GS=5 | | Gr=9; GS=2 | | | |
| | Absolute | Row- relative | Absolute | Row- relative | Absolute | Row- relative | Absolute | Row- relative | Absolute | Row- relative |
| SUKUK 2016 (2-8) | 2 | 11.77% | 14 | 82.35% | 1 | 5.88% | 0 | 0.00% | 17 | 100.00% |
| SUKUK 2017 (4-14) | 10 | 27.78% | 22 | 61.11% | 2 | 5.56% | 2 | 5.56% | 36 | 100.00% |
| SUKUK 2018 (2-6) | 4 | 8.70% | 39 | 84.78% | 3 | 6.52% | 0 | 0.00% | 46 | 100.00% |
| SUKUK 2019 (2-6) | 2 | 20.00% | 5 | 50.00% | 1 | 10.00% | 2 | 20.00% | 10 | 100.00% |
| SUKUK 2020 (11- 36) | 33 | 24.26% | 86 | 63.24% | 12 | 8.82% | 5 | 3.68% | 136 | 100.00% |
| SUKUK 2021 (3-11) | 13 | 28.89% | 27 | 60.00% | 5 | 11.11% | 0 | 0.00% | 45 | 100.00% |
| Totals | 64 | 22.07% | 193 | 66.55% | 24 | 8.28% | 9 | 3.10% | 290 | 100.00% |

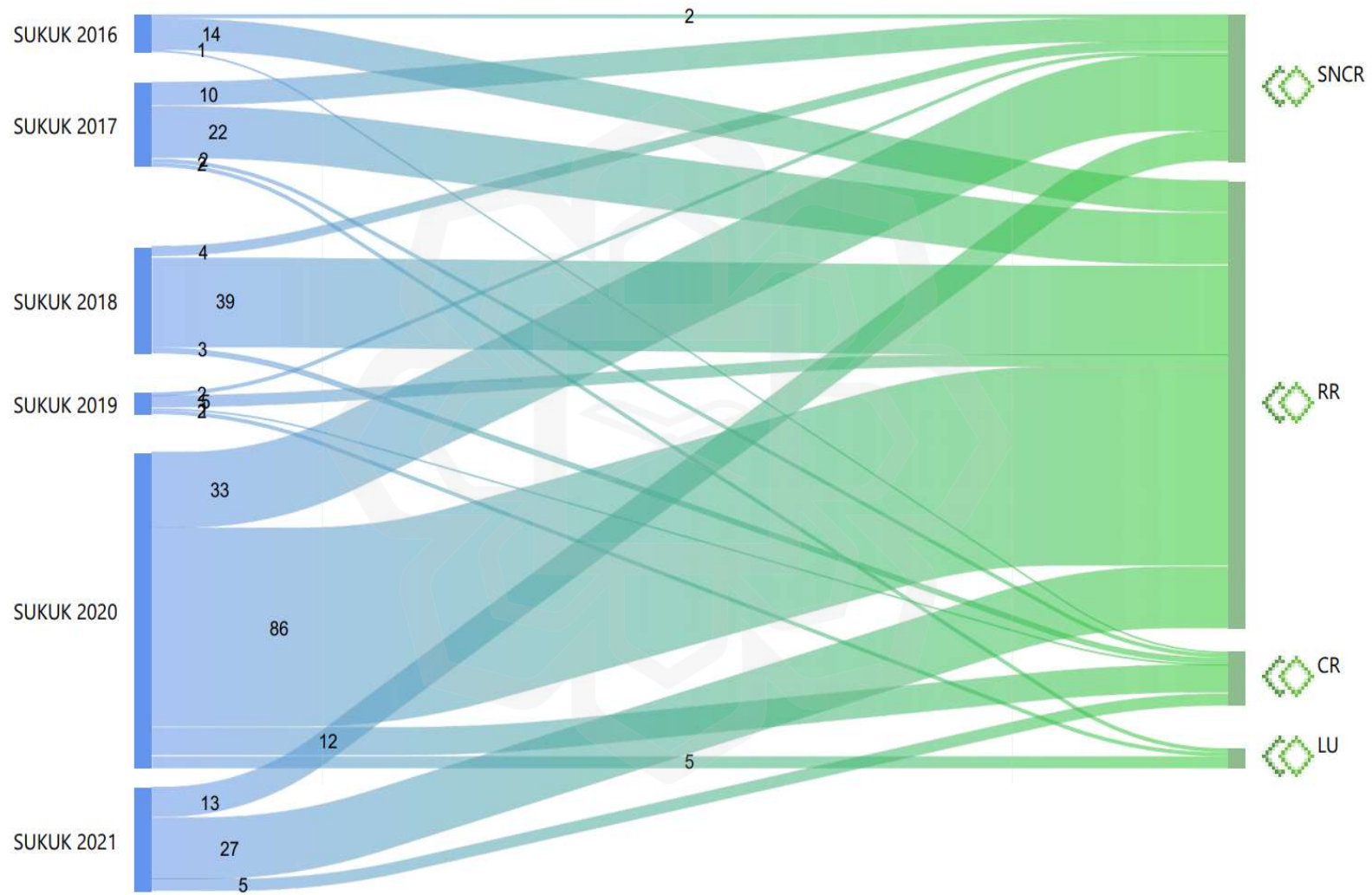


Figure 7.5 Legal Risks in 24 Wakalah Sukuk Documents by Year

Table 7.5 Legal Risks in 24 Wakalah Sukuk Documents by Issuer's Industry

| | SNCR | | RR | | CR | | LU | | Totals | |
|---|-------------|--------------|---------------|--------------|-------------|--------------|------------|--------------|----------|--------------|
| | Gr=64; GS=3 | | Gr=193; GS=12 | | Gr=24; GS=5 | | Gr=9; GS=2 | | Absolute | Row-relative |
| | Absolute | Row-relative | Absolute | Row-relative | Absolute | Row-relative | Absolute | Row-relative | | |
| ISSUER AGRICULTURE INDUSTRY | 6 | 42.86% | 7 | 43.75% | 1 | 6.25% | 0 | 0.00% | 14 | 100.00% |
| ISSUER AUTOMOTIVE INDUSTRY | 2 | 20.00% | 6 | 60.00% | 0 | 0.00% | 2 | 20.00% | 10 | 100.00% |
| ISSUER CONSTRUCTION & MANUFACTURING INDUSTRY | 4 | 14.29% | 22 | 78.57% | 2 | 7.14% | 0 | 0.00% | 28 | 100.00% |
| ISSUER CONSUMER GOODS INDUSTRY | 5 | 20.83% | 16 | 66.67% | 2 | 8.33% | 1 | 4.17% | 24 | 100.00% |
| ISSUER FINANCIAL INSTITUTIONS | 13 | 33.33% | 19 | 48.72% | 2 | 5.13% | 5 | 12.82% | 39 | 100.00% |
| ISSUER OIL, GAS & PETROCHEMICAL INDUSTRY | 4 | 26.67% | 9 | 60.00% | 1 | 6.67% | 1 | 6.67% | 15 | 100.00% |
| ISSUER POWER GENERATION INDUSTRY | 13 | 13.68% | 74 | 77.89% | 8 | 8.42% | 0 | 0.00% | 95 | 100.00% |

| | SNCR | | RR | | CR | | LU | | Totals | |
|---|-------------|--------------|---------------|--------------|-------------|--------------|------------|--------------|----------|--------------|
| | Gr=64; GS=3 | | Gr=193; GS=12 | | Gr=24; GS=5 | | Gr=9; GS=2 | | | |
| | Absolute | Row-relative | Absolute | Row-relative | Absolute | Row-relative | Absolute | Row-relative | Absolute | Row-relative |
| ISSUER PROPERTY AND RECREATION RELATED | 16 | 26.67% | 36 | 60.00% | 8 | 13.33% | 0 | 0.00% | 60 | 100.00% |
| ISSUER SUPRANATIONAL BODY | 1 | 20.00% | 4 | 80.00% | 0 | 0.00% | 0 | 0.00% | 5 | 100.00% |
| TOTAL | 64 | 22.07% | 193 | 66.55% | 24 | 8.28% | 9 | 3.10% | 290 | 100.00% |

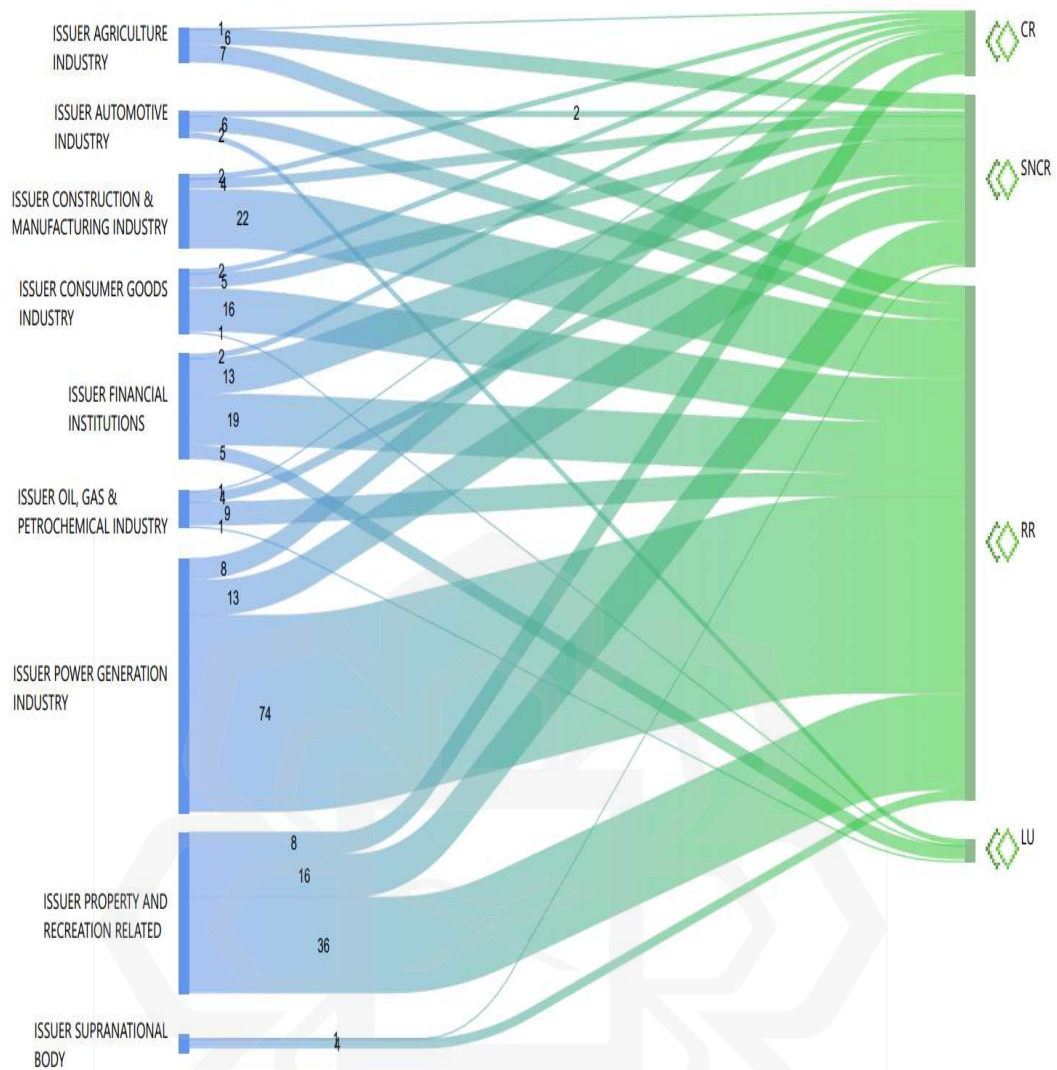


Figure 7.6 Legal Risks in 24 Wakalah Sukuk Documents by Issuer's Industry

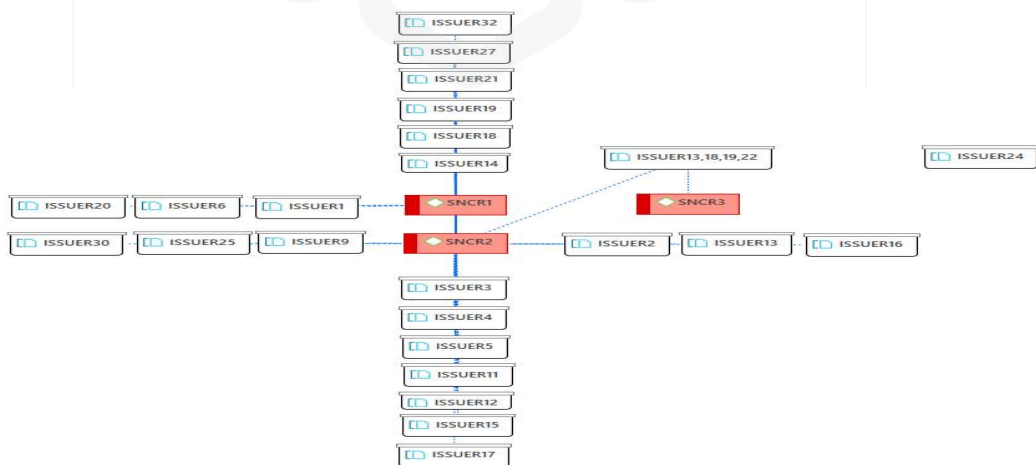


Figure 7.7 Network Analysis of 3 SNCRs in 24 Wakalah Sukuk Documents

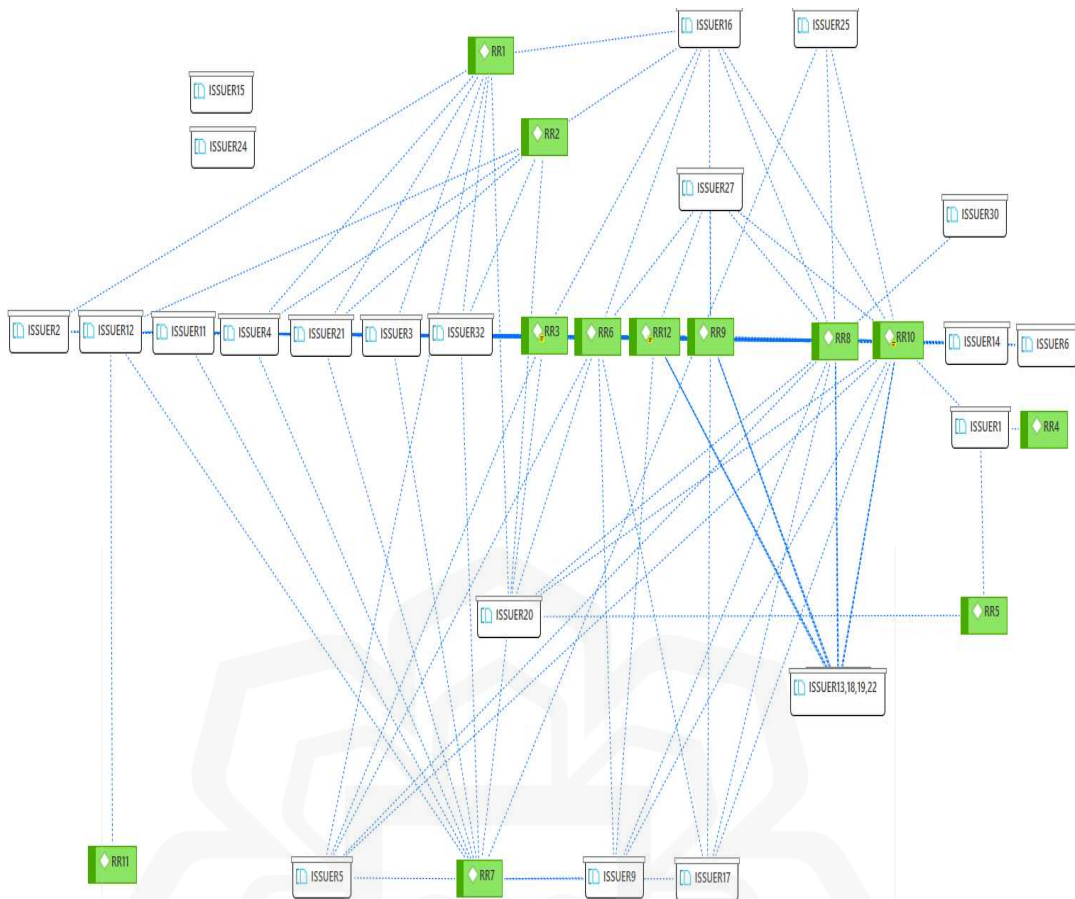


Figure 7.8 Network Analysis of 12 RR in 24 Wakalah Sukuk Documents

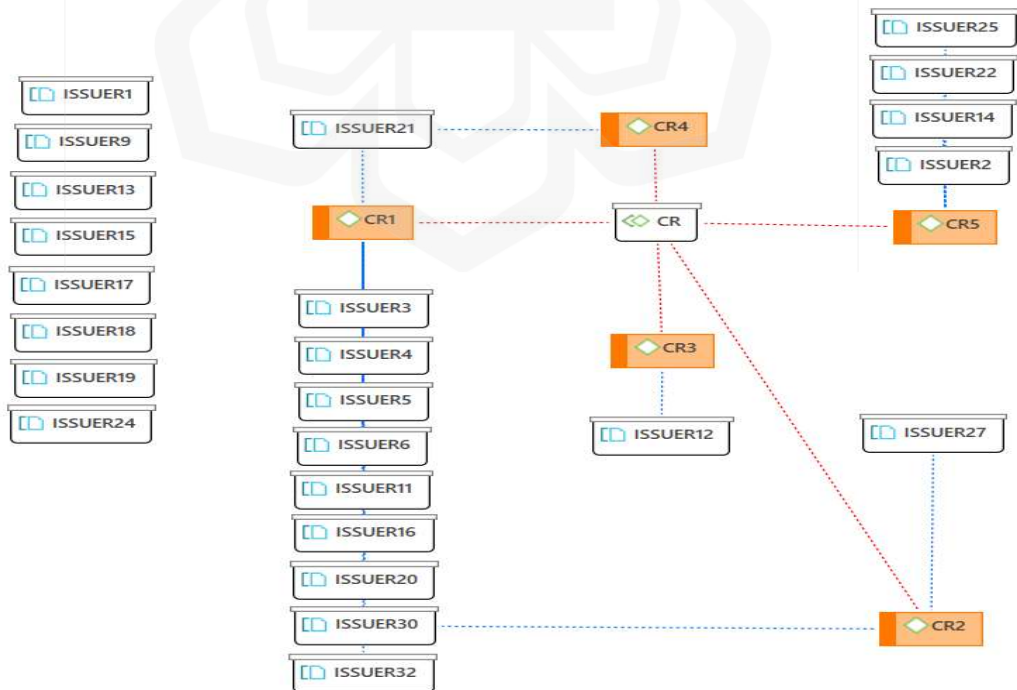


Figure 7.9 Network Analysis of 3 CR in 24 Wakalah Sukuk Documents

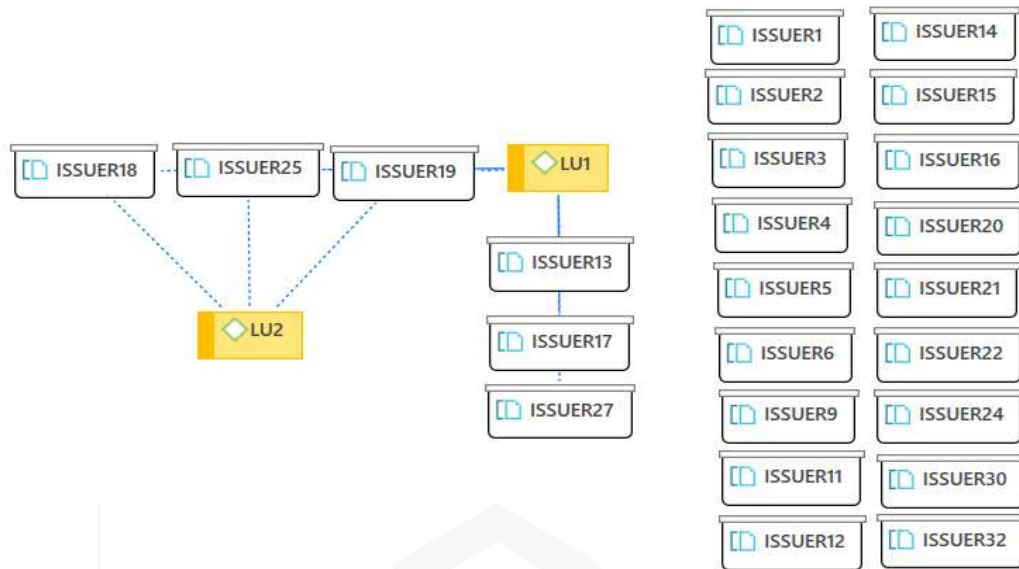


Figure 7.10 Network Analysis of 2 LU in 24 Wakalah Sukuk Documents

Based on Figure 25 below, there are 22 codes, i.e., legal risks that have been identified. To produce a more beneficial visualization of the findings, the 22 legal risks have been put into four groups, as follows:

- 1) Shariah Non-Compliance Risk (SNCR) (1-3);
- 2) Regulatory Risk (RR) (1-12);
- 3) Compliance Risk (CR) (1-5); and
- 4) Legal Uncertainty (LU) (1-2).

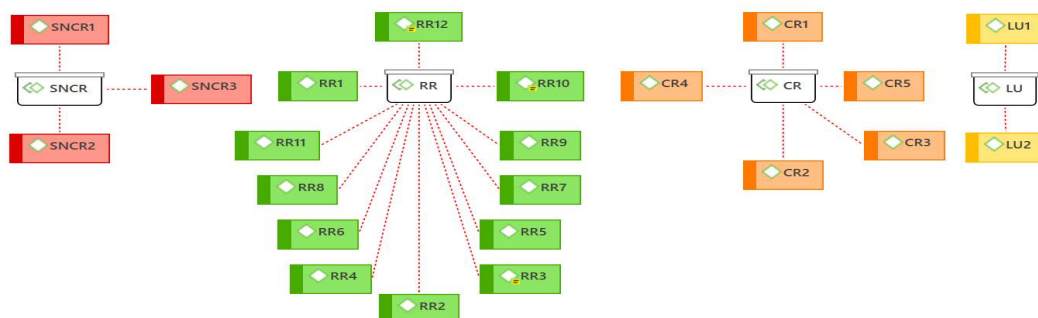


Figure 7.11 Network of Four Groups of Legal Risks

Legal risks disclosed in the *wakalah sukuk* documents are presented descriptively in Tables 6, 7, 8, and 9. Visualization of the legal risks disclosed in the documents is also presented through the four types of legal risks as indicated in Figure 23. Details of disclosures are presented in Figures 18, 19, 20, 21, 22, 23, and 24.

Based on Table 6, it was found that regulatory risk is the most frequently disclosed legal risk in the *wakalah sukuk* documents, with 88.6% disclosure in the IM over the total risk. However, the most frequently disclosed legal risk in the TD is the Shariah non-compliance risk. The legal uncertainty group is the least frequently disclosed in the *wakalah sukuk* documents. At the same time, it can be observed that all categories of risks are mostly disclosed in the IM at 85.2%, compared to their disclosure in TD, at only 14.8%. Visualization of the disclosures in the *sukuk* documents is also presented through Figure 18.

Apart from the distribution of legal risk categories disclosure within the *sukuk* documents, there are also different frequencies of legal risk disclosure among the 24 issuers. Issuer 20, Issuer 21, and Issuer 32 are among the issuers with the highest frequency of disclosed legal risks, at frequencies of 30, 24 and 23, respectively. Issuer 15, Issuer 1, Issuer 17 have reported the three lowest frequencies, at 2, 5, and 6, respectively. These are evident in Table 7.

Based on Table 8 and Figure 19, the disclosure of legal risk was analyzed according to the year of *sukuk* issuance. The findings indicate that the highest level of disclosure of legal risk is evident in *wakalah sukuk* issued in 2020. However, it is notable that the *sukuk* documents for 2020 are of the highest quantity, i.e. 36 documents from 11 issuers, compared to other years' *sukuk* documents. Compared to other years, i.e., 2016, 2018, and 2019, there were only 2 *wakalah sukuk* documents that were available for each year. For 2021, the cutoff date for the data collection was May 2021.

Thus, only 3 *wakalah sukuk* documents were collected for this analysis, due to the availability of the IM and TD for these three *sukuks*.

Table 9 shows legal risk disclosure according to the type of issuers' main business activity or industry. It was found that issuers of industry related to power generation have disclosed more risks compared to other issuers. The issuer with the least disclosed legal risks is Islamic Development Bank (IDB). This issuer was not regarded as a financial institution because it is a supranational body, of which it was found that some of the legal risks disclosed are different from others, particularly for RR4. Disclosures according to the issuers' industry are also presented in Figure 20.

These disclosures showed that there are four types of legal risk documented in the *wakalah sukuk*. While some of the risks were disclosed more than others, the legal risks remain inherent in the *wakalah sukuk*. Differences in terms of the legal risk disclosures between the issuers, or the different industries of the issuers, may be due to the fact that some of these risks are prevalent in certain businesses or industries compared to others.

