

OPALESQUE

ISLAMIC FINANCE

INTELLIGENCE



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Featured Resource

Islamic Finance Training
Programs and Certifications

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Wa'd and the completeness of
Islamic markets

Lex Islamicus

Preventative & Remedial Measures
Protecting Sukuk Investment
Account Holders

Al Majallah Opalesque

First of all we would like to extend to all a blessed Ramadan Mubarak. As Muslims around the globe observe the holy month we take this opportunity to pause and reflect on where Islamic finance stands today and what's in store for the industry's future. As millions of Muslims reflect, so does the industry ponder on its very own direction, principles and ultimate purpose.

This is barely our third edition, but the feedback can be summarized by one of our readers (a director of an Asian-based investment bank) who put it plainly: "there is some really good stuff in this thing". We push forward and for this edition of OIFI we begin by addressing what we term the "Two Schools of Islamic Finance" as we delve into a rather unassuming - although significant - division in opinion on how the practice of Shariah compliance should be approached. Interpretation can have far reaching implications, take for instance the Majallah (the civil code of the Ottoman caliphate) which is regarded as the first attempt to codify Islamic law and remains an important source of reference to the present day.

We follow with one of our most requested items – and a good indicator of industry renaissance – a compilation of Islamic finance training programs and certifications. Thereafter, Nikan tackles a more specific discussion on Wa'd in our Featured Structure section, whereas Khalil delves into a forward looking analysis of Islamic financial instruments and arbitration channels in his Lex Islamicus column. Their perspectives are complemented by additional opinions on the role of the Islamic finance framework in our Discussion Board.

This month's edition includes a Manager Interview with Dieter Küffer, of Sustainable Asset Management, regarding their Islamic water strategy. Their SRI background is by no means accidental, as our Opinion Column further profiles views on social responsibility and corporate governance from Sayd Farook and Usama DeLorenzo respectively. To round it all out, the spirit of transparency is alive and well in our final piece which explores the rather unusual: products from the graveyard (liquidated, obsolete, dare we say unsuccessful).

Once again we welcome your comments & suggestions, and a reminder that you can check the free online archive of Opalesque Islamic Finance Briefing (our daily news summary) which provides a historical data bank of industry news and articles, as well as the back issues of OIFI. It's all there, it's all free.

Thanks & Regards,
Bernardo
Editor, Opalesque Islamic Finance Intelligence

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In This Issue

Editor's Note

The Two Schools of Islamic Finance
Bernardo Vizcaino, CAIA 3

Featured Resource

Islamic Finance Training Programs
and Certifications 5

Featured Structure

Wa'd and the completeness of
Islamic markets
Nikan Firoozye, Ph.D. 6

Manager Interview

Dieter Küffer, Senior Portfolio
Manager, SAM 9

Lex Islamicus

Preventative & Remedial Measures
Protecting Sukuk Investment
Account Holders
Khalil Jarrar, J.D. 11

Discussion Board

The Islamic Finance Framework..... 13

Opinion Column

Sayd Farook, Dar Al-Istithmar and
Usama DeLorenzo,
Securities Commission
Malaysia..... 15

Industry Snapshot

A Walk Thru the Graveyard
Bernardo Vizcaino, CAIA 17

Photography by: Kelly Lemon

The Two Schools of Islamic Finance

By Bernardo Vizcaino, CAIA

The global financial marketplace stands at a crossroads, undoubtedly the recent (and many) events in the capital markets have ignited a slow but steady analysis of regulation, governance, risk management and ultimately it's beneficial role in society. Islamic finance is no different – faced with equally important and far-reaching choices to make for itself. Nevertheless, the bifurcation in the road has little to do with clearinghouses, oversubscribed issues or exotic solutions. It has nothing to do with GCC versus Malaysia, nor AAOIFI versus IFSB, and most certainly this is not about petrodollars or tapping so-called Middle East liquidity. The latter has to be one of the most ill-conceived and utterly-shortsighted concepts in the history of finance.

The industry is being defined – at every level – by two increasingly polarized schools of thought. These two have enough energy and influence to supercede in importance the differing interpretations found in the Hanbali, Hanafi, Maliki or Shafi'i traditions. The stakes are that high. These two 'schools' embody the quintessential decision that practitioners, investors, economists, and even Scholars need to make. This choice has been made even more poignant as Islamic finance moves into the mainstream.

