



Firasat Newsletter

Dear friends and clients,

Eid Mubarak to all Muslims. It is the time of the year where we meet and reminisce on good times over the many open houses held at various places in the city. Personally, attending open houses be it at relatives, friends and clients has been a blessing as it is one of the most unique feature of Malaysia where we can co mingle in a harmonious nature irrespective of race or religion. Over the years, some have lost the plot citing minor differences which threatens the fabric of our society without considering the consequences. We pray that common sense will prevail amongst them. In countries like Singapore and Brunei, it is heartening to note that they still practise visiting friends and relatives in the full Baju Melayu and songket and baju kurung throughout Syawal. When MRCO was involved in a sukuk deal involving a Brunei corporate a couple of years ago during the month of Syawal, I too had the pleasure of experiencing it first hand which also reminds me of the good old days.

Amidst the joy of festivities, we continue to have terrorism rearing its ugly head in the name of religion to the extent that we do not know when, where and why they strike. Islam as a religion has always promoted peace and their actions totally runs contrary to the tenets of the shariah. The OIC should take the lead in denouncing these terrorists and act firmly against them before more bloodshed happens.

In this month's edition, our associate Fakhri will dwell on the intricacies of preference shares from the conventional and Islamic finance angle including the treatment accorded in different jurisdictions. As a law firm, we have had the opportunity of being involved in varying investment structures utilising preference shares and musyarakah types of investment providing the flexibility and optimising shareholders return. We hope that with this article, our readers will have a better understanding on its nature and concept.

Yours truly,
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PREFERENCE SHARES – AN ALTERNATIVE OR A PREFERENCE?

Introduction - Preference shares

A preference share is among the hybrid instruments that combine equity and debt in a capital market. According to section 4 of the Companies Act 1965 (the “Act”), preference share is defined as a share by whatever name called, which does not entitle the holder thereof to the right to vote at a general meeting or to any right to participate beyond a specified amount in any distribution whether by way of dividend, or on redemption, in a winding up, or otherwise.

The preference shareholders are treated in preference or priority over the ordinary shareholders in the following manner:

preference shareholders receive their dividends first in priority to ordinary shareholders;

preference shareholders are entitled to receive repayment of capital after creditors of the company have been paid, and in priority to ordinary shareholders;

preference shareholders shall have the preferred right to the dividend up till the agreed fixed dividend. Only after they get their fixed dividend, the ordinary shareholders shall take their dividend which rank parri passu among themselves.

preference shares may be issued as redeemable or as convertible; and

have no voting rights in the general meeting except in matters affecting their right as preference shareholders.

Pursuant to section 66 (1) of the Act, no company shall allot any preference shares or convert any issued shares into preference shares unless there is set out in its memorandum or articles the rights of the holders of those shares with respect to repayment of capital, participation in surplus assets and profits, cumulative or non-cumulative dividends, voting, and priority of payment of capital and dividend in relation to other shares or other classes of preference shares. In the meantime, this provision also has been mentioned in section 90 (4) of the Companies Bill 2015.

There are many forms of preference shares in the market, among which are:

Cumulative or non-cumulative preference shares

In accordance with section 66 (1) of the Act, the company's constitution may confer on preference shares a cumulative right to dividends which entitles the preferential shareholder to accumulate unpaid dividends of the previous years. On the other hand, non-cumulative preference shares entitle the holder to a dividend at a fixed rate only in the years where a dividend is declared and paid.[1]

Convertible or non-convertible preference shares

Convertible preference shares allow or require the preference shares to be converted into ordinary shares at the end of the term or upon the happening of a particular event, often at a pre-determined time frame and rate.

Shariah Perspective

It is important to take note of the Shariah scholars' opinion with regard to the distribution of profit and loss to be borne by each partner to a partnership and/or joint venture. From Shafi'i's and the Malikis point of view, the profit generated from a partnership and/or joint venture is to be distributed in accordance to the ratio of capital contribution by each partner. This principle must be implemented in such partnership and/or joint venture because the profit is derived from the contribution of capital, thus the distribution of profit shall be proportionate with

the capital. The failure to observe the principle shall render the partnership and/or joint venture void. With respect to losses, all jurists unanimously agreed that losses shall be borne in accordance with the portion of capital contribution by each partner. This opinion is based on the maxim:

“The profit is in accordance to the agreement of the partners, but the losses is based on the ratio of capital contribution”[2].

According to Shariah, it is pertinent to note that there shall be no determination of return or any arrangement that may lead to the possible profit guarantee to the partners in a partnership and/or joint venture. As some conventional structures have embedded features of certainty on the expected profit, for the sake of competitiveness, some quarters have suggested that there shall be a mechanism in the Islamic structuring that can affect the same feature to the Islamic investors. Hence, this is where tanazul plays its role in making adjustments to structures that are based on Islamic equity.