Based on Figure 21 above, the disclosure of SNCR by most issuers is evident. This disclosure is supported by the regulatory requirements of Shariah compliance in *sukuk* as stated in Division 2, Chapter 12, para 12.04 of the Prospectus Guidelines. Findings of non-disclosure of SNCR by Issuer 24 was due to the unavailability of its IM. There are three types of SNCRs in the *wakalah sukuk*, as follows (reference can be made to Table 6.1. for the list of codes):

- 1) Shariah Non-Compliance Risk (SNCR):
 - i. **(SNCR1) Shariah Non-Compliance Risk (Court's Interpretation):**
Risks associated with the Court's examination of the *wakalah sukuk* in

terms of Shariah compliance, notwithstanding confirmation/certification given by the Shariah Adviser. This risk is usually disclosed in the *sukuk* IC of the IM, particularly in the clause “Risks related to the *wakalah sukuk*”.

ii. **(SNCR2) Shariah Non-Compliance Risk (Scholar’s Interpretation):**

Risks that the Shariah compliance of the *wakalah sukuk* is subject to differences of opinion among the scholars, and differing interpretations by Shariah scholars, Shariah supervisory and advisory boards, or any arbitral tribunal. This risk is usually disclosed in the *sukuk* IN or Statement of Responsibilities, and IC of the IM, particularly in the clause “Risks related to the *wakalah sukuk*”.

iii. **(SNCR3) Shariah Non-Compliance Risk (Issuer’s Compliance):**

Risks associated with the issuer’s compliance with Shariah. It is stated in the IM that the issuer has adopted a comprehensive Shariah compliance framework and that all Shariah-related risks have been adequately mitigated. However, the issuer gives no assurance that such framework will remain adequate or effective in the future. Hence, a Shariah non-compliance risk does exist. This risk is usually disclosed in the *sukuk* IC of the IM, particularly under the clause “Risks related to the Issuer”.

Based on Figure 22 above, most of the issuers have disclosed Regulatory Risk (RR) in their documents. Non-disclosure of RR was only found in the case of Issuer 15 and Issuer 24. This is due to the unavailability of the Issuers’ IM on the website (Details of the Issuers are provided in Appendix I). For others, it was found that there are 12 types of RRs in *wakalah sukuk*. Details are as follows:

2) Regulatory Risk (RR)

- i. **(RR1) Security Realization Risk:** Risk that the enforcement and realization of security upon Dissolution Events by Security Agent is not guaranteed due to unforeseeable changes in governmental rules and regulations. This includes the realization value of the security. These risks may be due to numerous factors, including the laws itself, e.g., changes in governmental rules and regulations etc. that are beyond the control of the issuer or the Security Agent.
- ii. **(RR2) Legal Charge Risk:** Creation of legal charge over the charged assets or perfection of security under the *sukuk* is subject to approval of the state authority. Therefore, there is a risk that the charge may not be registered to the Security Agent to secure the rights of the *sukuk* holders. Similarly, the creation of legal charge may also not be perfected yet due to certain limitations, e.g., the charged redemption is still due to the existing financiers and will only be perfected during the interim period after the *sukuk* issuance, as seen in 32.A., also the charge may not be perfected due to injunction by third party who may allege fraud, as seen in 2.A.
- iii. **(RR3) Risks Relating to Laws on Compulsory Acquisition and the Like:** The issuer may be subject to compulsory laws, e.g., Land Acquisition Act 1960 that may force the issuer/ project company to relocate and this will have adverse effects on revenue and cash flow, hence affect payments to the *sukuk* holders. At the same time, certain projects funded through *wakalah sukuk* require the acquisition of land. For instance, when the project involves design and construction of expressway, there are risks that the land involved is privately owned land which acquisition is subject to the Land

Acquisition Act 1960 with compensation to be paid to the owner. At the same time, there could be delays attributed to the land acquisition itself. These create legal risks to the *sukuk* holders.

- iv. **(RR4) Enforcement Risk:** Risk that the legal enforcement is not capable of being executed. Notwithstanding the agreed governing laws and court of jurisdiction, this risk is inherent in a few aspects:
 - a. Jurisdiction of the issuer/obligor to be subjected to the Malaysian court's judicial decisions;
 - b. Limited assets/inaccessibility of assets due to differing jurisdictions to be subjected to the Malaysian court's judicial decisions; and
 - c. Immunity of issuer/obligor assets from seizure, attachment, or execution before the delivery of the Malaysian court's final judicial decisions.

This risk was only found in 1.A., an issuer that is a supranational body

- v. **(RR5) Claims for Specific Enforcement Risk:** Risks that specific enforcement claims that are brought against the issuer/obligor may be subject to the discretionary powers of the Court, e.g., in deciding the quantum of damages. This includes the damages agreed in embedded contracts, i.e., contracts between the issuer and contractor/sub-contractor to be challenged by the latter. This risk was only found in 1.A., an issuer that is a supranational body.
- vi. **(RR6) Licensing Risk:** Risk in obtaining/renewing/acquiring additional license/ permit/ authorization/ certification for issuer to operate. The issuer is subject to conditions set by relevant regulatory body that may affect its

existing compliance. This may lead to expiration, suspension, revocation, or delay in issuer's license/operation.

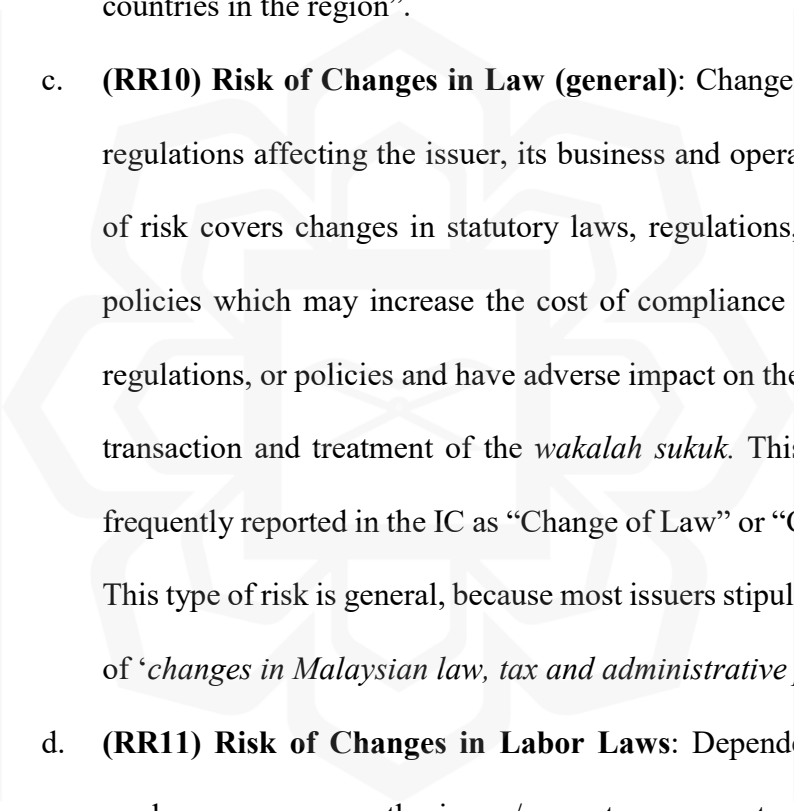
vii. **(RR7) Health, Safety and Environmental Laws Risk:** Risks associated with health, safety, and environmental laws. For some issuers, these risks cover many aspects e.g., laws pertaining to water, air, noise pollution, and the disposal of waste materials. Changes in environmental laws or standards imposed by the relevant regulatory body may lead to changes in costs or revenue of the issuer. This is particularly apparent when the laws or standards become more stringent in the future.

viii. **Regulatory Risk related to Changes in Laws:** There are four types of risks related to changes in regulatory conditions or laws, as disclosed in the *wakalah sukuk* documents. The risks are as follows:

a. **(RR8) Risk of Changes in Domestic Regulatory Conditions:** Changes in domestic regulatory conditions that may have adverse impact on the *wakalah sukuk*. This type of risk is frequently reported in the IC as "Political, Economic and Regulatory Considerations". This risk also includes changes or "adverse developments" in the government's current regulations and policies, e.g. Movement Control Orders in curbing the Covid-19 spread. This is relevant for *sukuk* issued from year 2020 onwards. These changes in the regulatory conditions may dampen the business or operations of the parties in the *sukuk* transaction.

b. **(RR9) Risk of Changes in International Regulatory Conditions:** Changes in international regulatory conditions that may have adverse impact on the *wakalah sukuk*. For issuers that hold businesses or

investments outside of Malaysia, this risk is associated with the laws and regulations of that foreign country, e.g., its taxation laws. This risk also includes changes in the foreign government's current regulations and policies in curbing the Covid-19 spread. This is relevant for *sukuk* issued from year 2020 onwards. This type of risk is reported in the IC as "Political, Economic and Regulatory Considerations" with the inclusion of the words "other countries", e.g., "Malaysia and other countries in the region".

- c. **(RR10) Risk of Changes in Law (general):** Changes in law and tax regulations affecting the issuer, its business and operations. This type of risk covers changes in statutory laws, regulations, or government policies which may increase the cost of compliance with such laws, regulations, or policies and have adverse impact on the structure of the transaction and treatment of the *wakalah sukuk*. This type of risk is frequently reported in the IC as "Change of Law" or "Change in Law". This type of risk is general, because most issuers stipulate it as the risks of '*changes in Malaysian law, tax and administrative practices*'.

- d. **(RR11) Risk of Changes in Labor Laws:** Dependency on foreign workers may expose the issuer/ parent company to risks relating to labor regulatory changes and issues. This may affect the issuer/ parent company's business, financial conditions, operational results, and prospects.
- e. **(RR12) Inherent Regulatory Risk:** Inherent regulatory risks that require parties, especially the issuer, to comply on an ongoing basis. These inherent risks depend on the nature of project/business of the

issuer, e.g., imposition of windfall profit levy for power producer issuer, changes in law and tax regulations affecting palm oil for palm oil producer, changes in standards and policies in regards to food quality, e.g., FSSC 22000, HACCP quality assurance programme, HALAL and Kosher certification for food processing company, etc. This type of risk is frequently reported in the IC as “Inherent Regulatory Risk”. This risk is also mainly associated with the changes of laws that the issuer is required to comply with.

Based on Figure 23 above, CR1 is the most disclosed legal risk. Hence, it is highly associated with *wakalah sukuk* in Malaysia. In addition to CR1, there are four other compliance risks in *wakalah sukuk*. Details of the risks are as follows:

3) Compliance Risk (CR)

- i. **(CR1) Risk of Non-Compliance with Environmental Laws:** Risks associated with compliance with various environmental laws. The issuer is subject to various environmental laws, policies, and regulations. Non-compliance with the laws may lead to a few implications, e.g., suspension or revocation of issuer’s license to operate, and financial and criminal liabilities. This risk arises when the issuer/guarantor, as the case may be, gives no assurance that compliance with the laws can be made and that third parties to the contract, e.g., the Contractors, will not violate environmental laws and regulations in their operations, as indicated in 11.A.
- ii. **(CR2) Risk of Non-Compliance with Occupational Health and Safety Laws:** Risks associated with compliance by the issuer with occupational

health and safety laws. Non-compliance with the laws may lead to financial and criminal liabilities and may have adverse effects on the issuer's reputation and operation.

- iii. **(CR3) Risk of Non-Compliance with Certification Requirements:** Risks associated with complying with certification requirements necessary for the conduct of the issuer's business, e.g., certification with Malaysian Sustainable Palm Oil Scheme (MSPO). This certification requires the issuer to fulfil certain standards relating to economic, social, and environmental viability. Failure to secure the certification will affect the issuer's sales and eventually the *sukuk* and *sukuk* holders.
- iv. **(CR4) Risk of Non-Compliance with Specific Reporting:** This risk is prevalent in Green ASEAN and SRI *sukuk*. As prescribed in Part 3, Chapters 6 and 7 of LOLA Guidelines, there are additional requirements for the issuance of these *sukuk*. Further, there are also additional compliance required by the ASEAN Capital Markets Forum (ACMF), including reporting obligations to retain the "Green ASEAN *sukuk*". In other words, the titles retained are associated with additional compliance requirements, particularly to attain the objectives of sustainability, responsibility, and green investments. Non-fulfilment of the obligations may render the *sukuk* to be non-compliant with the relevant guidelines/laws.
- v. **(CR5) Risk of Non-Compliance with Relevant Regulatory Requirements:** Risk that the issuer does not comply with standards or maintenance/safety measures applicable to the issuer's project that are set by regulatory bodies. The regulatory bodies may be the Government, the

local authorities, or specific professional bodies assigned to produce such standards or measures.

Based on Figure 24 above, there are two legal uncertainties in *wakalah sukuk*, i.e., LU1 and LU2. Details are as follows:

4) Legal Uncertainties (LU)

- i. **(LU1) Uncertainties in Judicial Decision:** This refers to the uncertainty regarding how the Court will apply certain laws *ex post*. This gives rise to uncertainties in the judicial decisions that may have adverse effects on the *wakalah sukuk*. This risk is associated with RR10, i.e., risk of change of law. However, only a few *wakalah sukuk*s have incorporated legal uncertainties in judicial decisions arising from the impact of the change of laws.
- ii. **(LU2) Uncertainties in Application of the Law and its Interpretations:** Uncertainties in the application of certain laws *ex ante*, i.e., to predict the legality of certain matters that may have adverse effects on the *wakalah sukuk*. This legal uncertainty may also relate to the regulatory uncertainties faced by issuers who hold or plan to hold businesses or investments outside Malaysia, as indicated in 14.A and 18.A. This risk includes the uncertainties due to untested regulations pertaining to ‘Non-Viability Events’ (NVE) for certain bank issuers, as seen in 19.A and 25.A. It was reported in these IMs that the NVE may occur when BNM, Malaysia Deposit Insurance Corporation (PIDM) or Relevant Regulatory Body are of the opinion that

write off or conversion of *sukuk* into ordinary shares is necessary, and this gives rise to uncertainties.

Other than the four types of LRs, it was discovered that other risks related to contract and litigation were also disclosed in the *wakalah sukuk* documents. However, these risks were not thoroughly discussed because they are more suited to be classified as third party risk, i.e., risks between the issuers and a third party. The risks are:

- i. Renewal of agreement risk, i.e., risk relating to renewal of agreement between the issuer and a third party to ensure continuity in the issuer's operation and business. As there is no assurance that such agreement may be renewed, there is also no assurance that the renewed agreement will have similar provisions as the existing ones.
- ii. Litigation risk, i.e., risk that the issuer may, from time to time, be involved in disputes with various parties involved in its operations. The issuer may also have disagreements with regulatory bodies mainly due to different understanding or interpretation of the Malaysian laws and regulations. These may lead to additional financial liabilities, delays in operation, as well as legal/other proceedings.

In summary, it was found that there are some similarities between these legal risks and the legal risks discussed in the literature. For instance, the observed and hypothetical legal risks in *sukuk* include regulatory risks, compliance risks, legal uncertainties, contract risk, documentation risk, transaction risk, and operational legal risk. From the findings, it was observed that most of these risks were evident. Nonetheless, they may have been tackled differently in the literature. For instance, the

unenforceability of *sukuk* contract was mentioned widely in the literature. This risk was linked to the unenforceability of governing law clause. Notably, this was not evident in the findings. However, the unenforceability of *sukuk* contract was linked to ‘workability’ of the *sukuk* structure, namely that the structure was not able to secure the intentions of the parties, particularly in relation to investor protection. Hence, this is also a form of legal risk.

In the literature, legal uncertainties surrounding the *sukuk* dispute and default, as well as those that involve multiple jurisdictions, were discussed. These legal uncertainties were only partially evident in the findings, where only legal uncertainties in regards to judicial decision and application of law and its interpretation were found. The participants did not mention legal uncertainty as a legal risk in the *wakalah sukuk*. However, a participant has elaborated on how the Malaysian *wakalah sukuk* framework is quite loose, such that it can create confusion in the drafting of the *wakalah sukuk* documents.

In a similar vein, some of the findings from the interviews have complemented the findings from the document analysis. For instance, legal risks that were not evident in *wakalah sukuk* are documentation risk (risk of incompatibility of two or more sets of documents) and transaction risk. Nonetheless, transaction risk was mentioned by a participant when he related the risk with the purchase undertaking risk.

In relation to legal risks perceived by the participants, it was found that the legal risks disclosed in the *wakalah sukuk* documents are more extensive and some of them provide clearer explanation. For instance, while the participants elaborated on the legal risks arising from the law or the regulatory risks of *wakalah sukuk*, the *wakalah sukuk* documents have documented 12 types of regulatory risks. In a similar vein, the participants have perceived only one compliance risk, i.e. SNCR, but the *wakalah sukuk*

documents have revealed 3 SNCRs and another five compliance risks. Besides these, contract risk was not evident in the *wakalah sukuk* documents although it was evident in the document analysis.

7.4 LEGAL RISK MANAGEMENT (LRM) IN *WAKALAH SUKUK* IN MALAYSIA

As stated in Chapter 5, findings on LRM are presented based on three LRM aspects, i.e., LRM strategies, LRM techniques, and LRM tools. These findings are presented using the themes prevalent in the research questions in line with the generic (Braun & Clarke, 2006). In addition to the three aspects, some of the LRM findings are presented based on the participants. As indicated in the previous section, some of the legal risks in *wakalah sukuk* were perceived differently due to the different roles of the participants in a *sukuk* and their different functions, e.g., adviser, trustee etc. As a result, LRM findings are presented and discussed from each of their unique perspectives. The codes and code groups are developed based on the functions/ types of participants.

7.4.1 Legal Risk Management Approaches

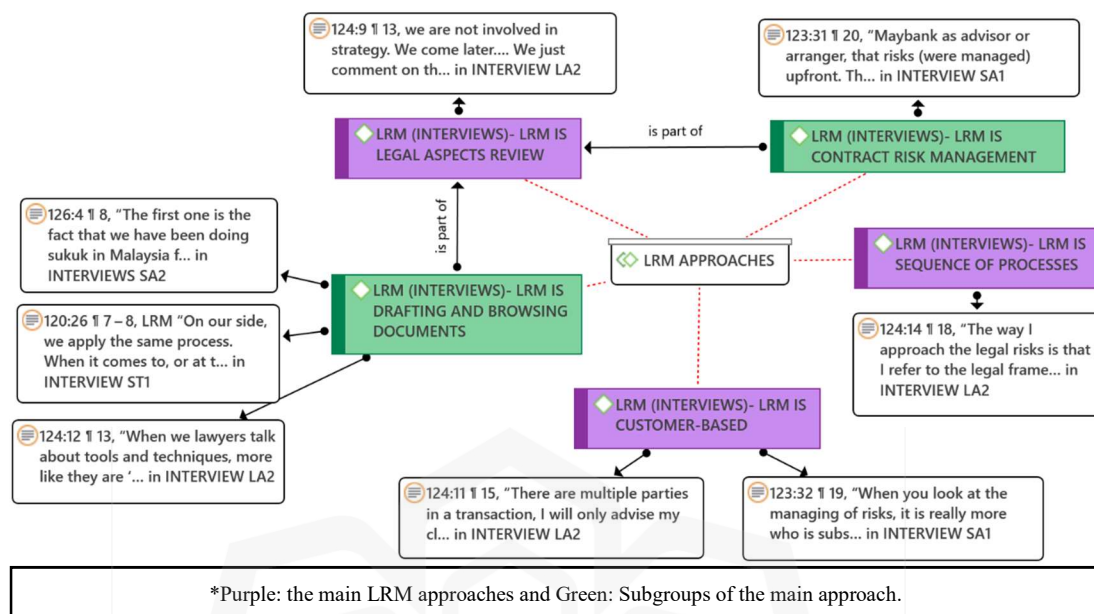


Figure 7.12 LRM from the perspectives of the participants

When all of these participants were asked generally about LRM strategies, techniques, or tools they employed to manage legal risks, their responses can be summarized into three main code groups. These code groups were viewed as LRM approaches, as depicted in Figure 26 above. They are not the strategies, techniques, or tools employed for LRM but they reflect the participants' mere understanding of LRM. These findings provide some insights on how they approached LRM. As stated by LA2, he was not involved in the LRM strategy because it falls under the responsibility of the issuer and the risks are assessed internally. Nonetheless, LA2 explained that from his position as an advisor, LRM is about reviewing the legal aspects of *sukuk*. Besides this, two subthemes were found to be in relation to this, i.e., LRM is a contract risk management (CRM) and LRM is about drafting and browsing the *sukuk* documents to ensure compliance with relevant laws.

It was found that SA1 has viewed LRM as CRM. In her responses, she discussed LRM from the perspective of contract provisions. This was evident in SA1's responses when she mentioned the use of disclaimer as an LRM technique. She said:

“Maybank as advisor or arranger, that risks (were managed) upfront. The arranger, there would just,.. in the Information Memorandum, usually they have a disclaimer that say that they (disclaim by way of stating that), the view of Shariah does not come from their perspectives”.

The responses of ST1, SA2, and LA2 revealed that they perceived LRM as the drafting and browsing of the *wakalah sukuk* documents. ST1 said:

“On our side, we apply the same process. When it comes to, or at the stage of drafting, we browse the legal documents.. to comply with relevant guidelines especially those issued by the SC”.

Even though LA2 said that he is not involved in the LRM strategy, he has employed some techniques and tools for LRM. As a matter of fact, he viewed these techniques as certain ‘styles’ employed by individual legal advisers in drafting the *sukuk* documents. In a similar vein, SA2 viewed LRM also from the perspectives of drafting the *sukuk* documents. Both LA2 and SA2 have mentioned following precedents based on how they previously drafted and documented *sukuk*.

Other than these, LA2 added that LRM is a sequence of processes. These processes involve ‘analytical reviews’ by the advisor throughout the drafting processes, i.e., pre-drafting, post-drafting (*ex-ante* and *ex-post* stages), and reviewing the implications that may result from the drafting or documentation. Quite similar to what was mentioned by ST1, LA2 tried to explain that LRM involves a sequence of processes that *sukuk* parties need to undergo to be able to manage the legal risks.

In addition to these, it was noted that both LA2 and SA1 have mentioned that LRM is customer-based. Their responses indicate that legal risks in *sukuk* are managed differently depending on the customer that the participants represent. LA2 said:

“There are multiple parties in a transaction, I will only advise my client party. For each client party, there’s a different risk management technique, because they carry different risks, the issuer carries the risk of default, so they have to ensure that their legal risk management covers (that), .. investors legal risk management is how best they can enforce their rights, .. how they can exit. They are looking at the same elephant from a different angle. There cannot be one answer for this question.. investors will have their legal risk management techniques, issuers will have their legal risk management techniques, trustees will have their legal risk management techniques”

Based on the above, LA2 will only manage the legal risks of the customer who has appointed him as adviser. This point is critical because according to LA2, different customers carry different risks, hence, different LRM. While investors’ LRM is mainly related to the recourse that they have in the *sukuk* and how they can enforce it, the issuer’s LRM is about how to prevent default of the *sukuk*. This view was also consistent with the views of SA1. She highlighted different LRM strategies which she employed to advise a bank which is an investor, compared to the LRM strategies she employed to advise a bank which is an issuer.

Based on these findings, a better understanding of the LRM has been achieved. While some are focused on the ‘macro-level’, i.e. viewing LRM as a customer-based process, others have perceived LRM at the ‘micro-level’, i.e., legal risks are managed through the drafting of documents, managed through documents’ browsing and through the provisions employed in the documents. Similar findings were found when literature on LRM were reviewed in section 5.3, Chapter 5. This was because the literature have approached LRM from both organization’s perspective (macro-level) and legal

adviser's perspective (micro-level). From the interviews, similar perspectives of LRM were also found.

7.5 LRM STRATEGIES, TECHNIQUES, AND TOOLS

7.5.1 Analysis of LRM Strategies for Wakalah Sukuk in Malaysia

Previously, in Chapter 6, **LRM strategies**, **LRM techniques** and **LRM tools** have been delineated. However, it is noteworthy that the LRM strategies, techniques, and tools collected from the data were quite different. In other words, to construe the 'concepts' of LRM strategies, techniques, and tools as found in the literature into the data was difficult and required a few adjustments. For instance, as mentioned by LA2, a legal adviser is not involved in the strategy plan for LRM. This is because, the LRM strategy should be part of the issuer's plan, before they decide to issue a *sukuk*. Alternatively, **LRM strategies** may be perceived as the general actions taken by the participants to discharge their duties, e.g., as adviser or trustee.

For **LRM techniques**, they are construed according to the findings in the literature, i.e., specific techniques as employed in the contract or the contract risk management techniques. The document analysis have presented abundant techniques in the form of clauses/ provisions in the *sukuk* documents issued to the *sukuk* investor in the IM and the TD, i.e. *sukuk* documents that govern the relationships between the parties involved in the *sukuk*. These techniques were reviewed by the participants with additional techniques that were not found in the IM and TD.

For **LRM tools**, it was found that there was no specific external tool employed by the participants. However, the interview data have shown several external or

additional techniques that were employed by the participants for LRM. These LRM strategies, techniques, and tools are presented in Figure 24 below.