The first school of thought reminds us – with every possible chance – that this is a young, constrained, repressed, and isolated industry (and we the villagers). It calls for tacit acceptance of the status quo – whichever practice that may be – and categorically shuns inquiry, suggestions or the occasional questionnaire. The industry is new, limited and forever under the shadow of conventional finance and hence it must accept its place in the corner of the marketplace. This school keeps reminding us that innovation is a dangerous scheme (unless of course it is a creation of their own) and standardisation efforts mere utopian

discourse (cost effectiveness and efficiency left for future generations to figure out).

The key to understanding Shariah compliance seems to lie with their crystal interpretation of the law – nevermind that the explanation (and to an extent the holy scriptures) have been copyrighted in the process (black boxes and non-disclosure agreements are ubiquitous). Their closing arguments often include a sense of infallibility, where apologies or retractions are reserved for lesser mortals, where conviction and devotion have been translated into the unequivocal ownership of the truth.

One might be tempted to call it the 'old school' of Islamic finance, but that would imply the observance of age-old traditions and practices. In fact, it embodies a very young (and reckless) mentality, one which has left the door wide open for circumvention, manipulation and the box-ticking approach that has turned instruments such as sukuk looking like bonds.

Herewith the second school of Islamic finance – immediately concerned with de-mistifying the product range and removing (or at least easing) the barriers to entry for new comers. Here the focus of attention is not so much the form but rather the substance of instruments and structures. It forges ahead aided by growing calls for a practical and transparent product manufacturing process, as well as a cost-conscious and sustainable business model for Shariah compliance.

Nonetheless, this forward-looking perspective might give it a 'new school' label, seemingly handicapped for its limited understanding of industry intricacies, enthralled in absurd initiatives and guilty of collective naivete. Thus being diminished as a superficial assessment, since this particular school is far more focused on the principles and objectives of compliance. It has placed a magnifying glass not on the



Editor's Note

inputs/devices but rather on the outputs/byproducts of Shariah compliant transactions.

These two schools – as opposite as they appear – are irrevocably intertwined with each other. Whether they like it or not, they need each other for the industry to develop further. Despite their seemingly polarizing characteristics, the new school is being fuelled by young & energetic Muslim professionals, a substantial undercurrent of human capital ready to be tapped. The old school is exemplified by several industry pioneers, holders of multiple awards and accolades, but ultimately aware that it will have to re-assess how sustainable is the business model they have erected over the past few decades.

It is beyond debate that the old school set the foundations for what is now a thriving industry, and did so while competing in the golden age of conventional finance. They provided the framework that – however flawed – has brought Islamic finance to where it is today. Then again, as the conventional world scrambles to redefine itself, a strong current of opinion is asking the same of Islamic finance. This is where the old is being met by the new.

Unfortunately there has been very little attention given to the revived Muslim identity and the throngs of practitioners eager and ready to contribute to the industry and to their faith. As they build their credentials one must wonder where are the Islamic finance graduate programs, internships, secondments, and apprenticeships that will utilize and maximize their potential. Perhaps it will be an awakening of sorts for the industry, as this 'generational change' gradually brings the new school approach into the roles and positions held by their old school counterparts. Time will tell.

Your feedback and comments are very important to us, please feel free to contact the author [via email](#).

Aside: Opening the Islamic window

Ramadan is very significant for the Muslim faith, but seldom attention is given to its importance and for that matter to the many other features of Islam. It is very much relevant to understand what drives the Muslim faith, as it has a direct relevance to why we have Islamic finance.

The Qur'an's central philosophy is that of tawhid (godliness), the acceptance of God's divine truth as revealed to the Prophet Mohammed (pbuh), a profound guide on how to lead one's life. It opens with the Bismillah ('In the name of Allah') and this phrase is repeated in almost all of its surahs (chapters), often offered in the call to prayer and at the beginning of any important activity (from conferences and gatherings, to textbooks and dissertations). Indeed the Qur'an has 114 surahs, and it can be further divided into ayats (verses) as well as sections (either thirty juz or seven manazil). This means that the entire text can be read through the month of Ramadan or within a single week. Moreover, the overall structure follows the rhythm and characteristics of ancient oral poetry, and thus a devout Muslim can commit the Qur'an to memory (approx 80,000 words) earning the honorific title of hafiz.