Shariah Advisory Council (“SAC”) of Securities Commission of Malaysia (“SC”) in its 20th meeting on 14 July 1999 resolved that the basic preference share (non-cumulative) is permissible based on tanazul. The ruling was given on a basis that the right to profit of the ordinary shareholder is willingly given to a preference shareholder. In this context, tanazul is agreed upon at an annual general meeting of a company which decides to issue preference shares in an effort to raise new capital. As it is agreed at the meeting to issue preference shares, this means that ordinary shareholders have also agreed to give priority to preference shareholders in dividing the profits, in accordance to tanazul. In the context of preference shares, tanazul means surrendering the rights to a share of the profits based on partnership, by giving priority to preference shareholders[3].

However, Accounting and Auditing Organization for Islamic Financial Institutions (“AAOIFI”) has taken different approach in respect of implementation of tanazul in the preference shares. AAOIFI has resolved that the preference share (non-cumulative) is not permissible based on tanazul basis as stated in its Shariah Standard No. (12) Sharika (Musharaka) and Modern Corporations, item 4/1/2/14:

“It is not permitted to issue preference shares i.e. shares that have special financial characteristics that give them a priority upon liquidation of the company or upon distribution of profit. However, it is permissible to grant certain shares, in addition to being entitled to rights attached to common shares, certain procedural and administrative privileges, such as a right to vote.”

Further, the Islamic Fiqh Academy, in its 14th session in Doha, Qatar, which was held from 11 – 16 January 2003, resolved the following:

“3. It is not permissible for a company to issue shares enjoyed or preference shares or debentures;

4. In occasions when the company suffers losses, it is compulsory for every shareholder to bear his share of the loss, in proportion to his capital contribution.”

Under the Shari’ah, the partners and/or investors shall participate in the same risk as the owner of the company. By implementing such principle, they will share the profit and loss in accordance with their capital contribution. There are 2 major reasons established by the Shariah scholars in respect of objections to preference shares:

the scholars agree that a partnership and/or joint venture should not contain provisions that may occasionally lead to the suspension of profit or loss sharing among partners. Preferred shareholders generally receive better returns in terms of dividend payment. The profit generated shall be paid to the preference shareholders in priority according to the specified coupon/dividend rate. Then, only the remaining profit will be paid to the ordinary shareholders; and

Upon liquidation of the company, preference shareholders may receive the full par value of their shares, in precedence over ordinary shareholders. Thus, they virtually stand as lenders rather than as partners. In the eye of Shariah, the lenders shall neither entitle nor receive any dividends and/or profits in the first place instead of only their principal. By right, a partner shall be treated as equal over the other partners, i.e., over ordinary shareholders.

Ideal Alternative to Conventional Preference Shares

In light of the conventional practice above, the Islamic preference shares are issued based on the Shari'ah principle of Musharakah. Literally, the Musharakah means 'sharing' or 'intermingling' or the conjunction of two or more estates, in such a manner that one of them is not distinguishable from the other. Technically, it means the union of two or more persons in one concern. Musharakah is a contract of capital joint venture partnership to establish a new project or share on the existing project. All parties to the joint venture will contribute their portion of capital and will subsequently share the profit or loss from the project in accordance to the proportion of the contributed capital.

This kind of partnership has been defined by Accounting and Auditing Organization for Islamic Financial Institutions ("AAOIFI") as "an agreement between two or more parties to combine their assets, labour or liabilities for the purpose of making profit[4]."

The Hanafi school has set out the general features of what constitutes a contract partnership which are as follows:

all partners are considered as agents towards each other and could act on behalf of the other partners in their capacity as partners;

the ratio of profit sharing must be disclosed accurately to all the partners; and

the profit must not be fixed or pre-determined due to the unknown amount of profit to be gained[5].

It is agreed by the ordinary shareholders that the Islamic preference share will be ranked ahead of the ordinary share in terms of priority to dividend payment up to the expected dividend and in terms of the return of capital in the event of liquidation. However, the payment of dividends is not fixed and guaranteed. It shall only be payable subject to the availability of distributable profits.

Conclusion

For jurisdictions which allow Islamic preference shares like Malaysia, it has to be structured to be consistent with the rulings of the SAC of Securities Commission of Malaysia. For international acceptances, it is best to structure an investment based on the principle of Musharakah which would provide flexibility for the investors as well particularly in terms of profits and exit mechanism.

[1] Shanthy R., Janine P., Anil J.(2010). Concise Principle of Company Law in Malaysia (2nd Ed.), Lexis Nexis: Malaysia, p.179

[2] Al-Zayla'i, Nasb al-Rayah; Al-Qadduri, Al-Tajrid, v. 6, p. 3047.

[3] Resolutions of Securities Commission Shariah Advisory Council (2nd Edition), retrieved from [http://www.sc.com.my/wp-content/uploads/eng/html/icm/Resolutions_SAC_2nd edition.pdf](http://www.sc.com.my/wp-content/uploads/eng/html/icm/Resolutions_SAC_2nd%20edition.pdf)

[4] AAOIFI, Shariah Standards, p.203

[5] Dr Aznan Hasan (2011). Fundamental of Shariah in Islamic Finance, IBFIM: Kuala Lumpur, p. 673.

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