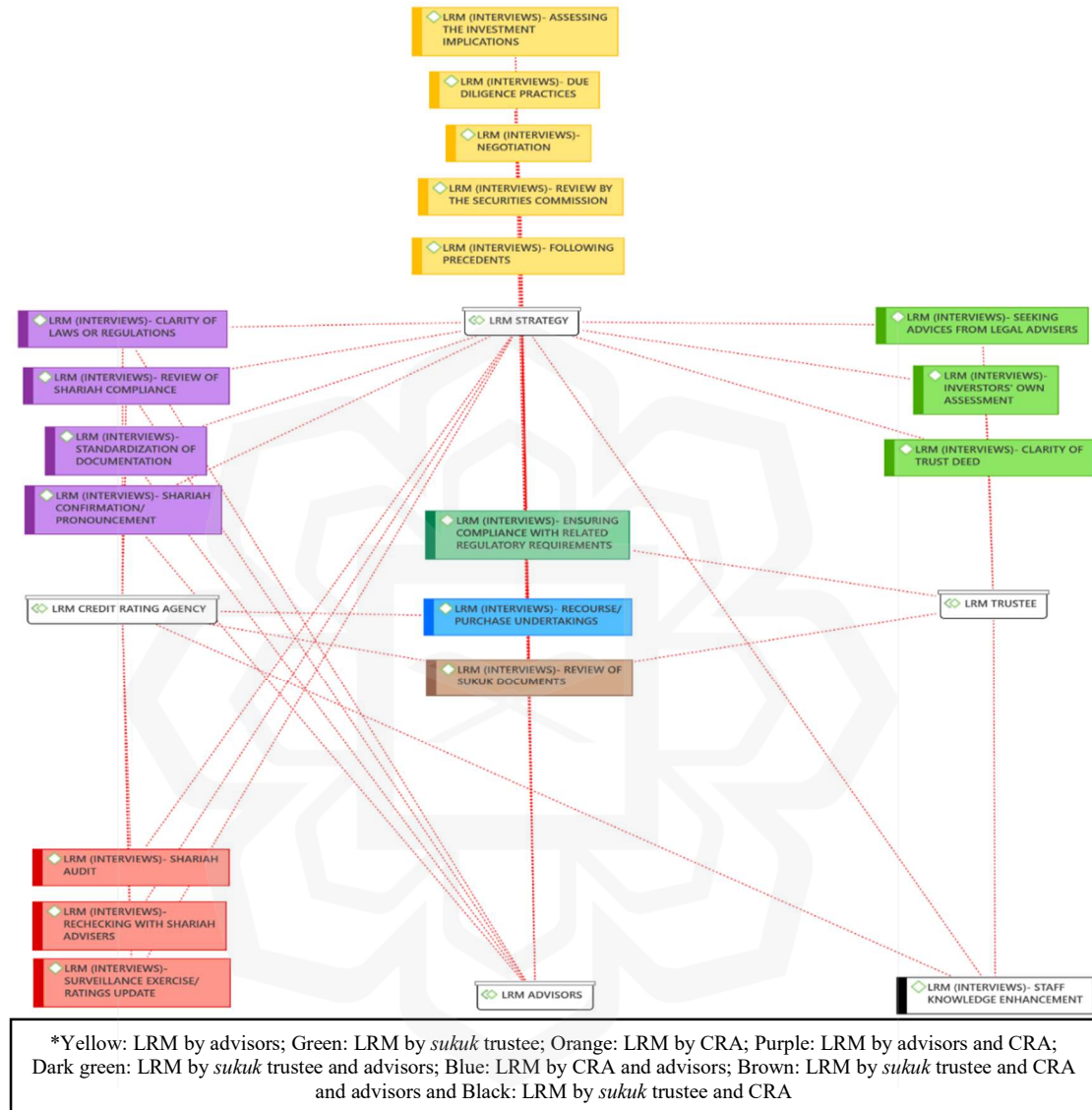


Figure 7.13 LRM Strategies from the Perspectives of the Participants

In order to produce meaningful network, findings on LRM strategies have been categorized into three. Each group is associated with a specific participant. Hence, LRM strategies are grouped into strategies employed by the advisors (LA1, LA2, SA1, SA2, PA/LA1), strategies employed by the trustee (ST1) and strategies employed by the

credit rating agency (CRA1). Based on Figure 27, there were 19 LRM strategies presented by 19 codes. These codes were differentiated through the use of different colors to provide clearer distinctions between them, since some of the LRM strategies were employed by only one group and others were employed by at least two groups of participants. Out of the 19 strategies, only eight strategies were employed by at least two groups of participants. There was only one LRM strategy that was employed by all participants. These strategies are discussed below:

7.5.1.1 LRM Strategies Employed in Wakalah Sukuk

As indicated in Figure 25, there were more differences than similarities in the LRM strategies employed by the participants. This may be due to their positions/functions in the *wakalah sukuk* which are distinguished from each other. However, some similarities among them can be captured in terms of eight strategies used for LRM, and they are:

- 1) Review of *sukuk* documents (Advisers, Trustee and Credit Rating Agency);
- 2) Recourse/ Purchase Undertakings (Advisers and Credit Rating Agency);
- 3) Ensuring compliance with related regulatory requirements (Trustee and Advisers);
- 4) Shariah confirmation/ pronouncement (Credit Rating Agency and Advisers);
- 5) Clarity of laws and regulations (Credit Rating Agency and Advisers);
- 6) Review on Shariah compliance (Credit Rating Agency and Advisers);
- 7) Standardization of documentation (Credit Rating Agency and Advisers);
and
- 8) Staff knowledge enhancement (Trustee and Credit Rating Agency).

PA/LA1, ST1 and CRA1 agreed that reviewing the *sukuk* documents is one of the LRM strategies employed by them. From this, it can be understood not only that all the participants employed this measure but it also implied the ‘applicability’ of this strategy to manage legal risks. All of the participants perceived reviewing the *sukuk* documents, particularly the IM and PTC, as important. PA/LA1 stated that it is important for these documents to be drafted clearly by taking into considerations all feedback from the parties, i.e. issuer, lawyer, and advisor. As for ST1, the importance of reviewing the documents was to ensure that the terms used in the PTC or inserted in the TD are complementing and that the sequence of the transactions was adequately documented. This, according to him, would help to manage SNCR and compliance with the laws.

According to SA1, managing legal risks is about ensuring that the *sukuk* provides recourse to the investors. When explaining this, she was referring to herself as adviser to a bank, or investor. Other than SA1, CRA1 also considered the same. In her responses, she mentioned that in order to manage legal risks, she will put emphasis on the factors that could bring risk to the investors, and these include recourse/ purchase undertaking (PU). She said:

“So for us to really determine where is that underlying obligation coming from, and be what need to flag factor that credit risk and credit exposure back to the underlying, so the issuer may be SPV or subsidiary, you know if I have got a PU, whose obligor will have the PU. So that’s how we will approach assessing that risk.”

As stated by ST1 and the advisers, ensuring the *sukuk* compliance is essential. While ST1 mentioned compliance with minimum content requirement, SA1 has placed emphasis on compliance with regulatory requirements of a *sukuk*. These include compliance with the SC resolutions, LOLA framework, and issuance guidelines, i.e.,

CBSR 2017. Besides these, Shariah confirmation or pronouncement was also regarded as LRM strategy by CRA1, SA1, and LA1. The importance of this strategy is in managing SNCR. As explained by SA1:

“the Shariah advisers would actually advise, what is the sequence that the documents must be executed. So the parties have to sign the documents in the particular sequence, which is in compliance with the Shariah. If they fail to follow that sequence, then they are actually in breach of Shariah compliance la. So, to mitigate that, usually the sequence will be set out in the Shariah pronouncement issued by the Shariah advisers”.

Similarities among Advisers and CRA1 were found in this strategy, as well as in another three strategies. LA1 was of the opinion that clarity in the regulations and their constant improvements (particularly on diligence practices) is one of the ways to manage regulatory risks. This would be a strategy by the policy maker that benefits LA1. He said:

“The regulatory side is quite clear, they have constantly improved the due diligence practices, the MIBA has also come up with their own due diligence guide, so these are ways to manage the regulatory risks, SC also from time to time, also issue the FAQ...”.

Other than that, it was found that a review of Shariah compliance or the process, apart from the Shariah confirmation/ pronouncement, was also deemed as an LRM strategy by LA1, PA/LA1, and CRA1. They believed that the process, which begins with the appointment of Shariah adviser until the stage of reviewing, is another significant LRM strategy to manage SNCR.

Standardization of documents was perceived by SA1, SA2, and CRA1 as an LRM strategy. According to them, the standardization has helped them to manage the legal risks, particularly when the new issuer’s project has similarities with the previous

ones. These were also linked to the participants' vast experience and long-term engagement in the market. Nonetheless, SA2 clarified that by standardization, he meant “*sukuk* contract that is already in good shape”. This is because, according to him, standardization is quite impossible considering the different needs of the issuers.

Further, both ST1 and CRA1 were of the opinion that knowledge enhancement of the staff is very important to manage legal risks in the long run. ST1 explained that in order to browse and understand the risks, parties involved in the *sukuk* must be knowledgeable and well-trained. Similar concerns were raised by CRA1. According to CRA1, it is imperative for her and her staff to be aware and keep themselves updated with new changes in the *sukuk* market and practices.

Other than these eight strategies, there were 11 other strategies employed by a single group participant. The first group is the advisers. Their strategies are discussed as follows:

1) Following precedents

According to LA1, LA2, and SA2, they have been managing legal risks by following precedents. By precedents, they are referring to their previous practices. All of these three participants are experienced advisers in *sukuk*. SA2 stated as follows:

“We all have been doing it for so long, now the documents will always be based on the documents that have been approved and worked for many other deals, right? So, as you spoke to ASL, they probably use, the probably have done quite a number on wakalah *sukuk*. If a new client comes, and they want to do on wakalah *sukuk*, they will definitely use the best, the closest wakalah *sukuk* that matches this new deal, and it has been approved before, and they would be meets and fixes to be adjusted, otherwise basic form is ready already.”

While SA2 confined precedents to ‘previous similar contracts’, LA1 referred to precedents in the context of certainty in laws. He said:

“But apart of that, you want a law that got precedents. It’s clear, so you know how this instrument will be construed”.

Similarly, LA2 was of the opinion that following precedents was proven to be a strategy for managing the risks. However, he also highlighted that merely following precedents may not necessarily be appropriate at all times and for all issuers. He said:

“However, the market grows, new product, new clients come into the market, different clients want different things, so we just follow. We cannot go, “Oh, we can’t do that”. It’s about how do I help them, we try to accommodate,... otherwise, we will turn them away”.

Due to this, it can be understood that while following precedents have helped the participants to manage the risks, its applicability in all cases of *sukuk* issuance may not be suitable.

2) Due Diligence Practices

Four out of the seven participants have mentioned due diligence practices as their LRM strategies. The practices refer to the due diligence reports and processes. According to PA/LA1, the accountability of the DDWG members towards the inputs they gave in the Due Diligence Reports (DDR) is very important in managing legal risk for the *sukuk*. The implementation of due diligence covers a few aspects, i.e., the preparation of due diligence planning memorandum, DDWG, due diligence questionnaire and interview, documentary of due diligence and the DDR (Interview with LA1). According to LA1

and LA2, due diligence is heightened in terms of disclosing the material information in the IM. As stated by LA2:

“At the end, what is the purpose of due diligence that it is required by the law... due diligence acts a shield/ protection for you. Before you put any information in the IM, you have checked through the due diligence process. In the DDWG, there’s lawyer, accountant, to validate all information. You are not doing it alone. That’s the idea of having the due diligence working group... so the real purpose of the due diligence, the due diligence report and due diligence process are to protect the issuer.”

As noted in LA2’s responses, due diligence practices are among the LRM strategies for the issuers.

3) Review by the Securities Commission (SC)

The significant role played by the SC in managing legal risks is undeniable. Considering the issuance process that an issuer has to undergo, review by the SC is indispensable to ensure reliable risk management of the *sukuk*. In regards to legal risks, review by the SC was considered as a strategy for LRM by SA1 and LA1. Although the review forms part of the issuance requirements, the participants perceived it to be helpful in managing risk. As stated by SA1:

“Because all the structures have to undergo review of the Securities Commission, so the Shariah non-compliance risk is mitigated”.

However, both responses on this were linked strategies to manage SNCR that forms part of legal risks in *wakalah sukuk*. In other words, both participants have emphasized specifically on the roles played by the SC and the SAC of the SC. Other than this, it was also noted that this strategy does not fall into the category of common

strategy, since it is one of the legal requirements of *sukuk* issuance that simultaneously functioned as an LRM strategy.

4) Negotiation

According to LA2, negotiation skills and implementation are both important to manage legal risks. This was mentioned when he was discussing transactional and litigation risks in *sukuk*, as well as default risk. He said:

“When it comes to default, everything is about negotiation skills and documentation skills. All are contractual”.

It was noted that this negotiation was perceived as a strategy for LRM for ex-post legal risks. In other words, if the *sukuk* defaults and litigation arises, negotiation can be held between the parties.

5) Assessing the Investment Implications

Based on the responses by SA1, it was noted that assessing the *sukuk*'s investment implications forms part of her LRM strategy. However, she explained this in relation to her position as adviser to the bank who is an investor of a *sukuk*. She said, in order to manage compliance risk of the bank, particularly in maintaining certain capital ratio, it is vital for her to assess the *sukuk*'s investments and the investments' implications on the bank.

7.5.1.2 LRM Strategies in the Perspectives of the Trustee

As indicated in the previous section, only one trustee was interviewed in this research. Considering the vast experience that this trustee has, the data obtained from the interview did shed some lights on the LRM from the perspective of a trustee. According to ST1, there were nine LRM strategies employed by him in *sukuk*. Nonetheless, only three will be elaborated in this section because the other six strategies were considered not perceived solely by ST1.

1) Clarity of Trust Deed

As seen in the LRM approach section, LRM by ST1 was about drafting and browsing the *sukuk* documents. Considering this, ST1 stated that clarity of trust deed (TD) is one of the important matters in managing legal risks. In the first part of his responses on LRM, he said that he will make sure the TD meets the minimum content requirement in line with the TD Guidelines. He further stated that when he browsed the PTC submitted by the issuer, he had to make sure that the information was complete. In line with this, he has to ensure that all the provisions in the TD are connected to each other and that they are in line with the terms provided in the *sukuk* PTC. His further elaborations on the provisions will be discussed in the next section on LRM technique.

2) Investor's Own Assessment

From ST1's view, managing legal risks requires the investor's own assessment. Although a trustee represents the investors, ST1 was of the opinion that the investors themselves should be equipped with relevant knowledge and they should assess the *sukuk* before investing. He said:

“... as the investors, they must have these principles in mind, ‘caveat emptor’, ‘bias beware’, as the investor they need to check, I mean, they need to have their own assessment, here and there, but if you ask me”.

3) Seeking Advice from Legal Adviser

ST1 mentioned litigation risk as a type of legal risk in *sukuk*. He stated that in such event, legal advice will be sought from the lawyers to manage the risk.

7.5.1.3 LRM Strategies from the Perspective of the CRA Representative

As indicated in the literature, the role played by the credit rating agency is imperative. For instance, it was recommended by some scholars that the agency includes assessment on the issuer’s compliance in the *sukuk* accreditation process (Al-Natoor & Brown, 2020). For the purpose of this research, only one credit rating agency representative was approached. However, the information she provided on LRM has been very insightful considering her vast experience. She mentioned about 10 LRM strategies. However, there were only three strategies that were mentioned by her alone, as follows:

1) Surveillance Exercise/ Rating Update

This strategy refers to the act of inspecting the issuer’s compliance by the credit rating agency. CRA1 explained that the agency will occasionally carry out inspection which starts by requesting the issuer to submit a ‘compliance statement’. This can be regarded as an LRM technique.

2) **Reliance on Shariah Audit**

This strategy was specifically mentioned by CRA1 to manage SNCR. She said that credit rating agencies conduct inspection on Shariah compliance by monitoring certain aspects, e.g., composition of Shariah and non-Shariah compliant assets underlying the *sukuk*. However, she said that the agency relies on the Shariah audit for continuous compliance check.

3) **Rechecking with Shariah Advisers**

In addition to Shariah pronouncement, CRA1 said that the agency also rechecks on Shariah compliance with the Shariah advisers. She noticed how some Shariah rulings could change over time. Thus, to manage potential SNCR in the *sukuk*, she will seek clarification from the Shariah advisers.

7.5.2 **Analysis of LRM Techniques in Wakalah Sukuk in Malaysia: General LRM Techniques:**

Based on the document analysis, it was found that there are two types of LRM techniques used within the *sukuk* documents:

- 1) **General LRM Techniques:** These techniques refer to independent/general provisions (in contrast to risk-specific techniques) within the *wakalah sukuk* documents that can be used to mitigate the effects of legal risks. These techniques or provisions are mostly standardized throughout the documents. Some of these techniques can be employed by the parties in order to mitigate the effects of legal risks, particularly in the events of near default and default.

- 2) **Risk Specific LRM Techniques:** These techniques refer to those associated with specific legal risk. They are employed within the same provision where the legal risk is disclosed. For instance, under the provision “Shariah Compliance Risk”, where the risk is disclosed, the issuer also employed a disclaimer, stating that no representation or assurance is given that the *wakalah sukuk* is Shariah compliant.

In sum, the general LRM techniques can be depicted as follows:



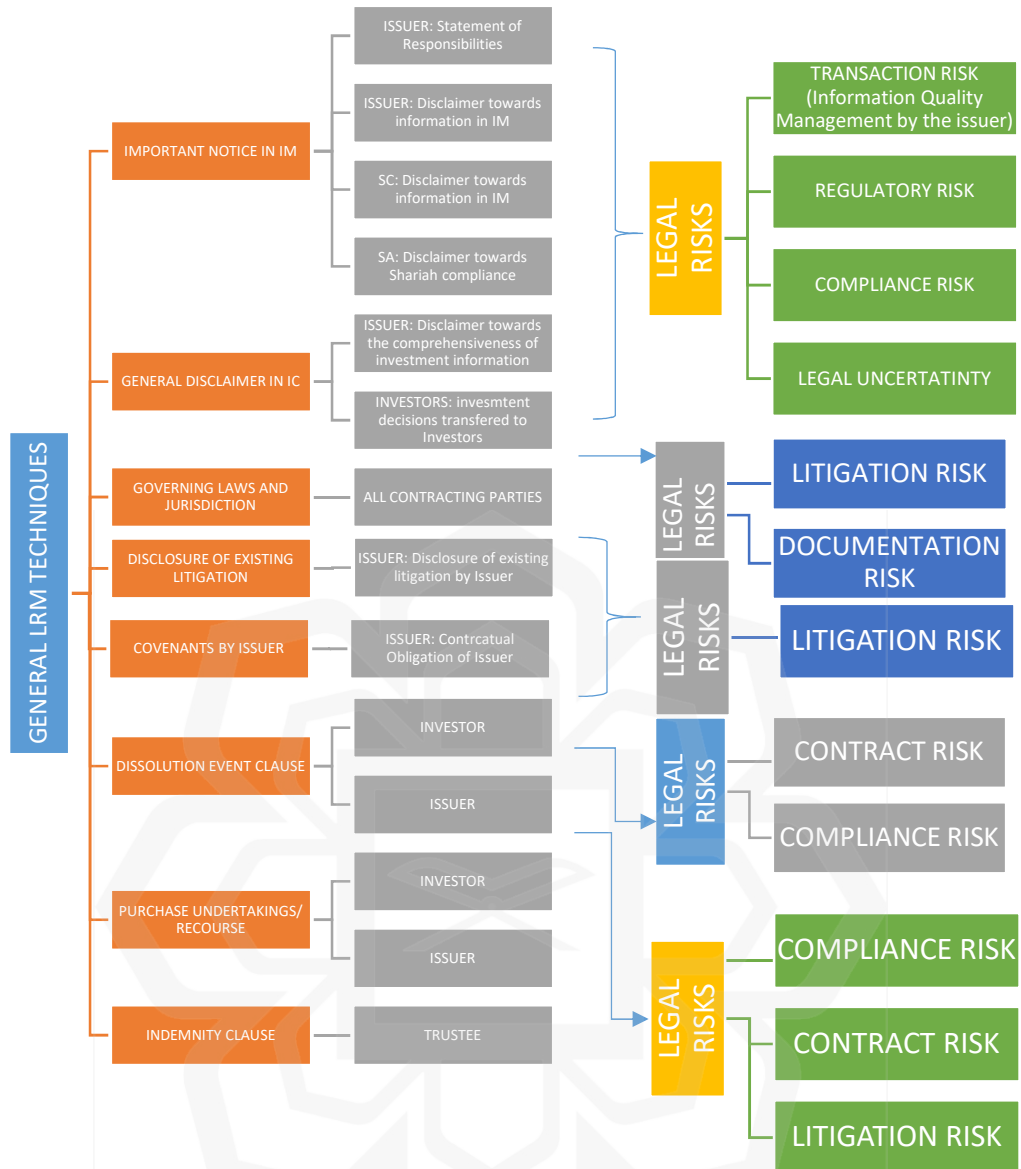


Figure 7.14 LRM Techniques in 24 Wakalah Sukuk Documents

Details of the general LRM techniques as depicted in Figure 26 are as follows:

1) **IMPORTANT NOTICE:**

Important Notice (IN) is incorporated in the *wakalah sukuk* IM. The IN generally contains:

- i. **Statement of Responsibilities:** In this statement, the issuer accepts responsibilities in regards to the accuracy of all information in the IM. The issuer, or its board, has confirmed that the material information within the IM are true and correct. The issuer also confirms that there is no omission of a material fact, false or misleading.
- ii. **Statement of Disclaimer by the Issuer:** Within the IN, general disclaimers are used by the issuer in regards to the fact that: 1) the IM does not constitute an offer; 2) if the IM is rated, the rating does not constitute a recommendation; 3) the DDWG, excluding the issuer, does not accept responsibilities in regards to the “*adequacy, legality, effectiveness, validity, genuineness, enforceability, admissibility, reasonableness, authenticity, origin, validity, accuracy or completeness of such information and data or for any other information, data or statement provided by the issuer*” in the IM; 4) the IM will not be made to comply with laws other than the laws of Malaysia. In addition to these disclaimers, the potential investors, upon accepting and subscribing to the *sukuk* also agree and confirm, among others, that: 1) they have sufficient knowledge to evaluate the merits and risks in the *sukuk*; 2) they are subscribing for their own account; and 3) they

can or have attained expert advice in regards to the laws relevant to the *sukuk*.

iii. **Statement of Disclaimer by the Securities Commission (SC) Malaysia:**

In this statement, the SC disclaims its responsibilities towards the contents of the IM and acknowledges that the offering/ issuance of the *wakalah sukuk* has been made by the issuer in accordance with the LOLA Guidelines.

iv. **Statement of Disclaimer by Shariah Advisors:** In some *wakalah sukuk*s, this disclaimer is provided within a separate clause in the IN. In this statement, the Shariah Advisors give no assurance that the Shariah compliance of the *sukuk* may not be challenged in the Court or may be subject to different opinions by others.

These disclaimers are required by the Prospectus Guidelines as provided in its Division 2, Chapter 3, para 3.01. As seen in the case of *CIMB Bank Bhd v Maybank Trustees Bhd and other appeals* [2014] MLJU 117, the Federal Court held that the disclaimers contained within the *sukuk* IN and IM were valid. At the Federal Court, the apportioned liability between the *sukuk* trustee and lead arranger as adjudicated by the previous Court was reviewed. According to the Federal Court, the lead arranger (KAF) cannot be held liable for the misappropriation of the *sukuk* proceeds because, among others, KAF duty of care on the information contained in the IM was excluded by the IM's important notice/disclaimer (p.192). Since this case has indicated the effectiveness of the disclaimer, other disclaimers within the IN may be considered as LRM techniques.

2) **INVESTMENT CONSIDERATIONS' GENERAL DISCLAIMER:**

In the IC or Risk Factors section in the IM, the issuers employ a general disclaimer on their liabilities in regards to the risks embedded in the *wakalah sukuk*. This disclaimer is required by the Prospectus Guidelines in Division 2, para 6.01. This general disclaimer contains:

- i. Issuer's disclaimer towards the incomprehensiveness of all the risks provided in the section.
- ii. Transfer of risks associated with investing to the investors as the investors are encouraged to evaluate the *wakalah sukuk* or any of its issuance based on its merits.

It was noted in the Prospectus Guidelines in Division 2, para 6.02. that the use of disclaimer by the issuers must not undermine the disclosure of the risks in the section. In other words, the applicability of disclaimer as a risk management technique is subject to the extent of the risk disclosures made by the issuers.

3) **GOVERNING LAW AND JURISDICTION CLAUSE:**

Determining the laws to govern the *wakalah sukuk* contract and manage disputes arising from it has been recognized as an important LRM strategy (Abdul Khaleq et al., 2007; Colon, 2011; Junius, 2007). In fact, the use of the governing law clause as a tool within the *sukuk* contract to safeguard the rights of the parties has been recognized by some (McMillen, 2007; Oseni & Hassan, 2015). Through the document analysis, it was found that the governing law and jurisdiction clause is a mandatory clause within the *wakalah sukuk* PTC and TD. The governing law clause in the TD stipulates that the governing

law for the *wakalah sukuk* contract is the laws of Malaysia and that parties to the contract unconditionally and irrevocably agree to submit to the exclusive or non-exclusive jurisdiction of the Malaysian courts. Considering the fact that the *wakalah sukuk* in this study are all issued in Malaysia, there is no other provision within the clause that includes other foreign jurisdictions or arbitration forums. The only exclusion was the governing law for Islamic Development Bank *wakalah sukuk* as seen in 2.A. This is due to the position of the issuer as a supranational body.

4) **COVENANTS OF THE ISSUER:**

The issuer is obliged through the covenants to perform certain obligations. Among the obligations are to ascertain its compliance with the laws, e.g., to:

“promptly comply with all applicable provisions of the CMSA and/ or the notes, circulars, conditions or guidelines issued by the SC, BNM and any other relevant regulatory authorities from time to time in relation to the Sukuk Wakalah”.

There are a few types of covenants available and disclosed in the TD and PTC, i.e., Positive Covenants, Negative Covenants, Financial Covenants, and Information Covenants. However, only the Positive Covenants include compliance obligations of the issuer which can be regarded as one of the LRM techniques.