The importance given to every word of the Qur'an is by no means trivial, in fact this serves as a starting point to understand why Islamic finance is effectively 'Islamic finance'. Certainly the Bible and the Torah – as Abrahamic scriptures – are regarded by Muslims as important divine revelations, but Muslim belief is that the Qur'an is the literal word of God, as revealed to the Prophet through the Archangel Gabriel. There is even widespread agreement that the original Arabic should be respected, thus making translations particularly difficult (one can trace a variety of attempts over the centuries) and this is compounded by the fact that many Arabic words have different meaning (which varies according to the context). This partly explains why we talk about sukuk, maslaha, maqasid, and riba. These should be considered as broad concepts/ideas rather than specific items/nouns.

Structure and guidance is given for every aspect of daily life, and such interpretation has been extended into Islamic law. Scholars can therefore rely on the Qur'an and the hadith (the traditions about the life and sayings of the Prophet) to find guidance in almost every aspect of life – and business activity. Hence the origin, importance and serious debate given to Islamic finance.

Islamic Finance Training Programs and Certifications

 **Blogger** [As featured in the Islamic Finance Resources Blog](#)

[AAOIFI: Certified Islamic Professional Accountant \(CIPA\)](#)

[Academy UK: MBA Islamic Banking and Finance](#)

[AIMS: MBA in Islamic Banking and Finance](#)

[BIBF: Masters of Science-Islamic Finance \(MSIF\)](#)

[CASS: Executive MBA - Islamic Finance stream](#)

[CIMA: Certificate in Islamic Finance](#)

[Durham Islamic Finance Program \(DIFP\); Islamic Finance Summer School](#)

[Ecole de Management Strasbourg – University Degree in Islamic Finance](#)

[ESA & SII: Islamic Finance Qualification \(IFQ\)](#)

[GARP - Certificate in Risk Management for Islamic Financial Institutions](#)

[IBFIM: i-Series Programme, CCP Islamic \(CCP-i\), Islamic Financial Planner \(IFP\)](#)

[IIBF: Post Graduate Diploma in Islamic banking and Insurance](#)

[IIIBF: Certified Islamic Banker and Others](#)

[INCEIF: Chartered Islamic Finance Professional \(CIFP\)](#)

[IslamicAdvisory.com: Online Courses](#)

[Islamic Finance Training: Various Courses](#)

[Islamic Online University: Various Islamic Courses](#)

[Knowledge Platform - Fundamentals of Islamic Finance](#)

[Markfield - Certificate in Islamic Finance](#)

[Straightway Ethical: Islamic Financial Ethics](#)

[Sunni Path Online Islamic Academy: Modern Financial Transactions](#)

[Tazkia - Islamic Undergraduate degree in Indonesia](#)

[Trisakti University - Islamic Economics and Finance degree in Indonesia](#)

[Universitas Indonesia - Islamic Economics and Finance degree in Indonesia](#)

[University College of Bahrain: MBA in Islamic Finance](#)

Wa'd and the completeness of Islamic markets

By Nikan Firoozye, PhD



First I want to wish our readers Ramadan Mubarak! May the peace and blessings of this month shower upon us and our families, enrich our lives and enlighten our opinions. Bernardo's opening piece mentioned divisions as he sees them in terms of philosophy and in this month's feature I wanted to focus on the divisions in terms of product.

To the casual observer, Islamic Finance may seem a cohesive whole but this view is deceptive. In fact, the industry is plagued by vigorous debates and vituperative exchanges. The basis may be due to differences in underlying philosophy but on the product line, one battleground is clearly drawn: the promise (wa'd) and in particular on the purchase of such a promise.

Wa'd or unilateral promise with no consideration is a concept that has been used since close to the start of institutionalized Islamic finance. It has been used primarily alongside murabaha for purchase order prior to its more recent spinoff. Rather than a standard contract in Islamic finance ('aqd) the wa'd was seen as being 'below radar coverage', having no or relatively few standards legislated purely to its use and applicability by international bodies such as IFSB and AAOIFI.

Opening new possibilities?

The wa'd's applicability seemed immense, although there was initial groundwork to be laid. One criteria which had to be established was its legal enforceability under Shariah.

First of all, this had to be done independently from its use in the murabaha for purchase order. While classical jurists had a wide range of opinions on this matter - from deliberate failure to uphold a wa'd being morally reprehensible (Hanafi, Hanbali, Shafi'i majority opinions), to being legally actionable subject to the promisee suffering loss due to reliance upon the promise (similar to promissory estoppel, the opinion held by majority Malikis), whereas modern jurists have for the most part said it is a cause for legal action if it is a wa'd given with specific conditions. Indeed the range of opinion is rich, for instance refer to:

- Nurdianawati Abdullah's paper (see [reference link](#)) for a range of opinions;
- Hussein Hassan's article (see [reference link](#)) for a discussion of moral obligation and legal obligation (with contract or 'aqd merely a type of promise);
- Rafic al-Masri's article (see [reference link](#)) for an argument against legal enforcement;
- Uberoi-Chatterji-Bidar's article (see [reference link](#)) for contrast to equity law principle of promissory estoppel (which is only applied as a 'shield not sword' and hence the wa'd is structured as a deed poll or a even as promissory note).

While the enforceability is the subject of some debate, the wa'd was set to debut in its wildest incarnations.

Limiting the use of wa'd or finding new loopholes?

To be fair, jurists had determined some limits to its use, in particular the use of muwa'dah (bilateral wa'd) as a means of circumventing shariah rules prohibiting forward transactions. But the ability to distinguish between muwa'dah and wa'dan (two unilateral wa'd, wu'd plural) was the subject of some deliberation. In general bilateral wa'd were considered to be somehow independent if the two conditional wa'd (effectively options each)

Featured Structure

had different entry conditions.

Shockingly, scholars seemed unaware of put-call parity; to enter a forward contract on a commodity I need not promise I will buy unconditionally at price f and you need not promise you will sell unconditionally at price f , instead I could promise to buy at price f only if the commodity price is above f (i.e., I short a call option) and you promise you will sell at price f only if commodity price is below f (you are long a put option). Only one wa'd is enforceable at any time, but together they are a forward contract. Suddenly forward contracts become admissible in Shari'ah.

With some minor twists this can be used as a means of delivering a total return swap (see Islamic Finance Resources reference links [here](#) and [here](#)). In other words, by a simple piece of trickery (or innovation) we avoid our transaction being classified a (prohibited) muwa'dah and instead classify it as a wa'dan but we manage to attain exactly the same goal. Similarly the use of third parties as intermediaries has been vetted as a means of avoiding the muwa'dah classification (in the original Deutsche Bank swap).

But this ability to exchange wa'ds was a major breakthrough. Because there were no shari'ah requirements on the actual conditions in the wa'd, as well as the promised action as long as it did not compel the Muslim investor to do anything haram (forbidden) but with no such prohibition on the non-Muslim counterparty, almost anything was allowed. The German bank and others subsequently saw this as an opportunity to deliver hedge funds to Muslim investors. The Muslim investor would invest in halal assets and use the wa'd swap arrangement to swap the returns for those of virtually any underlying held by a non-Muslim investor. Hedge funds, cross-currency swaps, exotic products, even gambling stocks, liquor, and all previously prohibited investments could be delivered this way.

This was in fact heralded as a major 'welfare-increasing' arrangement for Muslims who could still maintain their adherence to the letter of the law while getting financial and gaming exposures that they somehow always needed (see, e.g., Humayon Dar, Incentive Compatibility of Islamic Financing, [Handbook of Islamic Finance](#), pp. 85-96).

A Spanner in the Works: Rare Criticism

The backlash was novel in Islamic Finance, but altogether needed. Sh Yusuf Talal de Lorenzo wrote a now famous white paper (see [reference link](#)) on the 'Shariah Conversion Technology', decrying the fatwa which authorized it as the Doomsday Fatwa of Islamic Finance. In particular, he identified the ability to enter into otherwise haram investments as problematic from a shari'ah perspective because he showed that the Muslim investor's monies were in fact partly being used or enabling a prohibited investment. Doomsday was telling since as he put it, now that almost everything was legitimate, there was no point in spending time devising all the complicated (and costly) structures required to

make a deal halal: why bother when you could just invest in some halal asset, and swap it for any conventional product that one wished for. Limiting his criticism, Sh Yusuf did point out that as long as all the underlyings were halal, the arrangement was in fact halal as well.

This criticism did not end the use of the total-return swap, but in some attempt to save face and marginally comply with the criticism, the parties involved decided to willingly avoid using the swap in the most outlandish forms. They did not feel compelled to use only strictly halal underlyings, however, and the wa'd swap has been used for 'wrapping' commodity futures, exotic derivatives, hedge funds, most certainly broad market indices, etc. This self-curtailment (see [reference link](#) for the limits the DB Islamic Structuring desk has decided to place on itself, avoiding areas termed 'too aggressive') and basically the decision not to offer 'shariah-compliant pork bellies' was not due to any reinterpretations of the intricacies of Shari'ah, but rather was based purely on brand perception. In fact, pure compliance to their own version of Shari'ah would mean that DB and other banks who now use the same structure would continue to offer any and everything under the sun with a 'Shari'ah Compliant Wrapper'.