5) **DISCLOSURE OF EXISTING LITIGATION:**

These disclosures are provided by the issuer in relation to its existing litigation to help potential investors reach prudent decisions to invest. These disclosures are included in the IM, under the ‘Other Information’ section. These disclosures may act as LRM techniques, i.e., as disclaimers over future claims towards the issuer. In addition, they

may also be regarded as LRM techniques for *sukuk* holders, to assist them in making informed investment decisions. There are a few types of these disclosures, as follows:

- i. **(LIRD1) Disclosure of Material Litigation/Arbitration:** This disclosure helps potential investors and other relevant stakeholders to identify the ongoing litigation or ongoing arbitration that the issuer is involved in. The disclosure of the litigation/arbitration is to highlight the litigation risks, e.g., possible future proceedings, awards, or judgements which might materially and adversely affect the issuer's position or business.
- ii. **(LIRD2) Disclosure of Material Contracts:** This disclosure helps potential investors and other relevant stakeholders to identify the ongoing material contracts that the issuer has entered into, other than ordinary contracts related to the issuer's business or operation. This disclosure includes information in regards to borrowings and financing facilities received by the issuer. The material contracts disclosed are those ongoing material contracts that are effective from at least the past two or three years from the time of the *sukuk* issuance.
- iii. **(LIRD3) Disclosure of Material Liabilities:** This disclosure covers contingent liabilities, guarantees, and for some issuers, capital commitments of the issuer. In the disclosure, the issuer confirms that there are no contingent liabilities that are enforceable or will be made enforceable that may materially and adversely affect the financial positions of the issuer. Otherwise, the material liabilities were reported in detail.
- iv. **(LIRD4) Disclosure of Material Related Party:** This disclosure covers related party towards the operation of issuer, e.g., subsidiaries, joint

ventures, associates, or transactions that the issuer has entered into with a related party, e.g., contractual payment of dividends and interests to the joint ventures. Otherwise, the issuer confirms that there are no material related party transactions that the issuer has entered into, except those that have been disclosed in the issuer's audited financial reports for each respective financial year.

- v. **(LIRD5) Disclosure of Other Material Issues:** Other than disclosure of conflicts of interest and its mitigation mechanisms, it was found that there are additional disclosures of other material issues. However, this type of disclosure may be discretionary for the issuer to report. This disclosure includes information that may be within the perception of the issuer, material to the potential investors' decisions to invest in the *sukuk*. As indicated in 2.A., the issuer has disclosed the audit findings over its financial reports and in 12.A., the issuer has disclosed the processes undergone by the issuer over identified lands.

These disclosures are mandatory, in line with the Prospectus Guidelines in Division 2, Chapter 9, paras 9.01, 9.02, and 9.03.

6) **DISSOLUTION EVENTS CLAUSE (DEC):**

The DEC is provided within the TD of the *wakalah sukuk*. It provides a list of events that may lead to the dissolution of the *wakalah sukuk*. This has been termed as "Dissolution Events" or "Event of Default", or, as indicated in 6.B and 15.B, as "Mandatory Early Redemption". The DEC employed in the TD may be considered as

one of the LRM techniques because the clause includes events where non-compliance by the issuer have occurred, as follows:

- i. **Compliance Risk:** Some of the dissolution events relate to risk of compliance with the laws or towards the contractual obligations, such as:
 - a. Failure of the issuer to perform the contractual obligations prescribed in the *wakalah sukuk* TD;
 - b. Failure of the issuer to observe or perform other existing contractual obligations; and
 - c. Failure of the issuer or/and the security agent to maintain legal or lawful position to perform any of its obligations under the TD, or the issuer has become insolvent.
- ii. **Contract Risk:** Unenforceability of *sukuk* contract and disqualification of the issuer to contract are examples of legal risk/legal issues within *sukuk* which have been discussed in the previous chapters and also recognized by some (Djojosingito, 2008c; Rubock, 2010). The LRM technique found available to manage these is the DEC. Under most of the *wakalah sukuk*'s DEC, some of the dissolution events provided to address these risks are the events when:
 - a. The transaction documents have ceased to become binding on the parties, or they have become unenforceable;
 - b. The provisions under the transaction documents have become invalid, illegal or unenforceable, that prevent the issuer from performing its obligations under the *wakalah sukuk*;

- c. The issuer has changed its business, or the scope of its business, or ceased or suspended its business or a substantial part of its business;
- d. The issuer has become insolvent; or
- e. The issuer has been affected by nationalisation, expropriation, or its licences to operate have been suspended, etc.

iii. **Litigation Risk:** Within the OTC of the *wakalah sukuk*, the issuer is under an obligation to disclose its existing material litigation. Apart from these disclosures, the DEC also includes dissolution events that relate to litigation. Some examples are when the issuer:

- a. Fails to fulfil a judgement that has been given by the Court; and
- b. Convenes a meeting with its creditors for a rescheduling or deferral of its financial obligations, or a moratorium has been agreed upon that indicates the crippled financial position of the issuer.

This DEC clause may be deemed as an LRM technique since the occurrence of the events will render the *wakalah sukuk* dissolved. As a result of this, the *sukuk* Trustee will have the right to exercise the purchase undertakings (where applicable) and enforce the security interest created in accordance with the TD of the *wakalah sukuk*.

7) **PURCHASE UNDERTAKING PROVISION/ RECOURSE (PUR):**

As stated in the Prospectus Guidelines in Division 2, Chapter 10, para 10.3., it is a regulatory requirement for an issuer to disclose the recourse available to the investors in a default event. PUR was found in all of the *wakalah sukuk* documents. In the documents, it was noted that PUR was included under the DEC, where the PUR may be exercised upon the declaration of default event of the *wakalah sukuk*. At the same time,

the PUR was also included under the Facility Description section, under the ‘Underlying Transaction’ clause in the IM or PTC, where the PUR will be exercised upon a scheduled dissolution event.

8) INDEMNITY CLAUSE:

In the Pesaka *sukuk* case, the use of an indemnity clause was approved by the Court. In the clause, a party, i.e., the trustee, has protected itself from being liable due to the acts of another, i.e., the issuer. On the liability to pay the indemnity, the Federal Court held that the cause of the loss was mainly due to the fraudulent misappropriation by Pesaka (issuer) and the failure of MTB (trustee) in discharging its duty. MTB owed a duty to the *sukuk* holders as prescribed under clauses 7.3, 8, and 12.3 of the TD. Under clause 12.3, MTB, having been appointed as PESAKA’s attorney, has had wide powers to ring-fence the SDA. In the said case, MTB was found to have failed to take immediate and necessary action even though the *sukuk*’s date of issuance has been made known (p.199). Therefore, 100% liability rested on MTB. However, PESAKA was ordered to indemnify MTB in full for the total amount of RM107,000,000¹⁶⁷. This is because the Federal Court had agreed with the findings of the Court of Appeal that the actual cause of loss was the fraudulent misappropriation by PESAKA. The Federal Court also found that MTB was not disqualified under the indemnity claim as provided under clause 14.1 of the TD. Considering this, an indemnity clause may be apprehended as an LRM technique. This technique was found provisioned in the TD of all *wakalah sukuk*s.

¹⁶⁷ Revised amount. The Federal Court has revised the amount of indemnity to include only the face value of the *sukuk*, i.e., total loss to the *sukuk* holders. The amount excludes the foreign exchange loss claim.

In sum, these general LRM techniques are regulatory requirements. The inclusion of these techniques show that the relevant potential legal risks have been managed by the regulations issued by the SC.

7.5.3 Analysis of LRM Techniques in Wakalah Sukuk in Malaysia: Risk-Specific LRM Techniques

Based on the data, there are 18 LRM techniques that have been employed by the 24 *wakalah sukuk* issuers from nine different industries. The most employed LRM techniques as identified from the data are: Disclaimer (115 co-occurrences), Disclosure of Risk Implications (DRI) (51 co-occurrences), Transfer of Risk to Investors (TOR) (26 co-occurrences), Dissolution Event Clause (DEC) (25 co-occurrences), and Assurance (21 co-occurrences). These co-occurrences showed the frequencies in the data analysis. While Disclaimer, TOR, and DEC are well-established LRM techniques, DRI and Assurance have not been widely discussed in the literature.

Table 7.6 LRM Techniques Employed on 22 Legal Risks (Co-occurrence Analysis)

| LRM TECHNIQUES | SNCR | RR | CR | LU | SUM |
|---|------|----|----|----|-----|
| ● LRM- DISCLAIMER Gr=115 | 9 | 92 | 8 | 6 | 115 |
| ● LRM- DISCLOSURE OF RISK IMPLICATIONS Gr=51 | 5 | 39 | 7 | 0 | 51 |
| ● LRM- TRANSFER OF RISK TO INVESTORS Gr=26 | 23 | 1 | 0 | 2 | 26 |
| ● LRM- DISSOLUTION EVENTS CLAUSE Gr=25 | 0 | 22 | 3 | 0 | 25 |
| ● LRM- ASSURANCE Gr=21 | 1 | 14 | 6 | 1 | 22 |
| ● LRM- SHARIAH WAIVER Gr=18 | 18 | 0 | 0 | 0 | 18 |

| LRM TECHNIQUES | SNCR | RR | CR | LU | SUM |
|---|-------------|------------|-----------|-----------|------------|
| • LRM- DISCLAIMER BY ISSUER, DDWG EXCEPT SA Gr=19 | 17 | 0 | 0 | 0 | 17 |
| • LRM- DISCLAIMER BY DDWG, INCLUDING SA Gr=6 | 6 | 0 | 0 | 0 | 6 |
| • LRM- DISCLOSURE Gr=8 | 0 | 5 | 0 | 0 | 5 |
| • LRM- CONTRACT ADJUSTMENT Gr=4 | 0 | 4 | 0 | 0 | 4 |
| • LRM- FORCE MAJEURE Gr=7 | 0 | 3 | 0 | 0 | 3 |
| • LRM- FAIR MARKET COMPENSATION Gr=4 | 0 | 2 | 0 | 0 | 2 |
| • LRM- CONTINGENCY FUND Gr=2 | 0 | 2 | 0 | 0 | 2 |
| • LRM- CORPORATE GUARANTEE Gr=2 | 0 | 2 | 0 | 0 | 2 |
| • LRM- EXEMPTION OF LAWS Gr=5 | 0 | 3 | 0 | 0 | 3 |
| • LRM- RELOCATION/ ADJUSTMENT OF SOURCES Gr=2 | 0 | 2 | 0 | 0 | 2 |
| • LRM- DISCLAIMER OF INAPPLICABILITY OF GOVERNING LAW CLAUSE Gr=1 | 0 | 1 | 0 | 0 | 1 |
| • LRM- GOVERNMENT GUARANTEE Gr=1 | 0 | 1 | 0 | 0 | 1 |
| SUM | 79 | 192 | 24 | 9 | 305 |

Table 7.7 Content Analysis of 18 LRM Techniques and 22 Legal Risks (Co-occurrence Analysis)

| LRM TECHNIQUES | ● SNCR1 Gr=24 | ● SNCR2 Gr=39 | ● SNCR3 Gr=1 | ● RR1 Gr=8 | ● RR2 Gr=12 | ● RR3 Gr=18 | ● RR4 Gr=2 | ● RR5 Gr=2 | ● RR6 Gr=42 | ● RR7 Gr=12 | ● RR8 Gr=35 | ● RR9 Gr=18 | ● RR10 Gr=29 | ● RR11 Gr=1 | ● RR12 Gr=14 | ● CR1 Gr=14 | ● CR2 Gr=3 | ● CR3 Gr=1 | ● CR4 Gr=1 | ● CR5 Gr=5 | ● LU1 Gr=6 | ● LU2 Gr=3 | SUM |
|---|------------------|------------------|-----------------|---------------|----------------|----------------|---------------|---------------|----------------|----------------|----------------|----------------|-----------------|----------------|-----------------|----------------|---------------|---------------|---------------|---------------|---------------|---------------|-----|
| ● LRM-DISCLAIMER Gr=115 | 8 | 1 | 0 | 8 | 3 | 0 | 0 | 2 | 14 | 6 | 20 | 11 | 21 | 1 | 6 | 5 | 1 | 1 | 1 | 0 | 6 | 0 | 115 |
| ● LRM-DISCLOSURE OF RISK IMPLICATIONS (DRI) Gr=51 | 3 | 2 | 0 | 0 | 5 | 3 | 0 | 0 | 12 | 4 | 7 | 5 | 1 | 0 | 2 | 4 | 0 | 0 | 0 | 3 | 0 | 0 | 51 |
| ● LRM-TRANSFER OF RISK TO INVESTORS (TOR) Gr=26 | 6 | 17 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 1 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 2 | 26 |
| ● LRM-DISSOLUTION EVENTS CLAUSE (DEC) Gr=25 | 0 | 0 | 0 | 0 | 1 | 8 | 0 | 0 | 11 | 1 | 0 | 0 | 1 | 0 | 0 | 1 | 0 | 0 | 0 | 2 | 0 | 0 | 25 |
| ● LRM-ASSURANCE Gr=21 | 0 | 0 | 1 | 0 | 1 | 0 | 0 | 0 | 4 | 1 | 5 | 2 | 0 | 0 | 1 | 4 | 2 | 0 | 0 | 0 | 0 | 1 | 22 |
| ● LRM-SHARIAH WAIVER (SW) Gr=18 | 9 | 9 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 18 |
| ● LRM-DISCLAIMER BY DDWG ONLY (EXCLUDING SA) Gr=19 | 5 | 12 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 17 |
| ● LRM-DISCLAIMER BY DDWG AND SA Gr=6 | 1 | 5 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 6 |
| ● LRM-DISCLOSURE Gr=5 | 0 | 0 | 0 | 0 | 0 | 1 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 4 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 5 |

| LRM TECHNIQUES | ● SNCR1 Gr=24 | ● SNCR2 Gr=39 | ● SNCR3 Gr=1 | ● RR1 Gr=8 | ● RR2 Gr=12 | ● RR3 Gr=18 | ● RR4 Gr=2 | ● RR5 Gr=2 | ● RR6 Gr=42 | ● RR7 Gr=12 | ● RR8 Gr=35 | ● RR9 Gr=18 | ● RR10 Gr=29 | ● RR11 Gr=1 | ● RR12 Gr=14 | ● CR1 Gr=14 | ● CR2 Gr=3 | ● CR3 Gr=1 | ● CR4 Gr=1 | ● CR5 Gr=5 | ● LU1 Gr=6 | ● LU2 Gr=3 | SUM |
|--|------------------|------------------|-----------------|---------------|----------------|----------------|---------------|---------------|----------------|----------------|----------------|----------------|-----------------|----------------|-----------------|----------------|---------------|---------------|---------------|---------------|---------------|---------------|-----|
| ● LRM- CONTRACT ADJUSTMENT Gr=4 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 4 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 4 |
| ● LRM- FORCE MAJEURE Gr=7 | 0 | 0 | 0 | 0 | 0 | 1 | 0 | 0 | 1 | 0 | 0 | 0 | 0 | 0 | 1 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 3 |
| ● LRM- EXEMPTION OF LAWS Gr=2 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 3 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 3 |
| ● LRM- FAIR MARKET COMPENSATION Gr=4 | 0 | 0 | 0 | 0 | 0 | 2 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 2 |
| ● LRM- CONTINGENCY FUND Gr=2 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 2 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 2 |
| ● LRM- CORPORATE GUARANTEE Gr=2 | 0 | 0 | 0 | 0 | 2 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 2 |
| ● LRM- RELOCATION PLAN Gr=2 | 0 | 0 | 0 | 0 | 0 | 2 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 2 |
| ● LRM- DISCLAIMER OF INAPPLICABILITY OF GOVERNING LAW CLAUSE Gr=1 | 0 | 0 | 0 | 0 | 0 | 0 | 1 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 1 |
| ● LRM- GOVERNMENT GUARANTEE Gr=1 | 0 | 0 | 0 | 0 | 0 | 1 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 1 |
| SUM OF LR WITH LRM TECHNIQUES | 32 | 46 | 1 | 8 | 12 | 18 | 1 | 2 | 42 | 12 | 36 | 18 | 29 | 1 | 14 | 15 | 3 | 1 | 1 | 5 | 6 | 3 | 305 |

The details of the LRM techniques associated/ co-occurring with the legal risks presented in Table 10 and Table 11 are as follows:

1) Disclaimer

A disclaimer clause is the most frequently employed LRM technique in the *wakalah sukuk* documents. Its use is evident in all categories of legal risk, i.e., SNCR, RR, CR, as well as LU. When a risk is managed through a disclaimer, the issuer gives no representation, assurance, warranty, or undertaking over it. For SNCR1, this risk was disclaimed by the issuer notwithstanding confirmation/certification given by the Shariah Adviser. The risk is usually disclaimed with wordings such as, “*No assurance is given that the confirmation of the Shariah Adviser will not be subject to challenge on grounds that the Sukuk Wakalah is not Shariah compliant*”. This disclaimer is usually disclosed in the *sukuk* IC, particularly in the section “Risks related to the *wakalah sukuk*” in the IM, under the “Shariah Compliance” clause. This disclaimer is a general disclaimer where the risk is disclaimed by the issuer without specifying the parties included in the disclaimer. In contrast, it was found that two other disclaimers specifically mention the parties intended in the disclaimer. These two disclaimers were in relation to SNCR1 and SNCR2, as can be seen below:

- i. DISCLAIMER OF SNCR BY ISSUER, DDWG, AND SHARIAH ADVISER:** For SNCR1 and SNCR2, in some of the *wakalah sukuk* documents, the risks were disclaimed in a way that the issuer and the DDWG, particularly the lead arrangers, lead managers and also the Shariah advisers, give no representation or assurance that the *wakalah sukuk* will be not deemed Shariah non-compliant. This technique is usually embedded

within the “Shariah Compliance” clause of the IC. Upon review, this was evident in eight issuance documents.

- ii. DISCLAIMER OF SNCR BY ISSUER AND DDWG ONLY (EXCLUDING SHARIAH ADVISER):** In some of the *wakalah sukuk* documents, SNCR1 and SNCR2 were disclaimed in a way that the issuer and the DDWG, i.e., mainly the principal adviser/lead arrangers lead managers, and for some, *sukuk* trustee, security trustee and facility agent (as indicated in 5.A.) give no representation or assurance that the *wakalah sukuk* will not be deemed Shariah non-compliant. This includes disclaimer of liability usually stated as “*shall not be liable for any consequences of such reliance and/or assumption of any such compliance*”. This technique is usually embedded within the “Shariah Compliance” clause of the IC. Upon review, this was evident in 10 issuance documents.

Similar findings were found for regulatory risk, i.e., risk of financial loss due to the costs of regulation, and legal sanctions due to non-compliance issues. This risk originates from the regulation itself and the uncertainties it entails. For RR2, as found in 21.A. and 4.A., the issuers disclaimed legal charge risk by stating “Therefore, there can be no assurance that the Land Charge and Lease Charge will be registered in favour of the Security Trustee”. For RR6, in regards to licensing risk, the disclaimer was used by the issuer in a way that the issuer gives no assurance that the license, permit, authorization, or certification will be successfully obtained/renewed, or obtained/renewed in a timely manner. This disclaimer, applied for SNCR1, SNCR2, RR1, RR2, and RR6, is disclaiming the future status of a specified matter. In the case of SNCR1 and SNCR2, the specified matter is the status of Shariah compliance of the *wakalah*

sukuk. For RR1, it refers to the realization of security upon dissolution event. For RR2, it refers to the status of security registration and for RR6, it refers to the successful renewal of license, permit, authorization, or certification. For SNCR1 and SNCR2, these risks were disclaimed because they are subject to courts' interpretations and scholars' differing interpretations, respectively. For RR2 and RR6, these risks were disclaimed because they are subject to the relevant authority's approvals under the relevant laws and regulations.

In addition to these, it was found that the disclaimers were also used to directly disclaim against any changes in the laws and to indirectly disclaim the obligations or future liabilities. For instance, in 6.A., the issuer disclaimed RR6 as:

“The quarry and transportation of limestone is a state government regulated activity that requires licensing and permitting for the relevant state government authority and departments. Lafarge Malaysia Berhad's group has all the required licenses and permits to carry out its operations for all raw materials, and has always successfully obtained renewal. Nevertheless, there is no assurance that new conditions will not be imposed in connection with future renewals. Royalties, taxes, duties, and fees related to these licenses and permits may change or increase as a result of changes to policies governing the minerals and mining industry. Additionally, these licenses or permits may be revoked due to changes in laws and regulations governing the minerals and mining industry.”

For RR8 and RR9, it was found that the issuers have employed disclaimers to disclaim the changes in regulatory conditions, either local or international, and how they may affect the business of the issuers. These regulatory changes include:

- a. introduction of new legislation, as evident in 11.A.;
- b. '*sudden restrictive changes in government policies*', as per 16.A.;
- c. '*regulatory uncertainties*', e.g., execution of unfavorable industrial regulations and changes in taxation laws, as per 17.A.; and

- d. changes in foreign exchange control regulations, as in 18.A.

These disclaimers were employed by the issuers to protect themselves from future liabilities arising from the risks. In a similar vein, for RR7, i.e., health, safety, and environmental laws' risks, some issuers also disclaim future liabilities that may arise from the existing laws, future related laws or regulations, and different interpretations of the existing health and environmental laws or regulations. In other words, these laws may be imposing additional material environmental liabilities towards the issuer in the current state or in the future. Considering these, the disclaimer was used upfront in the IM. This disclaimer also included liability of a third party, e.g., contractor, as indicated in 12.A. The disclaimer was also employed in a way that would disclaim the issuer's liability over the acts of other parties. For instance, in the case of RR1, the risk was disclaimed by the issuer in a way that the issuer gives no assurance that the security agent/trustee will be in a position to realize the security for an amount that will cover all amounts outstanding to the *sukuk* holders, as seen in 3.A., 4.A., 5.A., 16.A., 20.A., 21.A., and 32.A.

In the case of RR4, there were specific types of disclaimers employed by the issuer. However, this risk is only prevalent in the case of issuer 1, i.e., a supranational body. The disclaimers are as follows:

i. DISCLAIMER ON INAPPLICABILITY OF GOVERNING LAW

CLAUSE: The issuer disclaimed the inapplicability of the governing law clause, as well as the availability of the issuer's assets, against judgment that may be enforced on it. As a result, the judgement in relation to the assets may not be successful. This was only found in 1.A.

- ii. **DISCLAIMER BY WAY OF IMMUNITY:** The risk is disclaimed by a statement of immunity, i.e., immunity of the issuer's assets against any seizure, attachment, or execution before final judgment. This was only found in 1.A.

In the case of RR5, it was found that the issuers have employed a disclaimer against claims of specific enforcement, which was discussed earlier as a legal risk. Such risk and disclaimer were found only in 1.A. and 20.A. In 1.A., the issuer had disclaimed the risk that the specific enforcement, i.e., claim for damages, will be ordered by the Court. In 20.A, the issuer had disclaimed the risk that the amount of damages that may be awarded by a court to its contractors will not be challenged, thus causing additional financial costs to the issuer.

A disclaimer was also employed to manage RR10, i.e., risk of changes in law. The co-occurrence of this disclaimer to cater for this risk was the highest, i.e., 21 co-occurrences out of 115. The risk was mostly associated with changes in Malaysian law, tax, and administrative practices. It was disclosed and disclaimed by the issuer frequently in a way that the issuer gives no assurance that the laws will not change and will not have adverse effects towards the issuer's business, financial position, and operation. Other than these, it was found that an issuer also used disclaimer to disclaim RR11, i.e., changes in labor law risk, as seen in 12.A. For some issuers, namely those in the agriculture, automotive, construction, manufacturing, property, and recreation-related industries, they have employed disclaimers against various inherent regulatory requirements or changes in them, i.e., RR12. These were evident in 2.A. (2 occurrences), 9.A., 11.A., 12.A., and 18.A.. It was also noted that all RRs co-occurred with the disclaimers, except for RR3.

As stated above, disclaimer was used to manage CR as well. In the document analysis, it was found that there were several issuers who had disclaimed this type of risk, particularly CR1. For 16.A. and 30.A., the issuers had disclaimed their future legal compliance and the material costs and liabilities that may be incurred by them. Other issuers had disclaimed the compliance of a third party (e.g., Project Company or contractors) as seen in 5.A., 11.A., and 21.A. For other types of CR, i.e., CR2, CR3, and CR4, there was only one co-occurrence between each of them with the disclaimer. At the same time, it was noted that this risk was among the least disclosed risks in the *wakalah sukuk* documents, with small frequencies of co-occurrence with the disclaimer. In the case of CR5, a disclaimer was not used by any issuer.

With regards to LU, it was found that disclaimers were employed solely for LU1. There were six co-occurrences between LU1 and the disclaimer. For this risk, the issuers had given no assurance on the possible impact of judicial decisions on the *wakalah sukuk*, particularly after the IM's date became effective.

In sum, considering that the control that the issuers have over the risks is minimal, the use of the disclaimers is understandable. Notwithstanding, there were also some disclaimers that disclaim the original liability of the issuer or parties in the *wakalah sukuk*. As for SNCR1 and SNCR2, it was discovered that the disclaimers were used to renunciate the original liability of the issuer, including the DDWG and Shariah advisers. All *sukuk* issued in Malaysia must be Shariah-compliant. Thus, the issuer, the DDWG and Shariah advisers must practice due diligence to ensure this. Nevertheless, it was found that these liabilities have been disclaimed using either a general disclaimer against Shariah non-compliance, or a disclaimer specifically to protect the DDWG and/or Shariah advisers.

In a similar vein, disclaimers were also employed by issuers to disown their original liability for compliance with any relevant laws. As seen in the co-occurrences between CR and disclaimer, some of the issuers have disclaimed their future compliance towards the laws even though they must comply with the laws at all times in the conduct of their businesses. Thus, the use of disclaimers for these risks is questionable, hence rebuttable, if any of the parties in the *wakalah sukuk* decide to challenge their enforceability. This was supported by a respondent in the interview, the details of which are given in the section on interview analysis.