Wa'd for Sale

Nevertheless, the door to radical innovation was still open. In 2004, yet another fatwa was obtained from a prominent Saudi cleric to allow them to enter into a wa'd on forex (a currency option), but only for hedging purposes. Certainly the rationale that creation of options increases the welfare (maslahah) of the muslim ummah cannot be argued with. However, the surprising part of the fatwa was that the cleric allowed them to charge a 'upfront fee' to offset the expense of this offering. This was in fact a first.

In Islam, sales are very specific and are quite different from leases. For instance, a short-sale in a conventional sense is not possible, since the conventional short sale requires one party to borrow an asset, only later to sell it.

In Islam, one cannot sell what one has merely borrowed. Sales depend on constructive possession, typically of some physical underlying (while borrowing only entitles the borrower to the usufruct rather than true ownership of the asset). Consequently there is no means to make a wa'd the subject of a sale. Nonetheless, the cleric saw fit to allow the bank to charge a fee. The actual sale of a promise is something not ever discussed as an object of sale. Hence the use of the 'fee' language. It was claimed that the structure was different from an option as it was not transferrable, but the fact that a fee was allowed meant that other than minor variations of nomenclature, one could effectively buy a promise. In fact, the Shariah compliant option was altogether worse than its conventional counterpart. For one thing, the fee was likely to be larger than an option premium, including portions to reimburse bankers, structurers, shariah scholars, salesmen and shareholders for their time and capital. All this for merely

Featured Structure

repackaging a forex call or put option and calling it a wa'd or promissory note?

This fatwa has apparently been extended and there are now many banks who will explain the pros of purchasing a promise over bai al arbun (a down-payment sale, only legitimized in the Hanbali school, and one with embedded optionality), comparing the two approaches to optionality for their flexibility and transaction costs. Forex options for hedging seem innocuous enough, but the wa'd, by the fact that many scholars have allowed the underlying conditions placed on the promise to depend on non-compliant underlyings made the entire promise-for-sale concept truly extensible.

If we look at the delivery mechanism for almost all Islamic structured or exotic products, we find an underlying wa'd for sale. Most intricately structured products are delivered by one of two methods, either DB's swap methodology, or through rolled murabaha contracts. The rolled murabaha is simple enough to explain.

Most structured product involves a principal protected component and a risky option component. To deliver the principal protection we merely enter into a Murabaha (a markup-sale, much like a zero-coupon bond) which at maturity delivers \$100. If we have rates at 5% and the maturity is 5 years, the price today is about \$75. The remaining \$25 is invested in an option, effectively, it will pay for a wa'd to enter a murabaha in 5Y, maturing in 5Y and 3M time, or something similarly small. The markup for this subsequent mubahaha will be (truly off-market) linked to the performance of some exotic index/structure over the first 5Y. In other words, by allowing the rolled murabaha, by effectively allowing wa'd for sale, the scholars have opened the door to virtually any cashflow for the Muslim investor.

Islamic Finance in a Complete Market

How did we arrive here? How did we effectively achieve the completeness of the Islamic finance marketplace? Two major steps were taken. In one case, it was a wa'd for swap, and in the other case it was a wa'd for sale. Both effectively allow consideration to be given in exchange for a promise.

While scholars may term it differently, calling it a promissory note or a wa'd with a small offsetting fee, the nomenclature means little. In fact, if we allow upfront fees, we might as well allow Islamic Banks to offer Qard al Hassan (a 0% interest benevolent loan) with a 'upfront fee' to offset the expense of tying up capital for the maturity of the loan. And we might as well have the fee be equal to LIBOR x Notional or some other pertinent interest rate. More likely than not, it will be LIBOR+Significant Spread where the Spread pays for the investors' religiosity. While we are at it, we can charge a 'upfront fee' for late payment of a loan and ensure foreclosure upon default. Such is the nature of this slippery slope.

In fact 'upfront fees' are the principal behind interesse, the original interest charged by Venetian and Genovese bankers for the opportunity cost of offering a loan. And we can trace the Church's acceptance of 'upfront fees' as the beginning of the end of the Ecclesiastical ban on usury. A survey of daily headlines will tell you where that has taken us.

Suddenly, the world is open to the Islamic investor, and might lead one to question what differentiates Islamic finance? Presumably, if Islamic finance was in fact adherence to a set of principles which change our investment behavior for the sake of longer-term blessings, then Islamic financial prohibitions should genuinely lead to a constraint in our investment universe and lead to a reduction in short-term 'welfare'. In the short run at least, the constrained optima will always be less welfare-producing than the unconstrained. As we have seen though, wa'd are being used to 'complete the market', to open up all opportunities to investors without the need to observe financial ratios, non-permissible activities and other trivial guidelines.

So is Islamic finance different? Or is it now the conventional dressed in new clothes? Islamic finance is different, we cannot invest in haram assets. No, we must wait three months longer for the second murabaha to pay off.

Your feedback and comments are very important to us, please feel free to contact the author [via email](#).

SAM Gatehouse

Interview with Dieter Küffer, Senior Portfolio Manager, SAM Gatehouse Islamic Water Strategy

"In early May of this year SAM and Gatehouse Bank jointly introduced their Shariah Compliant Water Strategy. On one hand a natural extension of SAM's already broad product range (product themes ranging from smart energy, climate to healthy living), and on the other a novel joint venture that capitalizes on Gatehouse Bank's know-how in the various aspects of Shariah compliance. Here we explore how their combined expertise in the fields of Sustainability and Islamic finance have been sown together."

Q1. What was the key driver behind the development of the Water fund and launching it at this point in time? Where do you see it fitting within a portfolio (whether a conventional or Shariah compliant portfolio)?

The long-term drivers in the water sector are intact. Water pollution, Water shortages, ageing infrastructure and climate change impact the water sector and will be a challenge for our generation as well as for the coming generations and offers attractive investment opportunities. Valuations of companies in the value chain of water are attractive compared to historic valuations. These days we launched an Islamic water strategy together with Gatehouse Bank which considers Shariah compliant investment criteria to benefit of the mentioned trends. The general SAM water strategy was launched already in 2001 and showed a strong performance.

Q3. Screening methodologies have been in the spotlight recently - how integrated is the screening process to the asset management process? How often is this reviewed and/or calibrated?

As Islamic investment criteria are binary they are used to define the investment universe. Gatehouse Bank will bring its know-how and expertise in the Shariah screening of the companies by its Shariah

Advisory Board in the product, while SAM will attend to the asset management aspects of the strategy. The screening for Shariah compliance is done quarterly.

Q4. The scope of potential investments spans across the entire value chain of the water industry, have you found specific areas that are less adept to passing the Shariah screens (i.e. sectors with high gearing, etc)? How does this differ from your conventional water strategies?

Generally about 60% of SAM's water universe passes the Shariah compliance check. The major issue for excluding is the leverage which may not be higher than 33% of the net worth of the company. Utilities often fail due to their levered balance sheet. So, it can be expected that the utility exposure will be smaller in the Islamic water strategy.

Q5. On average, how many holdings do you maintain and what is the level of turnover for the fund? Do you have any limits in place in terms of holding size or a maximum percentage of shares?

The number of holdings of the Shariah compliant water strategy is expected to be 45 companies approximately while the general water strategy of SAM holds 70 companies approximately. The maximum holding in a company is 10% of the strategy. The level of turnover will be around 100% p.a.

Portfolio Interview

10

Q6. Considering the number of holdings in the fund, would you label it as high-conviction? What are the pros/cons of running sector-specific strategies and how do you mitigate any potential issues of concentration, liquidity or idiosyncratic risk?

As we have a bottom up investment process the holdings in the strategy are considered as conviction buys. Sector-specific strategies benefits of secular long-term trends and we expect that sector strategies outperformed the general equity market. As an example SAM's water strategy launched September 2001 performed 80.1% in USD since inception while the MSCI World Index increased 30.3% only in the same period.

Q7. What are the key geographies that you monitor? Do you expect government or supranational support to be as vital in these regions (as it has been to the alternative energy sector in Europe)? Are there any regions/currencies where you limit your exposure to? Do you use any hedging?

It is a global strategy and we monitor water investments worldwide. When it comes to government support you need to consider, that globally 90 % of water utilities are government owned while 10% are privatized. However, also the majority of the privatized water utilities are regulated by public authorities. There are many different pricing model implemented and in some areas water prices and the infrastructure are subsidized by the government. On the other side the supplier of technology and services to the value chain are not regulated and benefits from above average growth rates. We will not use derivatives in the Islamic water strategy. The long-term currency allocation tends towards a global diversification in countries and currencies.

Q8. How often do you review the overall portfolio? Are there any sectors which you are delaying any allocation or that seem overheated? Have you found Shariah screen useful to identify these?