2) Disclosure of Risk's Implications (DRI)

For some legal risks, the use of disclaimers were not evident, i.e., RR3 and CR5. Instead, these risks were managed through disclosures of the risks' implications (DRI). Other than RR3 and CR5, it was noted that SNCR1, SNCR2, RR2, RR3, RR6, RR7, RR8, RR9, RR10, RR12, and CR1 were managed through DRI. There was no co-occurrence between LU and DRI. As seen in 5.A., the SNCR1's implications have been disclosed in terms of profit recoverability, as "*The recoverability of the profit element under the Sukuk Wakalah may be affected should the issued Sukuk Wakalah are held to be non-Shariah compliant.*" More detailed SNCR2's implications were also discovered in 13.A., which disclosed the legal implications, as, "*If the Sukuk Wakalah are deemed not to be Shariah-compliant by an investor's own standard of Shariah compliance, such investor may be required to sell or otherwise dispose of its Sukuk Wakalah by virtue of its own constitutional restraints or otherwise. Similarly, if the Sukuk Wakalah are deemed not to be Shariah-compliant by potential investors' standard of Shariah compliance, they may be prohibited from buying the Sukuk Wakalah by virtue of its own constitutional restraints or otherwise*".

DRI was also evidently used to manage most regulatory risks. The highest co-occurrence between RR and DRI was RR6. As shown in the IMs, the issuers have disclosed the risks of licensing that are related to regulatory requirements, change of laws, and relevant authority's approvals. These disclosures were accompanied by details of the risk implications, such as:

- i. the relevant licenses or permits' suspension, termination, monetary penalties, and cessation of issuer's operations and businesses, as seen in 17.A.;
- ii. criminal liabilities and delay in issuer's operations, as seen in 20.A.; and
- iii. forfeiture of project land as seen in 21.A.

Some of these risks were managed solely through DRI, while some were managed by both disclaimer and DRI, as evident in 21.A.

Another risk that frequently co-occurred with DRI was RR8, i.e., risk of changes in regulatory conditions. Most DRIs used for this risk have disclosed the risk's general implications, such as, *"Like all businesses, adverse developments in political, economic and regulatory conditions in the country could materially affect the financial and operational condition as well as the overall profitability of the Issuer"* or similar wordings as found in 6.A., 14.A., 19.A., 20.A., and 21.A. In 32.A. and 11.A., the implications were more detailed as they include the COVID-19 related regulatory changes in the disclosures. Both 32.A. and 11.A. *sukuks* were issued in 2020.

DRI was also employed for CR, i.e., for CR1 and CR5 only. There were four co-occurrences between CR1 and DRI, and three co-occurrences between CR5 and DRI. From the document analysis, it was found that for 21.A., the issuer had employed both disclaimer and DRI to manage CR1. It was also noted that for three issuers, they have

employed disclaimers for RR7 and at the same time, disclosed their non-compliance's implications for CR1, e.g., suspension or termination of issuer's operating licenses as seen in 3.A., 4.A., 20.A., and penalties or further legal actions as seen in 32.A. The former three issuers were all related to the power generation industry. In the case of CR5, the DRIs were mainly disclosing general implications of the risk towards issuers' businesses, financial positions, results of operations, as well as prospects, as seen in 22.A. and 25.A. In contrast to 2.A., the issuer has disclosed that its non-compliance with the relevant regulatory requirements, i.e., in traffic management programme, will result in the former paying compensation to the Government.

DRI is a type of risk disclosure. In the literature, risk disclosure was regarded as one of the risk management techniques (Barnes & Bagley, 1994; Mohammad, 2010). However, unlike common disclosure, DRI discloses the risk implications so that potential investors can have more insights on the risk disclosed. Although the use of DRI was noticeable in the documents, its applicability as an LRM technique is subject to further discussion that will be provided in the interview analysis section.

3) Transfer of Risk to Investors (TOR)

As indicated in Table 8, TOR is the third most employed LRM technique. However, only SNCR1, SNCR2, RR8, and LU2 had co-occurred with TOR. For SNCR1 and SNCR2, it was found that there were three different ways of employing this technique, as follows:

- i. It was employed in the *sukuk* IN (e.g. 17.A);
- ii. It was employed under a specific clause in the IC, "Shariah Compliance" clause (e.g., 14.A); or

iii. It was employed in both IN and IC (e.g. 16.A, 2.A).

Through TOR, the risks are usually managed by requiring the potential investors to seek other Shariah experts' views rather than merely relying on the Shariah pronouncement of the *wakalah sukuk*. TOR was frequently stated as "*Potential investors should obtain their own independent Shariah advice as to the Shariah compliance of amongst others, the structure and mechanism of the Sukuk Wakalah and trading of the Sukuk Wakalah*". Although through the literal interpretation of this clause, the liability of the issuer relating to the Shariah compliance was not wholly transferred, TOR can still be considered one of the LRM techniques. It was used to reduce the liability of the issuer because the issuer has expressly required the potential investors to seek independent Shariah advice.

Compared to SNCR1, the co-occurrence between TOR and SNCR2 is higher with 17 co-occurrences. It was also noted that the use of TOR was accompanied by disclaimers, i.e., disclaimer by DDWG (excluding Shariah advisor) and disclaimer by DDWG together with Shariah advisor. In other words, when the issuers disclaimed the risk, they also transferred the risk to the investors.

As indicated in Table 9, RR8 was widely managed by disclaimer, Assurance, and DIR. Nonetheless, one co-occurrence was found between TOR and RR8 in 25.A. In it, TOR was used to manage RR8, i.e., the risk of incompatibility between the *wakalah sukuk* and the potential investors' investment legal requirements. The risk was shifted to the investors in a way that the investors were required to consult further with their legal advisers. On the other hand, LU2 is the risk pertaining to the uncertainties associated with non-viability loss absorption regulations, since the regulations were still new. In this matter, the issuer had managed the uncertainties by transferring them to the

investors. As evident in 19.A. and 25.A., the issuers have advised the investors not to invest in the *wakalah sukuk* unless they have sufficient knowledge and expertise to invest in AT-1 and Tier-2 *wakalah sukuk*. The investors were also advised to evaluate their financial positions, investment objectives, and all the information included in the IM. With these statements, the LU2 may be deemed to be managed through TOR.

TOR as a risk management technique has been discussed in the literature (McCormick, 2013; Moorhead & Vaughn, 2015; Trzaskowski, 2006). However, the context of discussion on TOR in the literature was in relation to insurance, where the risk is transferred to an insurance company or a third party. Meanwhile, the use of TOR in the *wakalah sukuk* documents was in relation to transferring the risk to the investors. This was restricted mainly to SNCR and LU probably because they are subjective, i.e., SNCR is subject to different Shariah opinions while LU, as indicated in the documents, is subject to uncertainties surrounding the new regulations. Nevertheless, its use as an LRM technique will be discussed further in the interview analysis section.

4) Dissolution Events Clause (DEC)

As discussed in the previous section, DEC is one of the LRM techniques employed by the issuer. Numerous events have been listed under the DEC. However, in relation to LR, there were only a few risks that have been included, i.e., compliance risk, contract risk, and litigation risk. These are uniform throughout all the 24 *wakalah sukuk* documents and have been thoroughly discussed in the previous section on general LRM techniques. However, other LRs were not uniformly listed. These LRs (i.e., RR2, RR3, RR6, RR7, CR1, and CR5) that were managed by DEC will be elaborated below.

In 20.B., RR2 was managed through the DEC. The risk was mentioned as “Jeopardy”. It refers to the event where the security interest created under the *sukuk* is

in jeopardy, invalid, defective, or cannot be perfected. Besides this, RR3 was also found managed through the DEC in some *wakalah sukuk* TD, i.e. 2.B., 5.B., 6.B., 14.B., 20.B, 21.B, and 32.B (two co-occurrences). It was stipulated under the DEC that if all or any part of the issuer's business, properties, assets, undertakings etc. are subject to seizure, compulsory acquisition, expropriation, or nationalized (in some *wakalah sukuk*, this particular provision under the DEC is called "nationalization"), by the government, then a dissolution event may be declared; hence enabling the purchase undertakings, redemption, or others as documented. In addition to these, RR6 was found to be the most frequently co-occurring risk with the DEC, with 11 co-occurrences. It was observed that among the most frequently used terms/provisions under the DEC to denote this risk were 'Approvals', 'Governmental Authorisation', "Revocation of License' etc. These 11 co-occurrences were found either in the *wakalah sukuk* TD or PTC.

Other than RR, CR1 and CR5 were also found to be managed by the DEC. As seen in 20.B., the issuer included non-compliance with the environmental laws as one of the *wakalah sukuk* dissolution events. This was understandable considering the nature of the issuer's business, Sinar Kamiri, as an energy generation company. The business requires strict observance and adherence to the environmental laws. Nevertheless, for the rest of the issuers from the same business or industry, the co-occurrence of CR1 and the DEC was not found. Other than these, it was discovered that non-compliance with BNM guidelines constitutes one of the *wakalah sukuk* dissolution events as indicated in 14.B. There were two co-occurrences of these risks and the DEC in 14.B., with one in the main content of the TD and the other in Schedule 3 of the TD.

As seen in the data, the use of DEC by the issuers to manage LRs was evident but not uniform across the 24 *wakalah sukuk* documents. It was also noticed that, while

some risks were managed through DEC in the TD, the same risks were also managed by using other LRM techniques. These were found in RR3 in 2.A. and 2.B., as well as in 21.A. and 21.B.

5) Assurance

Assurance is a statement that consists of information on an issuer's existing strategies and efforts to manage risk. In addition to disclosure of the risk, the issuers have added information to assure the potential investors on the management of risk. Assurance as one of the LRM techniques was solely based on the findings from the *wakalah sukuk* document analysis. In contrast to disclaimers, TOR, and DEC, Assurance is not an established LRM technique. This is because Assurance has not been found in the LRM literature. However, the application of Assurance as an LRM technique will be further discussed from the perspective of the participants, particularly LA, PA, and SA.

It was found that this LRM technique was employed for SNCR3, RR2, RR6, RR7, RR8, RR9, RR12, CR1, CR2, and LU2. Although Assurance is the fifth most employed LRM technique, it was employed by all types of LRs. The co-occurrence between Assurance and RR6 is the highest, with five co-occurrences. These occurred in 11.A., 19.A., 27.A., 30.A., and 32.A. Unlike the co-occurrence in 19.A., other co-occurrences were linked to the Implications of COVID-19 risk. Considering uncertain implications that the risk entails, the issuers have assured the potential investors that the risk has been adequately managed.

Besides RR, Assurance has also been employed to manage CR1 and CR2. CR1 was managed through assurance given by the issuer on its compliance with the environmental laws. This technique was employed by four out of 10 issuers who disclosed the risk. For instance, in 16.A., it was noted that the issuer had assured the

investors of its compliance with the environmental laws by presenting the green initiatives that the business had. On the other hand, CR2 was managed through assurance given by the issuers on the precautions that have been taken to manage the risk. From the aspect of LU2, there were only three occurrences found throughout the documents. While two were managed through TOR, one was managed through Assurance, as can be seen in 18.A. In the document, the issuer stated that:

“There may be a certain degree of uncertainty as to how the laws of Japan would apply under certain circumstances/events affecting the Group and such uncertainty also extends to the interpretation, implementation, and enforcement thereof. However, BAuto Group has maintained a good business relationship with Mazda Japan since 2008 and it has proven to be a strong and reliable partner of the Group. The Board believes that the JV Agreement, a collaboration which requires increased participation and commitment from Mazda Japan, is the outcome of a successful working relationship and a testament of a relationship which the Group has nurtured throughout the years.”

As mentioned, Assurance is not an established LRM technique because it was not found in the literature. Nonetheless, the use of Assurance is evident in all types of LRs by 12 out of 24 issuers, as if it was a standard practice. However, further clarifications were obtained from the participants considering the statements used in the Assurance as to whether it acts as an LRM technique or not. This will be discussed at length in the interview analysis section.

6) Shariah Waiver (SW)

The use of SW has been widely discussed in the literature, particularly during discussions on the *Dana Gas* court decision. In commenting on the improvements to be made, some have underscored the significance of waivers and warranties in *sukuk* (Al-Natoor & Brown, 2020; Busari et al., 2019). However, SW was only applicable in

relation to SNCR. As found in the documents, the SW has co-occurred with SNCR1 and SNCR2. The use of these SWs were found in a few TDs, i.e., 3.B., 4.B., 12.B., 14.B., 15.B., 21.B., and 32.B. For each document, two co-occurrences were found for each SNCR1 and SNCR2, except for 32.B. where three co-occurrences were found for each. The co-occurrences in 32.B. were under the Shariah compliance clause and jurisdiction clause, in paras 10 and 39 of the TD.

Unlike other types of LRM techniques for SNCR, this technique was only found in the *sukuk* TDs. Some issuers and trustees embed this technique in the governing laws and jurisdiction clause, while others embed it in a specific clause, i.e., clause on Shariah compliance.

In the former, the waiver was usually stated as:

“The parties herein further agree to waive any rights to raise any dispute that the Trust Deed and the other Transaction Documents are not Shariah compliant.”

Meanwhile in the latter, the waiver was stated in more detail, for example:

“Each of the parties hereby irrevocably agrees that it has accepted the Shariah compliant nature of the Sukuk Wakalah Programme and the Transaction Documents and further agrees that (a) it shall not take any steps or bring any proceedings in any forum to challenge the Shariah compliance of the Sukuk Wakalah Programme or the Transaction Documents; and (b) none of its obligations under the Sukuk Wakalah Programme and/or the Transaction Documents shall in any way be diminished, abrogated, impaired, invalidated or otherwise adversely affected by any finding, declaration, pronouncement, order or judgement of any court, tribunal or other body that the Sukuk Wakalah and/or the Transaction Documents are not in compliance with Shariah.”

Using this technique, the SNCRs were managed through a waiver accepted by the parties, i.e., the issuer and the trustee, stating that:

- i. They shall not take any legal action to challenge the Shariah compliance of the *sukuk*; and;
- ii. The obligations of the parties under the *wakalah sukuk* Transaction Documents will be effective regardless of the effects of any ruling on Shariah compliance.

Scrutiny of the use of SW by the issuers revealed that the SW consists of two parts, i.e., a waiver and a severance clause. In the first part, the parties waive their rights to challenge the Shariah compliance and in the second part, the parties accept the severance statement, i.e., the Shariah non-compliance is limited to a specified matter that is found to be Shariah non-compliant and it will not affect the contractual obligations between the parties. In view of this, SW may be deemed as an LRM technique, particularly for SNCR and future litigation risk.

7) Disclosure

In analyzing the LRM techniques for the LRs, it was found that while most of the LRs were disclosed together with a specific LRM technique, some LRs were not. However, mere disclosure of the LRs can be considered as the minimal LRM technique used by the issuer. Disclosure, as one of the LRM techniques for *sukuk*, has been underscored by Mohammad (2010). Based on the findings, there were only five co-occurrences between Disclosure and LRs, i.e., in RR3 and RR12 (four co-occurrences). For RR3, this risk relates to land acquisition by the issuer. In 3.A., it was found that this risk was merely disclosed by the issuer. Nonetheless, in a different section of the risk disclosure, the issuer had employed additional LRM techniques, i.e., Fair Market Compensation and Government Guarantee that will be elaborated on later. For RR12, the use of this

technique was evident in three power generation industry-related issuers, i.e., in 3.A., 4.A., and 21.A.. These risks were specifically related to the imposition of an annual windfall profit levy on independent power producers like the issuers and the Government's attempts to renegotiate their power purchase agreements etc. as part of changes in inherent regulatory requirements, in all three *wakalah sukuk*'s IM. The fifth co-occurrence was found in 13.A., in Development Financial Institution (DFI) documents.

While Disclosure was a minimal type of LRM technique, the small number of co-occurrences found in the documents show that this technique was not a preferred technique. The issuers have preferred to associate their risk disclosures with certain other techniques, such as disclaimer, DIR, and Assurance, as elaborated above.

8) Other LRM Techniques

These LRM techniques have four or less co-occurrences with specific legal risks. They are:

- i. **CONTRACT ADJUSTMENT:** In relation to RR10, where changes in the law have the potential to affect the Issuer's contractual obligations, the issuer and the other contracting parties will, in good faith, determine the extension of the current terms. Based on the document analysis, only three issuers employed this LRM technique, where all of them were involved in the power generation business, namely 3.A., 4.A. and 20.A. (2 co-occurrences). In the respective *wakalah sukuk*, the issuers provided that, in the occurrence of changes in laws that compel them to make material capital improvements or modifications, the parties in the contract will adjust the

existing terms, e.g. in the Power Purchase Agreement, or in Capacity Rate Financial.

- ii. FORCE MAJEURE:** The force majeure clause is commonly used to disclaim one's responsibilities in events which are beyond the parties' control (e.g., acts of war, terrorism, rebellion, insurrection etc.) and natural calamities (e.g., earthquake, fire, landslides). However, in 21.A., it was noted that the risk of expropriation by the Government that falls under RR3 was managed through this clause. Additionally, the force majeure clause was also employed to manage RR6 (i.e., "failure to obtain or renew any Government authorizations") by the same issuer. Another co-occurrence between LR and this clause was found in 27.A., where the issuer used this clause to manage RR12. This risk relates to changes in the regulatory requirements.
- iii. EXEMPTION OF LAWS:** RR8 includes risks arising from changes in regulatory conditions due to Government control over the COVID-19 spread. It was found that these risks were managed through the legal exemption granted to the issuers during the COVID-19 Movement Control Order. These were evident in 14.A., 16.A., and 27.A.
- iv. FAIR MARKET COMPENSATION:** For RR3 disclosure found in some *wakalah sukuk*, the risk was managed through the grant of compensation. In cases relating to the Land Acquisition Act 1960, where the project land is to be compulsorily acquired by the Government, compensation will be paid based on the fair market price of the acquired property/land. This was found in 2.A. and 16.A.

v. **CONTINGENCY FUND:** In order to manage RR10, the Issuers had used contingency funds. The funds will be used to meet additional costs incurred due to changes in the law. The use of the contingency funds was evident in 2.A. and 20.A. For instance, in 20.A., it was stated that:

“... (ii) if there is any change in laws which requires a material capital improvement, physical modification or addition to, or a physical change in, or replacement of any part of the Works thereof, in order to achieve compliance with such change but not compliance required under the EPCC Contract. Cost overruns in relation to the Project are expected to be funded from the contingency sum set aside by the Issuer in an amount equivalent to approximately 1.4% of the Project Costs and if insufficient, the Sponsor, through its performance of the Sponsor’s Letter of Undertaking, is to cover cost overruns relating to the Project.”

A similar technique was also found in 20.A.

vi. **CORPORATE GUARANTEE:** As indicated in 32.A., the security of the *wakalah sukuk* had not yet been created at the time when the *wakalah sukuk* was issued. Nonetheless, the issuer has managed this risk, RR2, through a corporate guarantee from the issuer’s parent company. The guarantee was stipulated as follows:

“... Therefore, it should be noted that the Sukukholders for Series 1 Sukuk Wakalah will not have the benefit of having the relevant Series 1 Secured Assets secured against Series 1 Sukuk Wakalah the moment Series 1 Sukuk Wakalah is issued until such time when the perfection of security has been completed. Nevertheless, the Sukukholders will have the corporate guarantee from EcoWorld Malaysia during this interim period. The failure to comply with the condition subsequent will be a breach of the covenant under the Sukuk Wakalah Programme and hence trigger a Dissolution Event.”

vii. **RELOCATION PLAN:** For some *wakalah sukuk*s, RR3 was managed through an alternative plan of relocation. If the issuer’s project land was

subjected to compulsory land acquisition, the issuer had intended to relocate the project, e.g. relocation of power plant. This strategy was evident in 21.A. and 32.A.

viii. GOVERNMENT GUARANTEE: For an issuer, RR3 was managed by a government guarantee. It was stipulated in 2.A. that compensation payment pursuant to the delay in the land acquisition by the Government will be borne by the Government.

In sum, there were 18 LRM techniques found in the *wakalah sukuk* documents. Some of the techniques were widely employed by the issuers, e.g., Disclaimer, DRI, TOR, DEC, and Assurance, while other techniques were only employed by several issuers. As there is no specific guidelines on LRM techniques for *sukuk* documents, the use of these LRM techniques more likely depended on the intentions of the issuers, contingent on their needs and the industries they were in. As seen in the findings, there were some similarities between the power generation issuers in terms of their LRM techniques, i.e., on the use of Fair Market Compensation, Government Guarantee, and Contract Adjustment.

Based on the discussion provided in Chapter 5, techniques like Disclaimer and TOR can be considered as LRM techniques. Thus, they can be used to manage the legal risks in the *wakalah sukuk*. However, the use of DRI and Assurance may be subject to differing opinions among the *sukuk* players. One of the reasons is that these techniques were not widely discussed in the literature. In addition to this, scrutiny on the statements used in the Assurance revealed that they were mere statements of assurance. This is similar with DRI, which stated only the risk implications. None of these statements mentioned about the rights and responsibilities of the contracting parties. In the

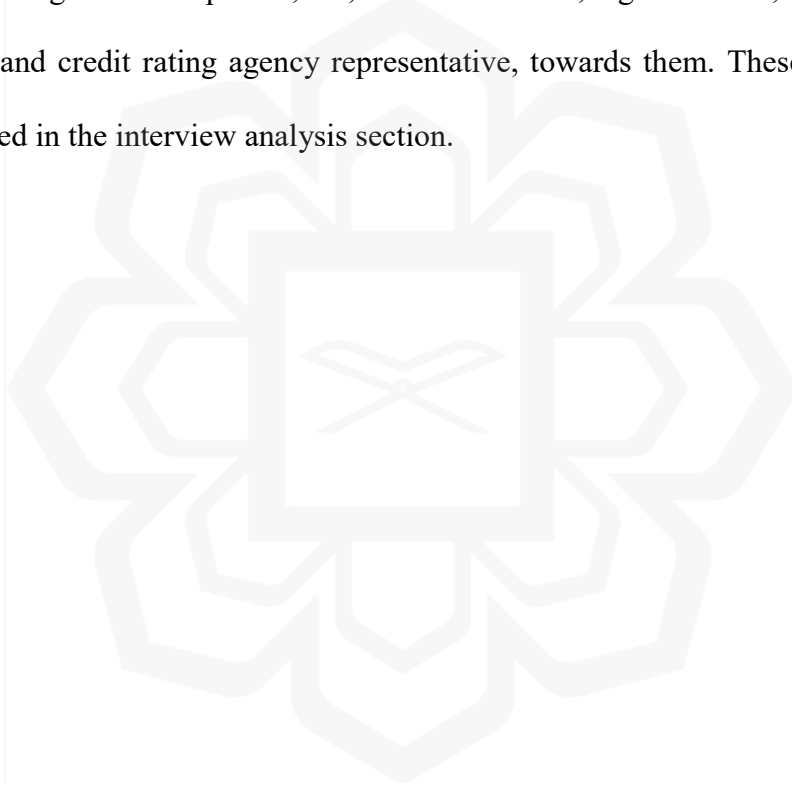
statements of Assurance and DRI, rights and responsibilities in regards to the relevant risks were not conferred, apportioned, or transferred to any contracting parties.

Besides these, it was also found that some of the LRM techniques are related to the law, i.e., the use of clauses that have legal impact on the contracting parties. Other LRM techniques are operational. Examples of these are the Relocation Plan, Contingency Fund, Fair Market Compensation, and Contract Adjustment. These showed that the *sukuk* contracting parties, particularly the issuers, have considered adjustments to their operations in order to manage legal risks in the *wakalah sukuk*.

Findings from the document analysis also revealed that some of the LRM techniques can be used to manage the legal risks of certain parties. As in the case of Disclaimer and TOR, these LRM techniques can be used to manage legal risks of the issuers. Others, like the Shariah pronouncement, Disclaimer of SNCR by issuers, DDWG and Shariah adviser and Disclaimer of SNCR by issuers and DDWG were meant to manage legal risks for each DDWG member. On the other hand, some of these LRM techniques can be used to manage the legal risks of investors, i.e., the DEC, DRI, and Assurance. DEC for instance, is important towards investors when one of the dissolution events occurs. This will assist the *sukuk* trustee, on behalf of the investors, to secure the latter's rights through enabling the purchase undertakings. In addition to these, it may be apprehended that whilst some LRM techniques were meant to protect a party, they also directly or indirectly protect other parties. Hence, LRM techniques are applicable for both issuers and investors. Examples of these are the SW, TOR, Contract Adjustment, Government Guarantee, Corporate Guarantee, Relocation Plan, and Contingency Plan. For instance, the use of SW has helped the issuers to manage future claims of SNCR by the investors and conversely, the investors to manage future claims of SNCR by the issuers. Another instance is the TOR. On the surface, this

technique was used by the issuers to manage their legal risks. However, TOR also assisted the investors indirectly as since the risk was transferred, it required the investors to obtain further clarification and views from their Shariah advisers and legal advisers.

From the *wakalah sukuk* documents, eight general LRM techniques and 18 risk-specific LRM techniques were found. This showed that altogether, there were 26 techniques employed to manage the 22 legal risks found in the documents. Regardless of the techniques' availability in the documents, it was found that there were different views among the *sukuk* parties, i.e., Shariah advisers, legal advisers, trustee, principal advisor and credit rating agency representative, towards them. These will be further elaborated in the interview analysis section.