We don't see overheated sectors in the water investment area. Generally the risk return characteristics of the Islamic water strategy is similar to the general water strategy. It is expected that the Islamic water strategy will have a lower exposure to utilities. When utilities underperform than the Islamic water strategy is expected to outperform SAM's general water strategy.

Q9. What is the target size for the fund and when would the fund reach capacity? How would this be mitigated, in particular with regards to smaller holdings in the portfolio?

We have not calculated a specific capacity for the Islamic water strategy as the universe overlap with the general water strategy. For the combined water strategies we calculated a total capacity of USD 7 billions based on market cap and trading volume.

Preventative & Remedial Measures Protecting Sukuk Investment Account Holders

By Khalil Jarrar, J.D.

In our first two articles of Lex Islamicus™, we have explored legal issues facing Islamic finance in one article and Murabaha in a separate article. Moving forward we will be combining both compliance and regulatory issues to benefit readers in an approach that will define each instrument and the legal implications and challenges facing it. Our focus this month will be on the most popular Islamic finance instruments beginning with Sukuk structures.

The growth of Islamic finance has resulted in a thriving multi billion-dollar market in Shariah compliant financial instruments known as Sukuk (plural of the Arabic word Sakk, meaning certificate). They are commonly described as Islamic bonds, trust certificates, or Islamic securities and are structured and traded in the capital market in accordance with Islamic law.

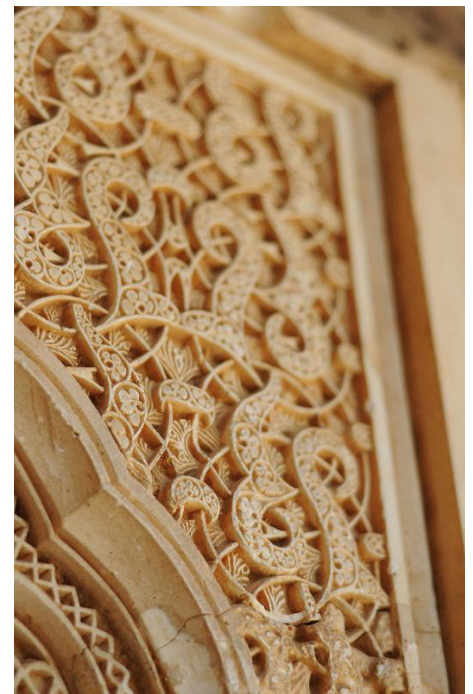
The Accounting and Auditing Organization for Islamic Financial Institution (AAOIFI) defines Sukuk as certificates of equal value representing undivided shares in ownership of tangible assets, usufruct, and services or the ownership of the assets of particular projects or special investment activity¹. The AAOIFI² has identified fourteen different types of Sukuk bonds, among these, Sukuk al-musharaka (partnership) and Sukuk al-ijarah (lease), these being the most common structures currently.

In today's turbulent financial markets, Sukuk structures have gained popularity as an alternative means to conventional financial instruments. To maintain this growth and gain consumer confidence, mechanisms have to be in place protecting the Sukukholders' rights.

Future discussions will explore available measures protecting Sukuk account holders by examining initiatives aimed to improve Corporate Governance and effecting foreign judgments through Arbitral Awards. Throughout we will take an international approach, using globally recognized governance standards set forth by the Basel II Accords and the New York Convention of 1958³ for effecting foreign judgments through Arbitral awards.

Although good governance is consistent with Islamic principles, the phenomenal growth of Islamic financing over the past several years has outpaced the development of standardized regulation, calling for a thorough examination of this growth-borne regulatory and Corporate Governance gap.

Corporate Governance (CG) is defined by the International Chamber of Commerce as; "the relationship between corporate managers, directors and the providers of equity, people, and



¹ AAOIFI Standard 17

² (AAOIFI) is an Islamic international organization responsible for preparing accounting, governance, and ethics for Islamic financial institutions.

³ The Convention on the Recognition and Enforcement of Foreign Arbitral Awards which was drafted by the ICC(International Chamber of Commerce)

institutions who save and invest their capital to earn a return.” It ensures that the board of directors is accountable for the pursuit of corporate objectives and that the corporation itself conforms to the law and regulations. The IFSB⁴ has taken the task of creating best practices and recommendations to protect the rights of investment account holders. These recommendations may vary with the different Sukuk types as to what duty is owed under each Sukuk structure and financing mode. The upcoming article series will expand on financing modes of such structures with special attention to the most common Sukuk types and the adherence to the International standards of corporate governance.