7.5.4 Analysis of LRM Techniques for Wakalah Sukuk in Malaysia from the Perspectives of the Participants

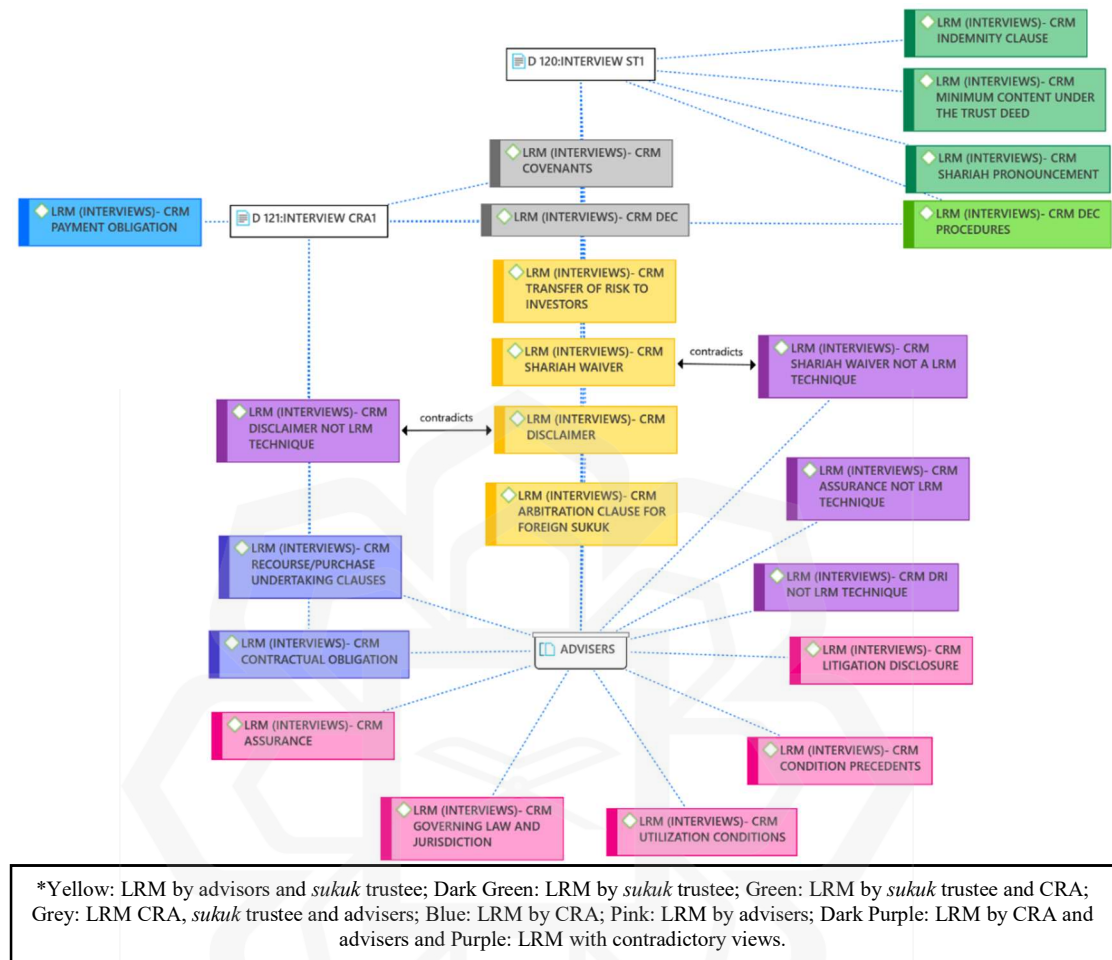


Figure 7.15 LRM Techniques Employed in Wakalah Sukuk

As discussed in the previous sections, there were 26 general and risk-specific LRM techniques employed by the issuers in their *wakalah sukuk* documents. Nonetheless, based on the responses of the participants, there were only 22 LRM techniques. Out of these 22 techniques, only seven LRM techniques have not been included in the previous section. These techniques are in relation to contract risk management, namely techniques used in a contract to manage LR. They are:

- 1) minimum content under the TD;
- 2) SNCR disclosure;
- 3) DEC procedures;
- 4) condition precedents;
- 5) utilization conditions;
- 6) contractual obligations; and
- 7) payment obligations.

Findings on these are presented in Figure 29 above.

Based on the interviews conducted with ST1, he considered the minimum content requirement in the TD as one of the LRM techniques. Although his view on this has been discussed before, i.e., LRM strategy to ensure compliance with regulatory requirements, this technique was included here because ST1 emphasized it from the perspective of *sukuk* contract, or CRM. Apart from this, ST1 also stressed on the provision of SNCR disclosure. According to ST1, this disclosure was made in the IC section of the *sukuk* IM. Being entrusted with the responsibility to protect the investors, ST1 perceived provisions on DEC procedures, apart from the DEC itself, as another important technique employed in the TD to manage legal risks, particularly litigation risk.

From in-depth interviews with the advisers, it was found that there are two other important techniques employed by them to manage legal risks. These are condition precedents and utilization conditions. The condition precedents provide a list of conditions to be met by an issuer before he can use any *sukuk* programme. Utilization conditions, on the other hand, refer to conditions to be met by an issuer before he can issue the *sukuk*. This was explained by SA1 who stated as follows:

“For each issuance, there is also utilization conditions. This is to ensure that for every issuance, they have to follow certain process before they can issue any particular sukuk. For instance, what are the documents to be signed, they give that reps and warranties, and making sure that the credit rating has not changed. Utilization conditions is also, in my opinion, a way to manage transaction risk when it comes to sukuk issuance.”

Other than these, contractual obligation clauses were found to be another LRM technique mentioned by SA1 and CRA1. Although they did not specifically mention any of these clauses in the *sukuk* documents, it is quite understandable that they meant to point to a set of provisions that provide details on the principal amount, estimated profit amount, etc. They believed that these clauses will assist the parties in managing any future litigation risks. In relation to this, CRA1 stressed the importance of the payment obligation clauses. She said:

“We also look at, depending on the, it’s a partnership contract, or it’s a sale-based contract, where’s the difference, what ultimately give that obligation to the issuer or the underlying obligor the commitment to pay and redeem the sukuk, and pay the profit on timely basis. And if it’s a partnership contract, what is the definition of profit, how do they define it, so for us it falls back down to where we can trace the contractual obligation reflected in the sukuk structure in the Shariah contract, where does it appear, is it in the purchase undertaking, is it in the redemption price, ... so different Shariah structures will give you some variations in between, so that’s what we’ve also noticed.”

Apart from the additional seven LRM techniques, it was found that there was no consensus among the participants in regards to the use of several LRM techniques, as listed below:

- 1) Disclaimer;
- 2) Shariah Waiver;
- 3) Assurance; and

4) DRI.

As indicated by CR1, the use of disclaimer negates the effects of the issuer's responsibilities as provided in the representation and warranties. She said:

“So they represent and warranty, that all the information provided is true and fair. So when there are disclaimer clauses, then for us, what is it that they are disclaiming, right?”

Different but interesting responses were also given by LA2 in regards to the use of SW. Similar to CRA1 in regards to Disclaimer, LA2 opined that the waiver would have no effect because the original obligation of the parties, i.e., the issuer and Shariah advisers, is to ensure Shariah compliance of the *sukuk* from the very beginning. He said:

“Definitely no... The legal framework for *sukuk* in Malaysia explicitly states that every *sukuk* issued in Malaysia must be Shariah-compliant, end to end. So there's no waiver, there's no way you can waive. In any way, explicitly or implicitly, your Shariah advisers will be liable... so there's no issue of Shariah waiver, .. that's my understanding towards Shariah compliance in *sukuk*”.

As in the case of Assurance and DRI, it was noted in the previous discussion that these two techniques were obtained directly from the document analysis and regarded as LRM techniques due to their frequent use. Based on the responses of the participants, the use of Assurance was accepted by SA1 but rejected by SA2 and LA1. According to the latter, the statements contained in the Assurance were mainly 'telling what has been done'. On the contrary, SA1 considered it to be good practice, so that the investors will be more comfortable with their investment decisions. As for DRI, it was found that both SA1 and LA1 mutually agreed that DRI is not an LRM technique because, according to SA1, it was merely “stating the implications” and according to LA1, it allowed the

investors to ask for more details. However, LA1 opined that DRI was nevertheless a good practice.

7.5.4.1 LRM Tools Employed in Wakalah Sukuk

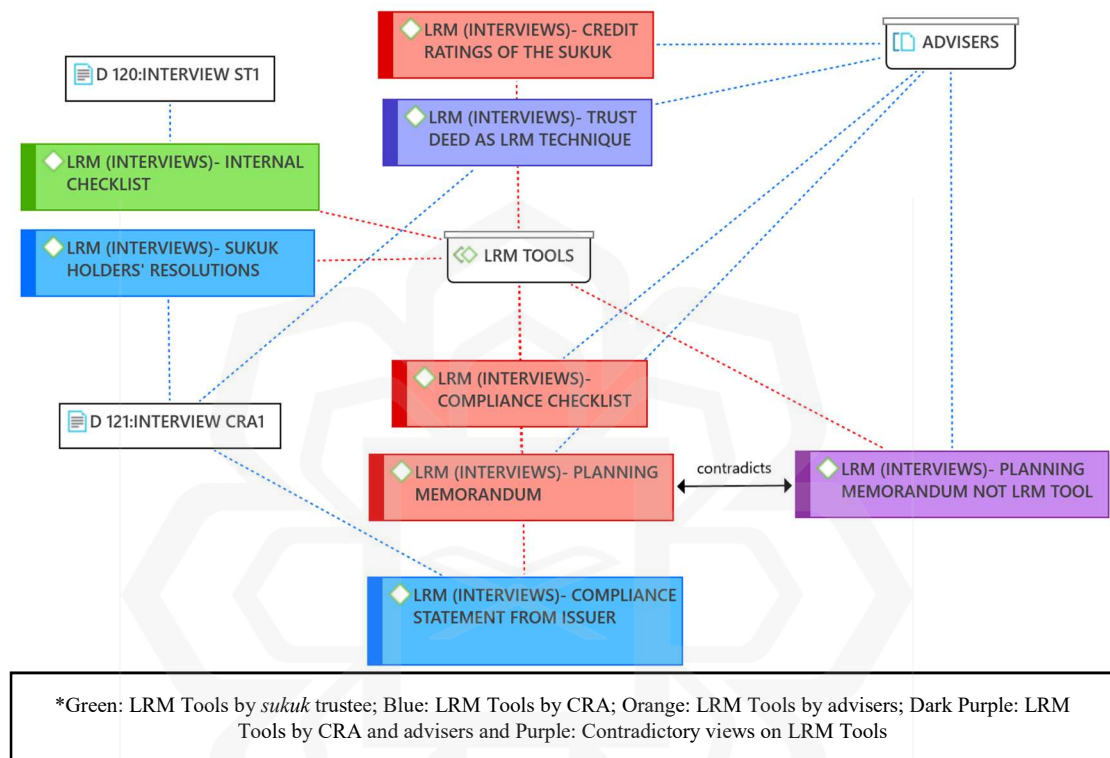


Figure 7.16 LRM Tools Employed in Wakalah Sukuk

LRM tools refer to additional techniques employed by the issuers that could not be found in the *wakalah sukuk* documents. In line with the discussion in Chapter 5, LRM tools may also be construed as physical tools that have assisted the participants in managing legal risks in *sukuk*. Based on the interviews, seven LRM tools were discovered. Out of these seven tools, only one tool was employed by both group participants, signalling a useful tool for LRM. The details of the tools are as follows:

1) Credit rating

SA1 in her responses had mentioned the use of credit rating to manage legal risks faced by investors. Speaking from the perspective of investor's adviser, SA1 was of the view that the credit rating of an issuer indicates his financial ability, thus reducing the risk of default. Even though default risk was not considered a legal risk, *sukuk* default may be a result of legal risk and *vice versa*.

2) Trust Deed (TD)

TD is a document that governs the relationship between the issuer and the investors through a trustee. Therefore, it is comprehensible that it is an important tool to manage legal risks. As stated by LA2:

“TD is very essential in any *sukuk*, TD will enforce the rights on behalf of the investors, investors come and go, the *sukuk* are being traded, therefore the investors are out there trading the *sukuk*, the one who stays throughout the *sukuk* period is the trustee, on behalf of the investors. In fact, if there's default, if you the documents carefully, the trustee can direct and immediately call investors to declare default or *sukuk* downgrade, so trustee will get mandate from investors, the current investors, and call for a meeting and get ... pass the resolution.. it is trustee who will issue the payment order to the issuer”.

Holding similar views with LA2, CRA1 also considered TD as an LRM tool as according to her, the contractual obligations between the issuer and the investors are mainly governed by the TD.

3) Compliance Checklist

According to SA1, there is a compliance checklist used when an issuer lodges an issuance. As explained by SA1, the issuer is required to fill in the checklist to indicate their compliance with the requirements or to prove their commitment to comply with

the requirements. In view of this, a compliance checklist may be deemed to be an LRM tool for the issuer.

4) Planning Memorandum

Planning Memorandum (PM) is a document that declares the duties and liabilities of each DDWG member. As stated by the participants, among the importance of a PM is the setting up of ‘material information’ disclosure in the IM. Based on responses by LA2 and SA2, not only is PM a regulatory requirement, it is also an LRM tool because it protects the rights of the issuer and the DDWG members in the case of default or alike. LA2 said:

“In the planning memorandum, we mentioned every of these liabilities... so from this perspective, it is a legal risk management technique because it ease our works, it prepares us to provide a good due diligence report and will become our shield in the case of dispute triggered from our IM, legal documents. However, until there’s any dispute, the value or importance of planning memorandum is almost none”.

5) Compliance Statement from issuer

Apart from a compliance checklist, it was found that CRA1 used compliance statement from the issuer to prove its compliance with the laws. This tool is in line with the surveillance exercise/ rating update employed by CRA1 to manage legal risks in *wakalah sukuk*.

6) Internal checklist

It is also noteworthy that one of the participants, ST1, mentioned the use of an internal checklist. According to ST1, having an internal checklist is a good practice for

managing legal risks. This is particularly true when ST1 mentioned that the use of the checklist was also to monitor payment and receipt of money owed in the *sukuk*.

7) ***Sukuk* holders' resolutions**

CRA1 has elaborated on the importance of the *sukuk* holders' resolutions or investors' resolutions because it will ascertain the point of default of a *sukuk*. As mentioned by CRA1:

“So, it is a question of what triggers these kind of clauses? What are the implications and what are the *sukuk* holders' remedies towards it? Whether they decide to accelerate or call it a default, that's the prerogatives, they have the *sukuk* holders' resolutions, then they need to pass, ... but they feel that it is temporary, its nothing to lead to material credit impairment, chances are they would probably waive it and say “okay, I will not declare”. So that's basically we have seen the Malaysian environment works”.

In view of the above, she regarded the resolutions as an LRM tool.

7.5.5 Gaps and Improvements within the LRM for Wakalah Sukuk in Malaysia

The findings of this section rely solely on the data collected from the participants. All of the participants were asked about the gaps or problems within the existing LRM framework for *sukuk* and the improvements required. Five out of the seven participants believed that the current legal framework has helped in managing the risks as well as in nurturing the *sukuk* market. They opined that the certainty and clarity in the *sukuk* legal framework, as well as the *sukuk* documentation and the document's enforceability, have reduced the legal risks.

For instance, SA2 stated:

“From my table, my view, in Malaysia, we are the most advanced sukuk market and part of the reason is there are certainty and clarity in all aspects that hold the sukuk, the legal aspect is quite clear what is allowed, what is not allowed, tax, commercial, everything is quite clear, we probably at a high level already. I don’t think there has been any sukuk where a legal risk has materialized. I don’t think, all the sukuk that we’ve had issues with, they failed because of commercial reason, there are not many anyway, either the company is no longer able to pay, or no longer could keep up with its commitment, then you fall back to what the documents have provided. How you manage a situation in this case. If it works quite well, I don’t think there has been any issues recently. In earlier years, yes, in financing. There were some financing cases that end up in the court, but, yes, the way to see whether somethings work well is to see when something go wrong whether all the terms and provisions hold up.”

In terms of gaps and improvements, responses on these were only obtained from LA1 and LA2. Their responses are depicted below:

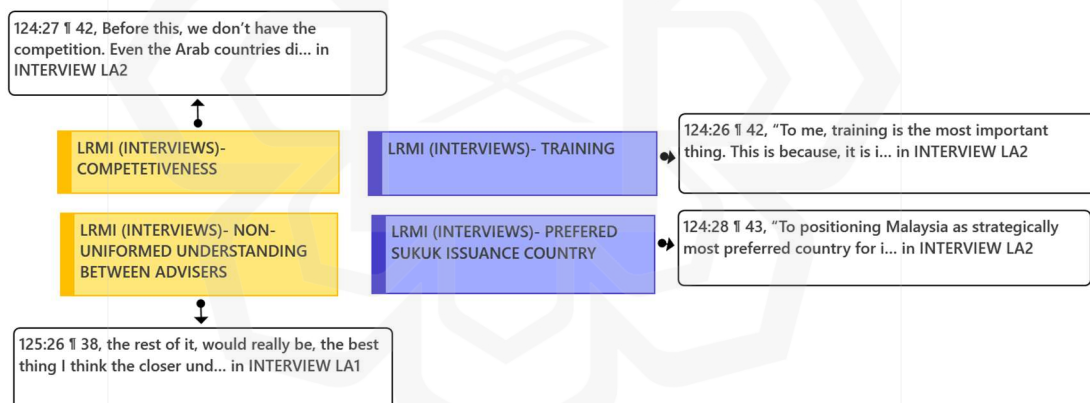


Figure 7.17 LRM Gaps and Improvements

Based on their responses, two gaps and two improvements have been determined. According to LA2, there is lack of competition in the *sukuk* market. Linking this to the LRM, he stated that LRM is not merely about making the current system better but it is also about how to make the *sukuk* market more competitive and more sustainable. He raised the issue of the small market that Malaysia has compared to other countries. He also explained how small the circle of *sukuk* legal advisers is at present.

This, according to him, leads to less innovative products and structures introduced to the market.

On the other hand, LA2 raised the issue of lack of uniformity among the advisers.

He said:

“The regulatory side is quite clear, they have constantly improved the due diligence practices, the MIBA has also come up with their own due diligence guide, so these are ways to manage the regulatory risks, SC also from time to time, also issue the FAQ as to what they are looking for, the rest of it, would really be, the best thing I think the closer understanding between the Shariah advisor and the legal advisor, because sometimes in between, (they) can have different views but they don't even know they have different views because they think they are of the same minds, .. then there will be problems”

He pinpointed the different viewpoints among the legal advisers and the Shariah advisers in terms of approaching certain structures and procedures. Quite similar notes were taken from the interview with CRA1, when she was answering questions on LRM. She mentioned that there could be changes in the Shariah views among the Shariah advisers, and these lead to difficulty in understanding their rationale and justification for the structure selected.

Apart from these, LA1 and LA2 have highlighted the need to train the players in *sukuk*, particularly legal advisers, which are small in number. LA2 also recommended that further improvements be made in the *sukuk* market in order to position Malaysia not only as a dominant *sukuk* issuing jurisdiction, but also a preferred one.

7.6 CONCLUSION: ADDRESSING THE RESEARCH QUESTIONS

There are three main questions that this study aims to answer. The questions are as follows:

1) What are the legal risks in *wakalah sukuk* in Malaysia?

- a. What is a legal risk?
- b. What are the legal risks in *wakalah sukuk* in Malaysia?

The term 'legal risk' refers to various types of risks, ranging from contract and regulatory risk, compliance risk, to financial risks (e.g. business risk, credit risk). The findings also showed that legal risk was perceived based on its consequences, rather than its sources/causes. The consequences include liability and financial loss. As discussed above, the participants held simple but logical definitions of legal risk. These definitions may be determined by the experiences and positions held by the participants in a *sukuk* arrangement. For instance, CRA1 associated legal risk with changes in taxation laws, credit risk, business risk, and default risk, which are plausible legal risks of *sukuk* from her perspective. Other views were also sought from the advisers, trustees and principal advisers but their responses were only partially similar.

As compared to the earlier discussion in Chapter 3 on the definition and scope of legal risk, the findings have highlighted only some types of legal risk. Legal risk was concluded as a risk that arises from the law itself, from contract, as well as from the operation of an organization that may result in financial loss, reputational loss, or legal liability. It encompasses legal uncertainty, regulatory risk, compliance risk, contract risk, documentation risk, transaction risk, and litigation risk. From the findings, transaction and litigation risks were not found. Meanwhile, some financial risks have been included in the definition or scope of legal risk which were not found in the literature as indicated above.

In terms of legal risks in *wakalah sukuk*, the findings indicated that they may be similar to legal risks in other types of *sukuk*. These risks include regulatory risk, contract

risk, compliance risk, and financial risk. To complement these, legal risks in the *wakalah sukuk* documents were analyzed. This study posits that when the risks are disclosed in the *sukuk* documents, it infers that they are inherent in the *wakalah sukuk*. It was found that the most significant type of legal risk inherent in the *wakalah sukuk* is regulatory risk. This encompasses change of law risk, licensing risk, environmental, health and security risk, changes in regulatory conditions risk, and other inherent regulatory risks. Another significant legal risk in the *wakalah sukuk* is Shariah non-compliance risk. In the existing literature, SNCRs were mostly associated with claim risk/ litigation risk as seen in some Islamic financing cases. Based on the findings, it was found that SNCRs were associated with the uncertainties that entail from differing interpretations by the Court and among the scholars, as seen in SNCR1 and SNCR2. For SNCR3, this risk was different because it does not relate to uncertainty, but to the risk of non-Shariah compliance of the issuer's business. Apart from these, other types of legal risk found are compliance risk and legal uncertainties.

Upon further scrutiny, another important point was found. Most of the legal risks disclosed or mentioned by the participants are general legal risks that are not attributed to the structure of the *sukuk*. In other words, the nature of the legal risks does not necessarily relate to the *wakalah* contract/structure. Only a few risks that are specific to *wakalah sukuk* contract/structure were mentioned. They are negligence risk, unenforceability risk, risk related to purchase undertaking, and risk related to the fiduciary duties between the issuer and the investor since their relationship is governed by *wakalah* contract. Negligence risk was also found to be hypothetical, considering the nature of *wakalah bil al-istithmar* contract.

When findings from both sources were merged, it was found that legal risk in *wakalah sukuk* in Malaysia comprised legal uncertainty, regulatory risks, Shariah non-

compliance risk, compliance risk, contractual risk, and documentation risk. Financial risk and operational risk were also perceived to be legal risks by several participants. Although all the risks may be grouped under the three categories (group family), most of the risks obtained from the interviews are general in nature, e.g., risk associated with *sukuk* legal framework and compliance risk, while most of those obtained from the documents are specific, e.g., RR1-RR12, CR1-CR5, etc. The summary of findings on legal risk in *wakalah sukuk* is as follows:

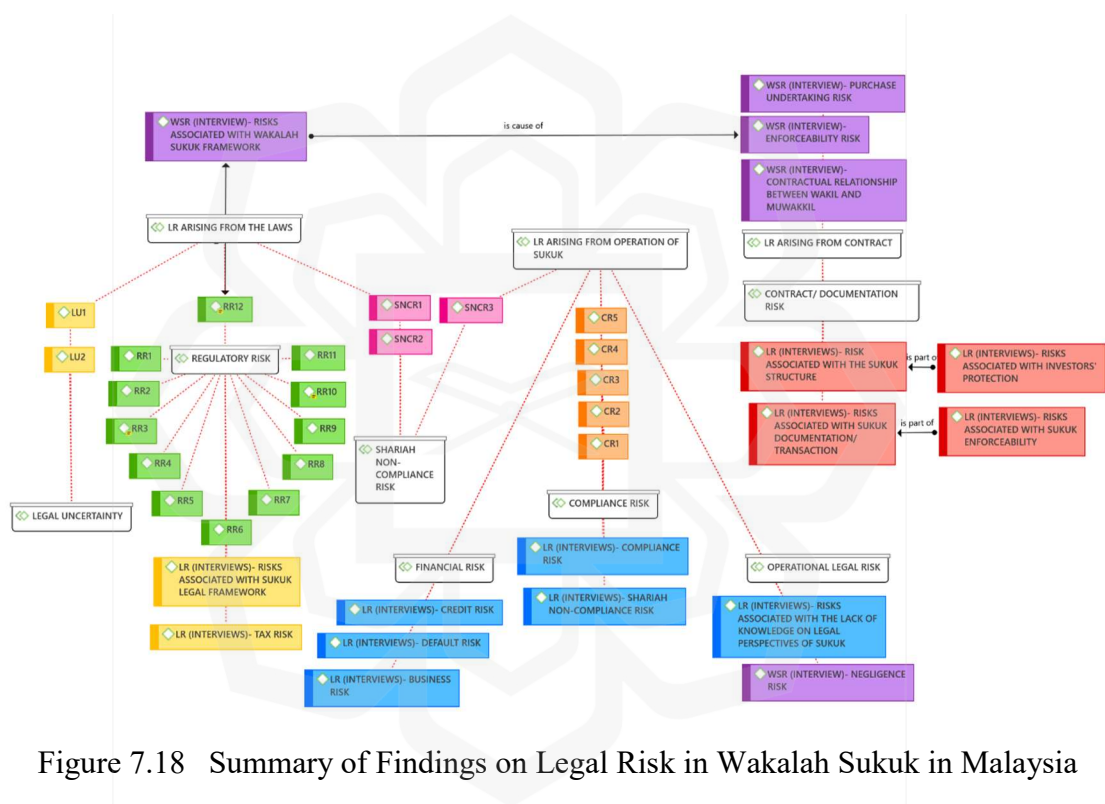


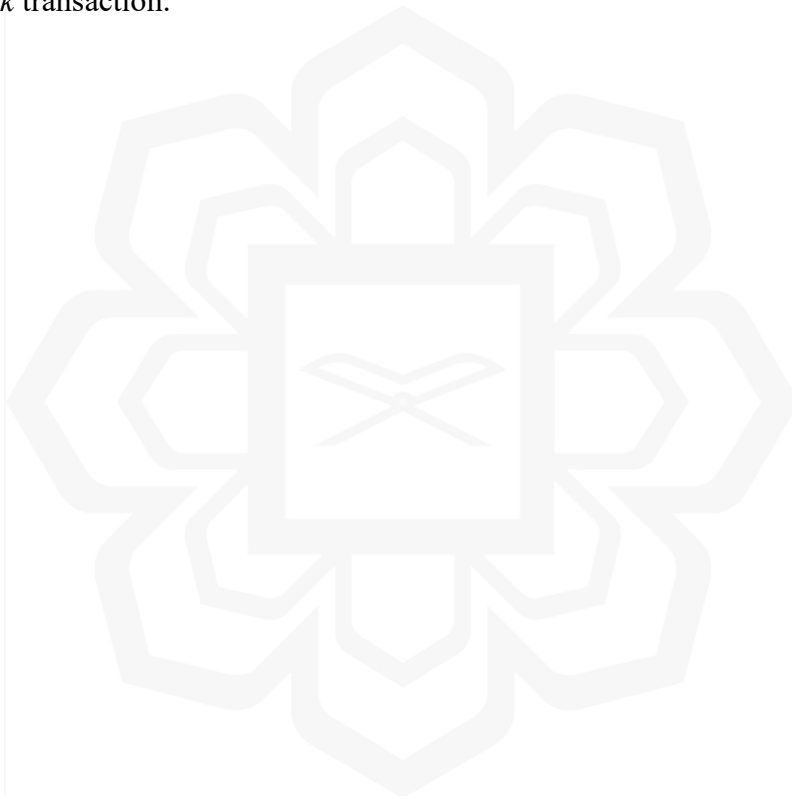
Figure 7.18 Summary of Findings on Legal Risk in Wakalah Sukuk in Malaysia

Overall, clear distinctions on legal risk in *wakalah sukuk* between those found in literature, document analysis, and interviews are presented below:

Table 7.8 LR based on three types of analysis

| Literature | Document Analysis | Interview |
|--|--|--|
| Types of legal risks | | |
| <p>There are three aspects/ themes of legal risk, namely those arising from the laws (the Malaysian legal environment), <i>sukuk</i> contract, and <i>sukuk</i> operation.</p> | <p>There are four types of legal risks, i.e., those related to Shariah non-compliance, regulatory risk, compliance risk, and legal uncertainty.</p> <p>When these four types of legal risks were grouped in the three aspects of legal risks (group family), only the legal risks arising from the laws and those arising from the <i>sukuk</i> operation were found.</p> <p>The legal risks found in the documents are specific, e.g., twelve types of regulatory risks, five types of compliance risks, etc.</p> | <p>Legal risks perceived by the participants can be grouped under the three group family. However, when the findings from both sources were merged, there are basically additional types of legal risks identified, i.e., financial risks and operational legal risks.</p> |
| Nature of the legal risks | | |
| <p>The legal risks are both hypothetical and observed risk</p> | <p>The risks are disclosed legal risks- the risks are presumed to be inherent and significant since disclosure in the IM, TD, and PTC is mainly for material information, hence material risk.</p> | <p>Some of the participants explained the legal risks based on real experiences while some explained the risks hypothetically.</p> |
| Coverage of legal risks | | |
| <p>The literature covers many types of risk, e.g. legal uncertainty, regulatory risk, compliance risk, contract risk, transaction risk, operational legal risk, etc.</p> | <p>Through the document analysis, only four types of legal risks are covered.</p> <p>Contract risk was not disclosed in the <i>sukuk</i> documents.</p> | <p>Some legal risks were similar to those found in the literature and document analysis: unenforceability risk, compliance risk, regulatory risk, contract risk etc.</p> |

The distinction between the legal risks examined from these three sources may be due to the perception about the scope of legal risk. While the literature and document analysis suggest that financial and some categories of operational risks (e.g., lack of expertise) are not associated with legal risks, several participants viewed these risks as legal risks. According to them, among the main sources of legal risks in *sukuk* are failure to secure payment to the investors, and bankruptcy of the issuer. Furthermore, the scope of legal risk is also perceived differently among the participants based on their roles in the *sukuk* transaction.



The second research question (RQ2) is set out below:

2) How are the legal risks in *wakalah sukuk* in Malaysia managed?

- a. What are the strategies employed to manage legal risks in *wakalah sukuk* in Malaysia?
- b. What are the techniques employed to manage legal risks in *wakalah sukuk* in Malaysia?
- c. What are the tools employed, if any, to manage legal risks in *wakalah sukuk* in Malaysia?

Before answering RQ2, this study has made extensive reviews on the literature related to LRM. From the literature, it is evident that there are abundant risk management strategies, techniques, and tools employed in LRM, ranging from the operational approach to specific tools like the quantification of risk.

From the literature related to LRM in *sukuk*, some of the LRM strategies identified were: (1) acquiring legal opinion particularly on the issues of regulatory and compliance requirements, the effects of governing law and jurisdiction clause, and alternative forum for dispute resolutions ; (2) competent *sukuk* promoters who are well-versed in regulatory and compliance requirements (Abdul Khaleq et al., 2007); (3) competent Shariah advisors who are well-versed in conventional financial and economic concepts and have the ability to communicate and review English documents (Abdul Khaleq et al., 2007); (4) use of Alternative Dispute Resolution (ADR); (5) adequacy of disclosure of material information particularly in the offering circulars (Barnes & Bagley, 1994; Mohammad, 2010); (6) Shariah Waiver (Bälz, 2008); (7) use of choice of law to ensure the applicability of Shariah laws, especially in non-Shariah

jurisdictions (Colon, 2011), e.g., governing law and jurisdiction clause, and (8) the use of credit rating/highlighting the roles played by credit rating agency in assessing legal risk.

While some of these strategies fall under the category of LRM techniques, such as the use of choice of law and Shariah waiver, others have been identified in the findings on the LRM strategies. For instance, it was found that seeking legal advice from the relevant authorities, e.g., legal advisers and Shariah advisers, is one of the strategies employed by the participants. Other than that, the strategy of ensuring the competency of the *sukuk* promoters and advisers was also evident in the findings when the participants highlighted the importance of staff knowledge enhancement as one of the LRM strategies. The strategies involving clauses in *wakalah sukuk* documents as well as credit ratings were also found in the findings on LRM techniques and tools.

The findings have provided insightful information on the actual strategies employed to manage legal risks. These strategies are diverse, considering the position that each of these participants held in a *sukuk* arrangement. While some regard the drafting of *wakalah sukuk* document as an LRM strategy, in the case of legal advisers, others like ST and CR1 considered browsing the documents and scrutinizing the provisions therein as their LRM strategies. Additionally, LRM strategies employed by a participant may also be influenced by who they are representing or advising. Similar points were mentioned by SA1 and LA2. For them, determination of the LRM strategies or techniques that they will employ is based on the clients they are representing.

From the aspects of LRM strategies, techniques and tools, the findings were grouped into the sources of the data, i.e., LRM employed by adviser, trustee, and credit rating agency. The grouping was anticipated to yield better understanding of the findings. However, in concluding these findings, more groupings of themes are used

because some of these LRMs are better visualized from the perspectives of LRM strategies' types. These types are: 1) strategies of risk identification, 2) strategies of risk assessment, 3) strategies of risk control, 4) strategies of risk monitor and 5) strategies of risk response (see Figure 7.19). For instance, while some LRM strategies employed by the participants are different from each other because of their positions and roles in the *sukuk*, they are actually of the same types, i.e., strategies employed to identify legal risks, in contrast to strategies employed to monitor such risks. At the same time, some of these strategies are only employed at the *sukuk* pre-issuance stage, while others are employed at the post-issuance stage. Nonetheless, to ensure that these findings are discussed in line with the findings in Chapter 5, they are presented based on the five LRM strategies, i.e., risk identification, risk assessment, risk control, risk monitoring, and risk response.

In the LRM literature, there were five and eight LRM strategies found employed by an organization and a legal adviser, respectively (see Figure 5.2, Chapter 5). The findings on LRM strategies as employed by the participants proved to be slightly different from the findings in the literature. Nevertheless, the risk identification, risk assessment, and risk control strategies employed among the participants can be summarized as follows:

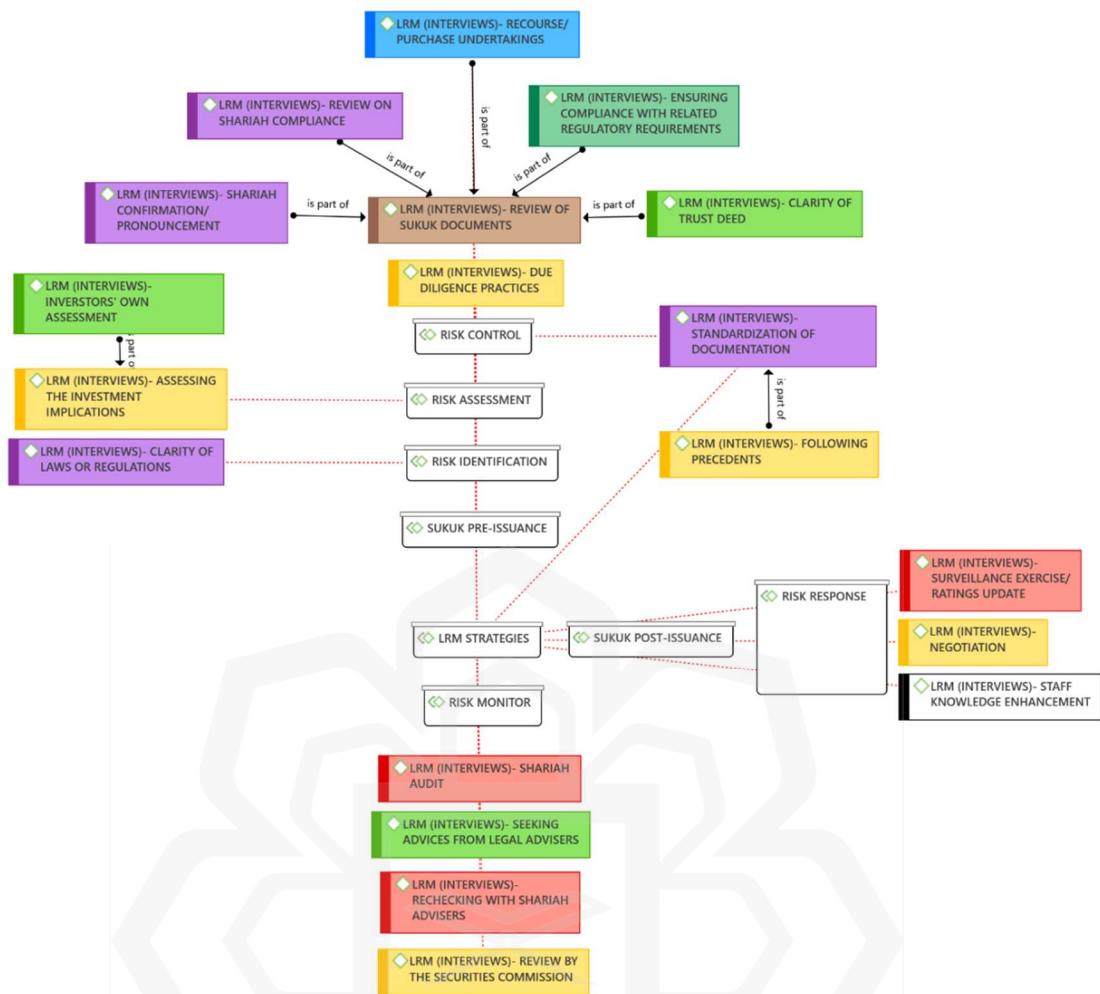


Figure 7.19 Summary of findings on LRM Strategies

Based on the findings, risk identification, risk assessment, and risk control are overlapping strategies employed by the participants. Apart from clarity of laws, due diligence practices and review of *sukuk* documents also help with risk identification. It was found that these strategies not only serve the purpose of risk identification, but also risk assessment and risk control. There are at least five main LRM strategies found, and these strategies are vital at the *sukuk* pre-issuance stage:

- 1) Clarity of laws and regulations (it may be perceived as an LRM strategy set by the *sukuk* policy maker towards good management of LR in *sukuk*);
- 2) Due diligence practices (conducted by the issuer and the DDWG);

- 3) Review of *sukuk* documents (conducted by the issuer and the DDWG);
- 4) Assessing the implications of the investment (conducted by the issuer and the DDWG, particularly legal adviser, for *sukuk* investors); and
- 5) Standardization of *wakalah sukuk* documents (strategy employed by the legal advisers in drafting and documenting material information of the *sukuk*).

At the same time, there are at least four risk monitoring strategies employed by the participants. In general, risk monitoring involves regular reporting of important information to departments which can assess its significance. It involves reviews of external parties, e.g., the SC, Shariah audit, and even rechecking done by the participants with the legal adviser and Shariah advisers. Even though these advisers are part of the DDWG, the data showed that these strategies were employed by the trustee and the credit rating agency representative.

Meanwhile, it was found that there are three LRM strategies that form part of the risk response. Unlike other strategies employed at pre-issuance stage, these risk response strategies are employed at the post-issuance stage, and they are:

- 1) Surveillance exercise/ ratings update (done by the credit rating agency);
- 2) Negotiation (mentioned by the legal adviser, to assist with default or near-default *sukuk*); and
- 3) Knowledge enhancement of staff (mentioned by the trustee and credit rating agency to cope with advancements in *sukuk* deals).

In terms of LRM techniques, findings from the document analysis revealed that there were at least eight general risk techniques and 18 risk-specific techniques

employed in the *sukuk* documents to manage the legal risks. The techniques are listed out as follows:

Table 7.9 LRM techniques in wakalah sukuk documents

| General Techniques | Risk-specific Techniques |
|---|--|
| Important Notice | Disclaimer (4 types of disclaimers) |
| Investment Consideration's General Disclaimer | Disclosure of Risk Implications |
| Governing Laws and Jurisdiction Clause | Transfer of Risk to Investors |
| Covenants of the Issuer | Dissolution Event Clause |
| Disclosure of Existing Litigation | Assurance |
| Dissolution Event Clause | Shariah Waiver |
| Purchase Undertaking Provisions | Disclosure |
| Indemnity Clause | Contract Adjustment |
| | Force Majeure |
| | Fair Market Compensation |
| | Contingency Fund |
| | Corporate Guarantee |
| | Exemption of Laws |
| | Relocation Plan/ Adjustment of Sources |
| | Government Guarantee |

Comparing these techniques to those found in the literature, some similarities were noted. Similar techniques were the function of governing law and jurisdiction, legal advice, disclosure and Shariah Waiver. Techniques other than these (e.g., the use of ADR clause, choice of laws clauses etc.) could not be found in the literature. In comparison to interviews, responses from the participants revealed that some of them did not even agree to the use of several techniques. These were evident in the use of Assurance, Disclaimer, DRI and Shariah Waiver. Most of the arguments provided in

the findings disregard these techniques as LRM techniques in relation to their incompatibility with other provisions in the *wakalah sukuk* contract. For instance, the incompatibility between Shariah pronouncement provision and the Shariah waiver, the Disclaimer, and the representation and covenants provided by the issuer. For Assurance and DRI, it was argued that they are not LRM techniques because they do not embed any rights and obligations.

In the literature on LRM, it was found that a quantification tool has been employed to manage legal risk. Based on the findings, it may be appropriate to note that these participants have been managing legal risk manually, i.e., without any tool specifically designed to manage legal risks in the *sukuk*. Nonetheless, seven LRM tools were found and they were regarded as the ‘hardware’ used for LRM. The findings also revealed that each party in the *sukuk* has employed different tools, e.g., compliance checklist, compliance statement, etc. Regardless of these differences, the LRM tools have the purpose of reducing legal risk, e.g., the use of compliance checklist to reduce one’s liability, the use of compliance statement to reduce the impact of legal risk by assessing them upfront, the use of planning memorandum to ensure responsibility and outline the liability to be borne by each DDWG member, thus protecting each of them from future dispute, etc. However, the lack of use of LRM tools as found in the literature, e.g., tools to quantify and visualize legal risks, may be deemed as one of the gaps in the existing LRM, thus requiring improvements in the future. This is considering that the use of these tools have been shown to improve the LRM.

The final research question (RQ3) is:

3) How can the management of legal risks in *wakalah sukuk* be improved?

- a. What are the gaps in the management of legal risks in *wakalah sukuk* in Malaysia?
- b. How can the management of legal risks in *wakalah sukuk* in Malaysia be improved?

In line with RQ3, the questions on the gaps in the management of legal risks in *wakalah sukuk* in Malaysia may well be answered with the lack of tool-assisted LRM as discussed above. The findings also revealed that one of the gaps was in terms of the lack of agreement between the legal advisers and the Shariah advisers, as noted by LA1. From the document analysis, some gaps in terms of LRM were evident. One of them is the uncertainty regarding the ‘workability’ of each LRM technique. This is true for some LRM techniques, e.g., Assurance, DRI, and Shariah Waiver. At the same time, it was found that some of the LRM techniques were used to negate the original responsibility of the parties. For instance, the use of Disclaimer towards non-compliance obligations and its implications. Recommendations on these gaps will be discussed in the next chapter.

Another gap was identified in terms of market competitiveness. The findings suggest that LRM heavily relates to the sustainability of the *sukuk* market. This finding is quite insightful compared to what this study has been trying to determine, i.e., legal risk and LRM. Thus, the findings provide a further glimpse into the future of LRM, particularly on how the LRM may sustain the Malaysian *sukuk* market. For instance, it gives insights on how a change of laws may be needed to allow for more competitive

and innovative *sukuk* market, and how the risk of change of laws may impact the *sukuk* players. Similarly, it also sheds some light on how a new asset class may impact the current *sukuk* market and affect the existing LRM techniques. Recommendations on these are set out in the next chapter.



CHAPTER EIGHT

CONCLUSION

8.1 INTRODUCTION

This chapter concludes the study by addressing the main findings of this study and their implications. At the end of this chapter, limitations of the study will be set out and recommendations for future studies will be provided.

8.2 MAIN FINDINGS

The main findings of this study are set out based on each chapter, as follows:

Table 8.1 Main Findings of the Study

| | |
|-----------------------------------|--|
| Literature Review: General Review | It has been revealed that most studies in the area of <i>sukuk</i> have been focusing on 'legal issues'. Specific study devoted to 'legal risk' in <i>sukuk</i> was not evident. |
| Review of Legal Risk | <p>Based on the reviews, it has been discovered that legal risk encompasses two concepts, i.e., risk and uncertainty. The implication is that legal uncertainty is included as a type of legal risk. Based on the existing literature, legal risk has been defined for further clarification on its use in this study.</p> <p>The existing literature have shown at least seven types of risks that have resemblances with legal risk. In this chapter, definitions and characteristics of these legal risks alike have been elaborated and demarcation lines between them have been drawn. Due to their similarities with the 'concept' of legal risks, the seven risks are regarded as types of legal risks. The implication is that, for the purpose of this study, these seven risks alike will be considered as legal risks in the data analysis.</p> |

| | |
|---|--|
| <p>Review on Legal Risk in <i>Wakalah Sukuk</i> in Malaysia</p> | <p>Building from a clear definition and concept of legal risk in the previous chapter, this chapter further discussed hypothetical and observed legal risks that are inherent in <i>wakalah sukuk</i>. The main findings of this chapter are the list of legal risks that are hypothetically inherent or which are observed to be inherent in <i>wakalah sukuk</i>.</p> |
| <p>Review on LRM</p> | <p>This chapter discovered various LRM approaches and strategies from both organizational and legal adviser’s perspectives. In the same chapter, relevant information on LRM in <i>sukuk</i> have been obtained. These were gathered from relevant literature that tackled legal issues in <i>sukuk</i> and provided ‘solutions’ for them. However, the main contribution of this chapter is the merging of the findings on LRM and the ‘solutions’. As a result, for LRM in <i>sukuk</i>, what constitutes LRM strategies, LRM techniques, and LRM tools have been outlined for further use in the data analysis.</p> |
| <p>Discussion and Analysis of Research Findings</p> | <p>The main findings of this study were recorded and presented in this chapter, as follows:</p> <ol style="list-style-type: none"> 1. Legal risks from the perspectives of <i>sukuk</i> parties; 2. Legal risks of <i>wakalah sukuk</i> as perceived by the <i>sukuk</i> parties; 3. Legal risks specifically associated with <i>wakalah sukuk</i> as perceived by the <i>sukuk</i> parties; 4. Legal risks of <i>wakalah sukuk</i> as documented in <i>wakalah sukuk</i> documents; 5. LRM strategies as employed by the <i>sukuk</i> parties; 6. LRM techniques as employed in the <i>wakalah sukuk</i> documents; 7. LRM techniques as employed by the <i>sukuk</i> parties; 8. LRM tools as employed by the <i>sukuk</i> parties; 9. Gaps in LRM in <i>sukuk</i>; and 10. Improvements needed in LRM in <i>sukuk</i> |

As indicated in Table 12 above, this study has noted that most of the relevant literature focused on legal issues. From what was reviewed in this chapter, evidently there has been no previous study that was specifically devoted to research on legal risk in *sukuk* and its management. Thus, there is room for further research on the nature of legal risks in *sukuk*, types of legal risks in *sukuk*, and the management of legal risks in *sukuk*.

Thus, after analyzing the concepts of risk, probability, uncertainty, as well as legal risk itself, it was found that legal risk encompasses more than a concept of 'risk'. Even though risk was differentiated from uncertainty based on known and unknown probabilities, respectively, it was discovered that legal risk constitutes both risk and uncertainty. At the same time, it has also been delineated through reviews in the past literature that legal risk consists of a few types of risks. These risks were discussed abundantly in past literature, whether associated with legal risk or otherwise. Nevertheless, the definitions of the risks have shed some light on the nature of the risks and their relationship with legal risk.

Based on the discussion provided above, legal risk can be defined in terms of both its consequences and its causes. Therefore, legal risk is a risk that arises from the law itself, from a contract as well as from the operation of an organization that may result in financial loss, reputational loss, or legal liability. It encompasses legal uncertainty, regulatory risk, compliance risk, contract risk, documentation risk, transaction risk, and litigation risk.

Building from the definition and concepts in relation to legal risk, legal risks in *sukuk* and *wakalah sukuk* have been identified. They were either hypothetical or observed risks, encapsulated within three aspects, namely: 1) legal risks arising from the Malaysian legal environment; 2) legal risks arising from the legal perspectives of

the *sukuk* contract, including *wakalah sukuk* structure; and, 3) legal risks arising from the operation of *sukuk*.

On the other hand, the LRM has been unraveled in Chapter 5. Through discussions provided therein, evidently there are abundant risk management strategies, techniques, and tools employed in LRM. They range from the operational approach to specific tools such as the quantification of risk. At the same time, reviews on relevant literature on *sukuk* have indicated that there were two types of recommendations on LRM, i.e., the general recommendations on how to manage legal risks and the specific recommendations.

These two types of LRM suggested in the literature have been categorized under the three group family found, i.e., LRM strategies, LRM techniques, and LRM tools. For LRM strategies, they were applicable to all general strategies employed by the *sukuk* parties. In regards to these, further enquiries will be made on how the LRM in *wakalah sukuk* has been conducted by the relevant parties, i.e., principal advisers, legal advisers, Shariah advisers, trustee, and even credit rating agency representative. These are in line with the suggestions made in the literature on the important roles played by these parties.

In terms of LRM techniques, they were applicable to all relevant provisions or clauses provided in the *wakalah sukuk* contract/documents. For this, all the suggested LRM techniques in the literature were asked to the *sukuk* parties will be determined that include: the use of governing law and jurisdiction clause, the use of ADR clause, the use of Shariah waiver, adequate disclosure of material information, and the use of any provision employed to manage legal risks in the *wakalah sukuk*, either generally or specifically.

In terms of LRM tools, they would be applicable to any external/physical tools, or additional tools employed by the *sukuk* parties to assist them in managing legal risks in *wakalah sukuk*.

The main findings of this study have been captured in Chapter 7. Not only were eight aspects of findings provided in the chapter, the findings also showed that some gaps were evident in terms of legal risks as discussed in the literature compared to those faced or disclosed in the *wakalah sukuk* documents (mismatches), differing views among the participants on the use of certain LRM techniques, hence their ‘workability’, as well as the lack of available tools to assist in the LRM of the parties. Although it was noted that each participant has their own way of managing risk, literature has shown more advanced tools in the field. Actions towards filling these gaps will be discussed in the next section.

It was also noticed that most of the legal risks and LRM strategies/ techniques/ tools presented in this study were not specifically in relation to *wakalah sukuk*. Selecting one specific *sukuk* structure at the beginning of this study was meant to lead to more insights on how legal risk and LRM work for the structure. Nonetheless, it appeared to the researcher that these findings are most probably applicable to all *sukuk* structures as well. To consider these as drawbacks may be inappropriate because so far, similar works on this topic is not yet evident. Thus, these unexpected findings may benefit future studies in related fields.

8.3 LIMITATIONS

As indicated in Chapter 6, data for this study were collected from publicly available documents on *wakalah sukuk*. Due to constraints in terms of time and networking, the actual *wakalah sukuk* transaction documents were not able to be secured and used in

this study. The documents used for this study are those obtained in 2016-2021 only. Coming to 2023, some changes and improvements may be evident in current *sukuk* documents which would not have been considered in this study. This study also considered only the laws and regulations that were effective prior to 2022. Based on the current search, several amendments have been made to some of the laws/ guidelines referred to in this study. Therefore, it is a limitation of this study that it does not take into consideration the new laws and the latest amendments to the existing laws.

8.4 RECOMMENDATIONS

Based on its findings, this study makes the following recommendations:

1. To conduct future studies that undertake bigger data on legal risks and LRM in *sukuk*.
2. To conduct future studies that research on legal risks and LRM in *sukuk* in foreign jurisdiction or multiple jurisdictions. Most of the participants in this study do not perceive much problems with the existing legal risk and LRM in the Malaysian jurisdiction. Therefore, it would be beneficial for future studies to give focus to other jurisdictions.
3. To conduct further research collaborations between *sukuk* parties and academicians so that more insights on *sukuk* risk management can be explored.
4. In relation to the gaps and improvements needed in the LRM, to conduct further research in collaboration with the SC and other relevant authorities to project the growth of the *sukuk* market in Malaysia.

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APPENDIX I: LIST OF WAKALAH SUKUK ISSUANCES

List of *wakalah sukuk* issuance under the Lodge and Launch Framework is as follows:

| No. | Issuer | Types | Size (Mil) | Principal Adviser | Issuance Date | Obligor | Sukuk Trustee | Legal Advisors | Credit Rating |
|-----|-----------------------------------|---------------|------------------|--|---------------|--------------------------|--------------------------|---|------------------------|
| 1. | Tadamun Services Berhad | Sukuk Wakalah | Up to RM400.00 | CIMB Investment Bank Berhad, RHB Investment Bank Berhad & Maybank Investment Bank Berhad | 29-Jun-16 | Islamic Development Bank | Malaysian Trustee Bhd. | Messr Zaid Ibrahim & Co. | MARC AAA _s |
| 2. | Lebuhraya DUKE Fasa 3 Sdn Bhd | Sukuk Wakalah | Up to RM3,640.00 | AmInvestment Bank Berhad (Shariah-Jointky with Dr. Mohd Daud Bakar) | 23-Aug-16 | - | Malaysian Trustee Bhd. | Messr Zaid Ibrahim & Co. | MARC AA- _{IS} |
| 3. | Southern Power Generation Sdn Bhd | Sukuk Wakalah | Up to RM4,000.00 | CIMB Investment Bank Berhad (Shariah-Jointly with Maybank Islamic Bank Bhd.) | 31-Oct-17 | - | AmanahRaya Trustees Bhd. | Adnan Sundra & Low (PA) Messr Zaid Ibrahim & Co. (I) | MARC AA- _{IS} |

| No. | Issuer | Types | Size (Mil) | Principal Adviser | Issuance Date | Obligor | Sukuk Trustee | Legal Advisors | Credit Rating |
|-----|---|-------------------------|------------------|--|---------------|---------------|--------------------------|--|-------------------------------|
| 4. | Edra Energy Sdn Bhd | Sukuk Wakalah | Up to RM5,280.00 | CIMB Investment Bank Berhad | 5-Jan-18 | - | Malaysian Trustee Bhd. | Adnan Sundra & Low (PA) Rahmat Lim & Partners (I) | RAM AA3 |
| 5. | SHC Capital Sdn. Bhd. | Sukuk Wakalah Programme | RM200.00 | Kenanga Investment Bank Berhad | 23-Dec-20 | - | Malaysian Trustee Bhd. | Messr Zaid Ibrahim & Co. | MARC AA-1S |
| 6. | Lafarge Cement Sdn Bhd | Sukuk Wakalah Programme | Up to RM500.00 | BNP Paribas Malaysia Berhad & Standard Chartered Saadiq Berhad | 13-Jan-17 | - | Malaysian Trustee Bhd. | Messrs. Albar & Partners | RAM P1 (ICP) AA2 (IMTN) |
| 7. | FGV Seri Costa Sdn Bhd | Sukuk Wakalah Programme | Up to RM1,500.00 | Maybank Investment Bank Berhad | - | Not Available | Not Available | Not Available | Not Available |
| 8. | Bina Darulaman Berhad | Sukuk Wakalah Programme | Up to RM100.00 | Maybank Investment Bank Berhad | 23-Jun-17 | - | AmanahRaya Trustees Bhd. | Shook Lin & Bok | MARC-2 _{IS} |
| 9. | Projek Lintasan Sungai Besi-Ulu Klang Sdn Bhd | Sukuk Wakalah Programme | Up to RM2,000.00 | AmInvestment Bank Berhad (Shariah- Datuk Dr. Mohd Daud Bakar) | 27-Nov-17 | - | AmanahRaya Trustees Bhd. | Zul Rafique & Partners | MARC A+ _{IS(S)} |

| No. | Issuer | Types | Size (Mil) | Principal Adviser | Issuance Date | Obligor | Sukuk Trustee | Legal Advisors | Credit Rating |
|-----|---|-------------------------|------------------|--|---------------|--|---------------------------|--|------------------------------|
| 10. | Kuantan Port Consortium Sdn Bhd | Sukuk Wakalah Programme | Up to RM3,000.00 | Maybank Investment Bank Berhad | 2-May-18 | Not available | Not available | Not available | Not available |
| 11. | BGRB Venture Sdn Bhd | Sukuk Wakalah Programme | RM1,000.00 | Kenanga Investment Bank Berhad | | Berjaya Golf Resort Berhad (Guarantor) | MTrustee Berhad | Messr Zaid Ibrahim & Co. | Unrated |
| 12. | Perbadanan Kemajuan Pertanian Negeri Pahang | Sukuk Wakalah Programme | Up to RM650.00 | Maybank Investment Bank Berhad | 30-Oct-20 | - | Pacific Trustess Berhad | Messr Kadri, Andri & Partners (PA) Abdul Raman Saad & Associates (Issuer) | RAM AA3 ^(s) |
| 13. | Bank Pembangunan Malaysia Berhad | Sukuk Wakalah Programme | Up to RM5,000.00 | AmInvestment Bank Berhad Hong Leong Islamic Bank Berhad | 12-Oct-20 | - | AmTrustees Berhad | Messr. Zaid Ibrahim & Co. | MARC MARC-1 _{ID} |
| 14. | Guan Chong Berhad | Sukuk Wakalah Programme | Up to RM800.00 | Maybank Investment Bank Berhad | 3-Dec-20 | - | Malaysian Trustees Berhad | Messr. Wong & Partners | MARC AA-1 _S |

| No. | Issuer | Types | Size (Mil) | Principal Adviser | Issuance Date | Obligor | Sukuk Trustee | Legal Advisors | Credit Rating |
|-----|--------------------------------|-----------------------------|--|--|---------------|---------|---------------------------|---|--------------------------------|
| 15. | Padiberas Nasional Berhad | Sukuk Wakalah Programme | Up to RM1,800.00 | Bank Muamalat Malaysia Bhd Standard Chartered Saadiq Berhad | 30-Oct-20 | - | Mayban Trustee Berhad | Messr. Andan, Sundra & Low (PA) Messr. Salleh & Co. (Issuer) | RAM P1 (ICPs) AA3 (IMTN) |
| 16. | Sunsuria Berhad | Sukuk Wakalah Programme | Up to RM500.00 | Maybank Investment Bank Berhad | 2-Dec-20 | - | Malaysian Trustees Berhad | Chooi & Company Cheang & Ariff | MARC A+ _{IS} |
| 17. | Evyap Sabun Malaysia Sdn. Bhd. | Sukuk Wakalah Programme | Up to RM500.00 | RHB Investment Bank Berhad | 30-Dec-20 | - | Pacific Trustees Berhad | Messrs Albar & Partners | MARC AA- _{IS} |
| 18. | Bermaz Auto Berhad | Sukuk Wakalah MTN Programme | 500 (Combined limit with Sukuk Wakalah CP Programme) | Hong Leong Investment Bank Berhad | 18-Dec-20 | - | MTrustees Berhad | Jeff Leong, Poon & Wong | RAM P1 (ICPs) |
| 19. | Bermaz Auto Berhad | Sukuk Wakalah CP Programme | 500 (Combined limit with Sukuk | Hong Leong Investment Bank Berhad | 18-Dec-20 | - | MTrustees Berhad | Jeff Leong, Poon & Wong | RAM AA3 (IMTN) |

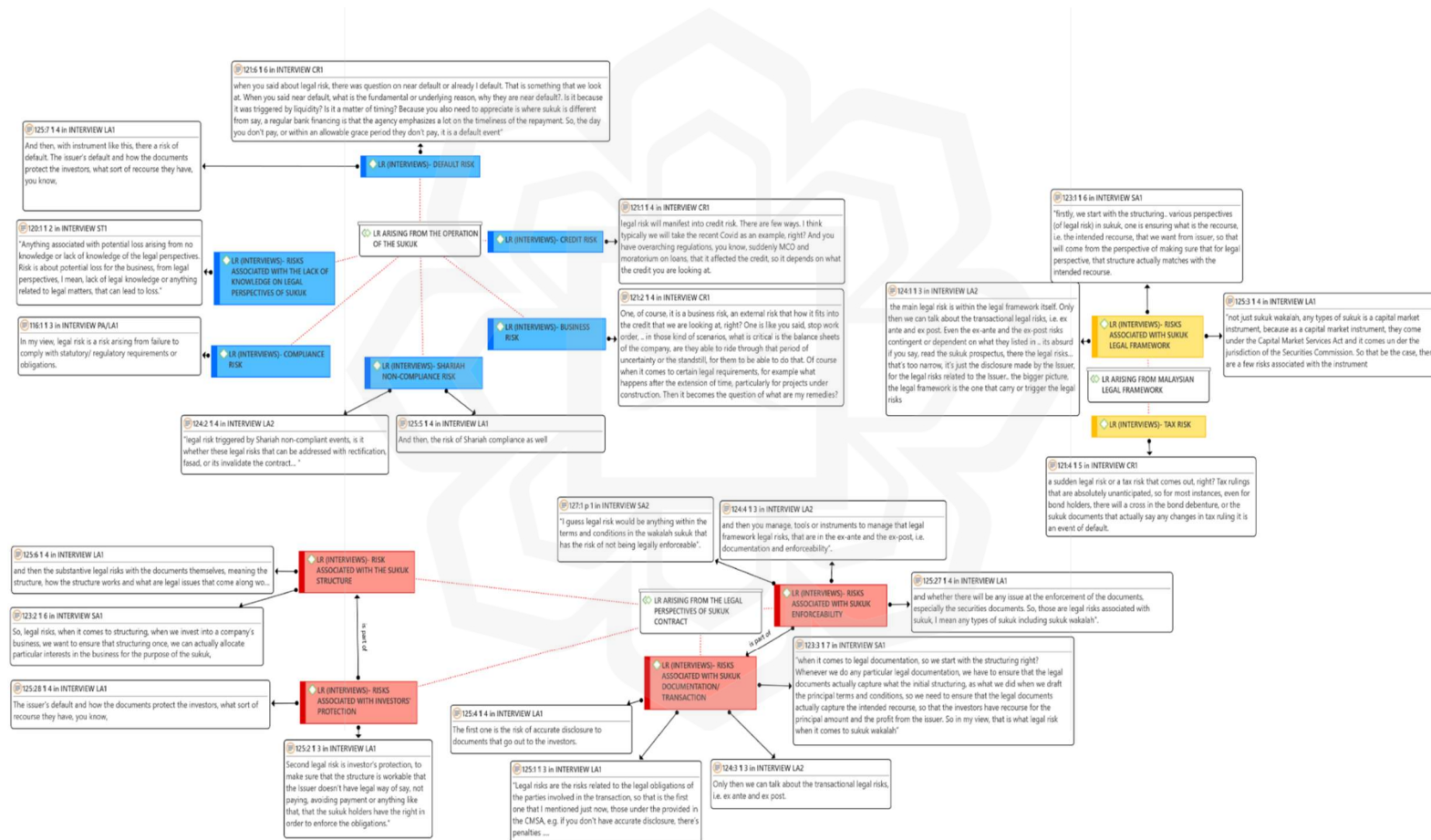
| No. | Issuer | Types | Size (Mil) | Principal Adviser | Issuance Date | Obligor | Sukuk Trustee | Legal Advisors | Credit Rating |
|-----|---------------------------|---|------------------------|--|---------------|---------|---------------------------|---------------------------|--|
| | | | Wakalah MTN Programme) | | | | | | |
| 20. | Maybank Islamic Berhad | Additional Tier 1 Sukuk Wakalah Programme | Up to RM10,000.00 | Maybank Investment Bank Berhad | 14-Dec-17 | - | Malaysian Trustees Berhad | Adnan Sundra & Low | RAM AA1 |
| 21. | Sinar Kamiri Sdn Bhd | Green Sustainable and Responsible Investment (SRI) Sukuk Wakalah | Up to RM245.00 | AmInvestment Bank Berhad | 30-Jan-18 | - | MTrustee Berhad | Messr Albar & Partners | MARC AA-IS |
| 22. | Leader Energy Sdn Bhd | ASEAN Green SRI Sukuk Wakalah | Up to RM260.00 | HSBC Amanah Malaysia Berhad | 16-Jul-20 | - | Pacific Trustees Berhad | Adnan Sundra & Low | MARC AA- |
| 23. | CIMB Islamic Bank Berhad | Senior Sukuk Wakalah Programme | RM10,000.00 | CIMB Investment Bank Berhad | 29-Dec-17 | - | Malaysian Trustees Berhad | Messrs Zaid Ibrahim & Co. | MARC AA _{IS} (Jr. Sukuk Programme) |
| 24. | Affin Islamic Bank Berhad | Senior Sukuk Murabahah, Tier 2 Sukuk Murabahah and/or Additional Tier 1 Capital Sukuk | RM5,000.00 | Affin Hwang Investment Bank Berhad (Shariah Advisor- Dr. Aznan Hasan) | 18-Oct-18 | - | Pacific Trustees Berhad | Adnan Sundra & Low | RAM (i) Senior Sukuk Murabahah – AA3 (ii) T2 |

| No. | Issuer | Types | Size (Mil) | Principal Adviser | Issuance Date | Obligor | Sukuk Trustee | Legal Advisors | Credit Rating |
|-----|------------------------------|---|-------------------|--|---------------|---------|---------------------------|--------------------------|---|
| | | Wakalah Programme | | | | | | | Sukuk Murabahah – A1 (iii) AT1 Sukuk Wakalah – A3 |
| 25. | Alliance Islamic Bank Berhad | Senior Sukuk Murabahah, Subordinated Tier 2 Sukuk Murabahah and Additional Tier 1 Sukuk Wakalah Programme | Up to RM2,500.00 | Alliance Investment Bank Berhad | 29-Mar-19 | - | Malaysian Trustees Berhad | Messr Adnan Sundra & Low | Unrated |
| 26. | MBSB Bank Berhad | Senior Sukuk Wakalah and/or Tier-2 Sukuk Wakalah and/or Additional Tier-1 Capital Sukuk Wakalah Programme | Up to RM10,000.00 | AmInvestment Bank Berhad and RHB Investment Bank Berhad (Joint Shariah Advisers) | 20-Dec-19 | - | Malaysian Trustees Berhad | Adnan Sundra & Low | RAM (i) Senior Sukuk Wakalah – A ₂ (ii) T2 Sukuk Wakalah – A ₃ (iii) AT1 Sukuk |

| No. | Issuer | Types | Size (Mil) | Principal Adviser | Issuance Date | Obligor | Sukuk Trustee | Legal Advisors | Credit Rating |
|-----|-------------------------------------|--|------------------|---|---------------|---------------|---------------------------|--|--|
| | | | | | | | | | Wakalah – BBB ₂ |
| 27. | AEON Credit Service (M) Berhad | Senior Sukuk Wakalah and/or Subordinated Sukuk Wakalah Programme | RM2,000.00 | RHB Investment Bank Berhad | 10-Feb-20 | - | Malaysian Trustees Berhad | Adnan Sundra & Low | RAM P1 |
| 28. | Dialog Group Berhad | Senior and/or Subordinated Perpetual Sukuk Wakalah Programme | Up to RM3,000.00 | AmInvestment Bank Berhad and CIMB Investment Bank Berhad (Joint Shariah Advisers) | 16-Nov-20 | - | MTrustee Berhad | Messr Adnan Sundra & Low (PA) Messr Zaid Ibrahim & Co. (Issuer) | RAM (i) Senior Sukuk Wakalah – AA ₂ (ii) Perpetual Sukuk Wakalah – A ₁ |
| 29. | S P Setia Berhad | Sukuk Wakalah Programme | Up to RM3,000.00 | HSBC Amanah Malaysia Berhad | 4-May-21 | Not available | Not available | Not available | Not available |
| 30. | The Holstein Milk Company Sdn. Bhd. | Sukuk Wakalah Programme | Up to RM1,000.00 | CIMB Investment Bank Berhad | 4-May-21 | Not available | Not available | Not available | Not available |
| 31. | Putrajaya Holdings Sdn. Bhd. | Sukuk Wakalah Programme | Up to RM1,000.00 | Maybank Investment Bank Berhad and RHB Investment Bank Berhad (Joint | 23-Mar-21 | - | Malaysian Trustees Berhad | Messr Kadir, Andri & Partners | MARC AAA _{IS} |

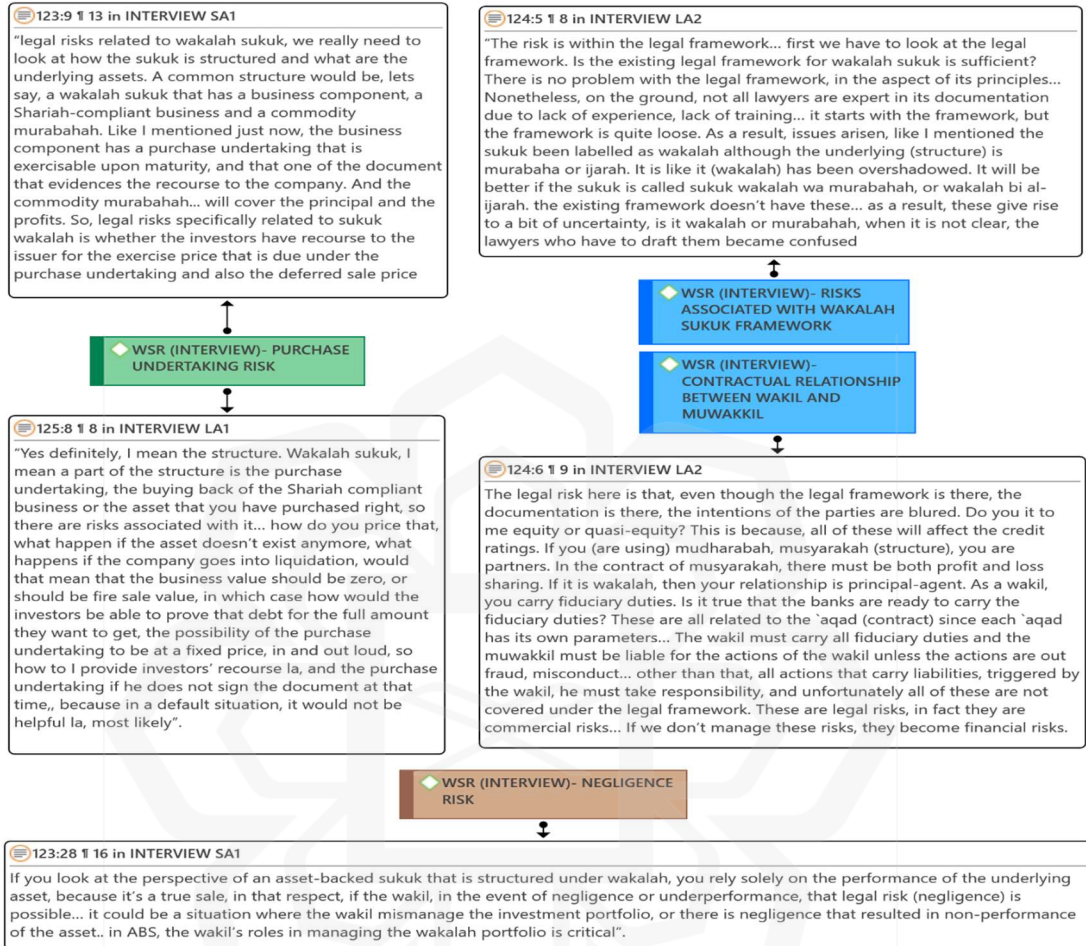
| No. | Issuer | Types | Size (Mil) | Principal Adviser | Issuance Date | Obligor | Sukuk Trustee | Legal Advisors | Credit Rating |
|-----|-----------------------------------|-------------------------|------------|---|---------------|---|-------------------------|--------------------------|---------------|
| | | | | Shariah Advisers) | | | | | |
| 32. | Sin Heng Chan (Malaya) Berhad | Sukuk Wakalah Programme | RM60.00 | Kenanga Investment Bank Berhad and Bank Islam Malaysia Berhad | 18-Mar-21 | Not Available | Not Available | Not Available | Not Available |
| 33. | Eco World Capital Services Berhad | Sukuk Wakalah Programme | RM500.00 | CIMB Investment Bank Berhad and RHB Investment Bank Berhad (Joint Shariah Advisers) | 26-Feb-21 | EcoWorld Development Group Berhad (Kafalah) | Pacific Trustees Berhad | Messr Adnan Sundra & Low | Unrated |

APPENDIX II: LEGAL RISKS FROM THE PERSPECTIVES OF THE PARTICIPANTS (WITH PREVIEWS)



Legal Risks from the Perspectives of the Participants (with Previews)

APPENDIX III: WAKALAH SUKUK LEGAL RISKS FROM THE PERSPECTIVES OF THE PARTICIPANTS (WITH PREVIEWS)



Wakalah sukuk Legal Risk from the Perspectives of the Participants (with Previews)

APPENDIX IV: SAMPLES OF TRANSCRIPTION AND CODING OF TRANSCRIBED DOCUMENTS (SA1)

The screenshot displays the ATLAS.ti software interface with the following components:

- Menu Bar:** File, Home, Search & Code, Analyze, Import & Export, Tools, Help, Document, Tools, Transcripts, View.
- Toolbar:** Includes icons for Create Free Quotation, Apply Codes, Code In Vivo, Quick Coding, Search & Code, Focus Group Coding, Quotation, Rename, Delete, Unlink, Reverse Link, Relation Link, Comment, Word Cloud, Word List, Search Document, Edit, and Print.
- Explore Panel (Left):** A hierarchical tree view of documents. The selected document is 'D 120: INTERVIEW ST1 (26)'. Below it, a list of codes is visible:
 - 120:1 ¶ 2, "Anything associated with j
 - 120:2 ¶ 8, When it comes to, or at the
 - 120:3 ¶ 8, So first thing, we have to hi
 - 120:4 ¶ 8, So, in a way, how we mitigi
 - 120:6 ¶ 10, "I think the requirement fc
 - 120:7 ¶ 11, "We have internal checklis
 - 120:8 ¶ 13, "First thing is about the St
 - 120:9 ¶ 13, So the main part is, the te
 - 120:10 ¶ 13, second is whatever term:
- Main Document View (Center):** Shows the transcription of document 'D 120: INTERVIEW ST1' with line numbers 1 through 8.
 - Line 1: LR
 - Line 2: *"Anything associated with potential loss arising from no knowledge or lack of knowledge of the legal perspectives. Risk is about potential loss for the business, from legal perspectives, I mean, lack of legal knowledge or anything related to legal matters, that can lead to loss."*
 - Line 3: SNCR
 - Line 4: *"Snrcr can lead to legal suits, but more or less, it can come from the regulators, from the investors, they are looking specifically of legal issues"*
 - Line 5: WSR
 - Line 6: *"In order for the sukuk issuance, there will be due diligence conducted by the DDWG. At first, there will be PTC to be approved by the Shariah Committee. So long as the Shariah Committee has give consent to the PTC, the risk is mitigated."*
 - Line 7: LRM
 - Line 8: *"On our side, we apply the same process. When it comes to, or at the stage of drafting, we browse the legal documents.. to comply with relevant guidelines especially those issued by the SC, and then.. I think you know that sukuk wakalah normally consists of two parts, tangible and*
- Annotation Panel (Right):** Displays various codes applied to the text:
 - LR (INTERVIEWS)- RISKS ASSOCIA...
 - LR (INTERVIEWS)- SHARIAH NON...
 - LRM (INTERVIEWS)- ROLES OF SH...
 - LRM (INTERVIEWS)- LRM IS DRAF...
 - LRM (INTERVIEWS)- REVIEW OF S...

APPENDIX V: SAMPLES OF TRANSCRIPTION AND CODING OF TRANSCRIBED DOCUMENTS (CRA1)

The screenshot displays the ATLAS.ti software interface. The main window shows a transcription of an interview with the following text:

1 | TRANSCRIPT OF RAM- MS SUET MING
 2 | LEGAL RISK-
 3 | *"For a credit agency, we normally don't go down into this level of diligence, but what we do ask is the implications from a credit perspective. If there are issues or market events as a result of sukuk structure or legal issues, then it is something for us to monitor, and to look at how the market reacted. What are the new things for us to watch out from. Because specifically when you talk about default and all that, at the end of the day it really comes down to the credit risk that triggers it".*
 4 | *"You were right when you said that how legal risk will manifest into credit risk. There are few ways. I think typically we will take the recent Covid as an example, right? And you have overarching regulations, you know, suddenly MCO and moratorium on loans, that it affected the credit, so it depends on what the credit you are looking at. One, of course, it is a business risk, an external risk that how it fits into the credit that we are looking at, right? One is like you said, stop work order, .. in those kind of scenarios, what is critical is the balance sheets of the company, are they able to ride through that period of uncertainty or the standstill, for them to be able to do that. Of course when it*

On the right side of the text, there are coding annotations:

- WLR- RELATED TO CREDIT RISK A...
- LR (INTERVIEWS)- CREDIT RISK
- LR (INTERVIEWS)- BUSINESS RISK

The left sidebar shows the 'Explore' panel with a search bar and a list of document segments. The selected segment is 'D 121: INTERVIEW CRA1 (27)'. Below the list, it says 'Not yet commented'.

The bottom right corner of the window shows a page number '7' and a zoom level of '100%'.