In addition to preventative measures, we have to examine available mechanism to remedy the injured parties. Arbitration as a private form of dispute resolution that has recently gained traction in resolving International disputes. The New York Convention of 1958 is one of the most important and successful United Nations sponsored commercial law treaties. As of January 1, 2009, 143 states, out of 192 member States, have adopted the New York Convention including all the major players in the Sukuk bonds market, Bahrain, Malaysia, Qatar, and UAE. As Sukuk issuance have gained global acceptance, Arbitration can be an effective tool to resolve international disputes arising under provisions of Sukuk contracts. It is important to examine domestic regulatory laws and its adequacy to protect investors and available mechanisms to enforce such laws effecting foreign judgments under the 1958 New York Convention.

In his published dissertation, 2004, Ali Arsalan Tariq⁵, identified three groups of literature that have been written about Sukuk; the first group involves theoretical work, which principally deals with the possible alternatives of issuing financial instruments that can be acceptable within the statutory Islamic legal framework. The second group of literature comprises of the actual Sukuk issuance prospectuses of various corporations, the third group of literature deals with alternative forms of fixed income securities and asset management issues. Such literature is pertinent for analyzing the competitiveness of the Sukuk framework.

The fourth group of literature with renewed attention to the rights of investment account holders, both preventative and remedial measures, which will be the focus and theme of our Lex Islamicus series. Although the research method will be adopting a comparative analysis, distinguishing the differences between conventional bonds and Sukuk structures and the duties owed under both common law and Islamic law, the use of empirical surveys will be inevitable to support any claims and contentions that might be concluded.

Once issues and gaps are identified in the current Sukuk structure system, recommendations can be made where the current system falls short of meeting the acceptable international standards in both preventative and remedial measures collectively or under specific jurisdictions. We aspire to generate interest with a more interactive approach including feedback from readers, subject matter experts and critics alike.

⁴ Islamic Financial Services Board.

⁵ A dissertation submitted in partial fulfillment of the requirements for the degree of Masters of Science at Loughborough University, UK.

Your feedback and comments are very important to us, please feel free to contact the author [via email](#).



"Recent industry discourse has delved into how Islamic Finance - and its overall framework - can help resolve some of the issues found in conventional finance. In that regard, where would the contribution of Islamic finance be more effective - at the institutional level (i.e. financial instruments, compliance procedures, etc.) or at the individual level (i.e. body of ethics, guiding principles, etc.)? Either way, how can such a framework be successfully 'exported'?"

Islamic finance has to instill emphasis on corporate responsibility, making the institutions and the individual responsible, educating them on particular principles and ethics and demanding ethical behavior in return.

The doctrines of ethics are nothing but a bunch of set principles that the Islamic Divine law has intended for mankind to follow in order to keep the interest of the entire society intact and ultimately forming a healthy welfare community. If we analyze a social corporate society we conclude that individuals within its periphery have certain responsibilities that have been entrusted upon them by the stake holders and expecting them to behave morally.

As construed earlier the fundamental reason behind the crisis was in simple words the unfettered behavior. Corporations are collectively group of individuals. Whenever we speak of corporate we collectively mean individuals. Any regulation when maltreated by any corporation is actually battered by its individuals. Fundamentally, they are the individuals who portray the picture of any organization. If individual understand their critical responsibility they will constitute a socially responsible corporation. It means that Islamic finance needs a lot of human resource development and reformation who at last are instilled with the ethical teachings in order to constitute a social responsible organization. One thing to comprehend is that social responsibility is not just limited to environment regulations and few charities, contributions and endowment made to the community but it has more to do with the interest and benefit of all stakeholders, especially the investors. Islamic finance will address and focus institution but institution without individuals has no meaning.

Ehsan Waquar

Member Shariah Committee/Manager Shariah Compliance
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Discussion Board

14

Islamic finance evolved and is still evolving within a conventional paradigm. It has been following the conventional pattern and has not been able to contribute much to the financial industry because it is quite different in products and spirit. However due to its miniscule dimension it does not have a big impact that will warrant the authorities to reconsider their position. On the other hand, with the credit crunch and the need to pull in the GCC's extra liquidity there, has been a small effort mainly from the Far East countries to accommodate Islamic finance a little further!

The whole issue is to grasp the differences between Islamic finance and conventional finance, which has been elaborated by many academics. The very nature of Islamic finance demands a full reconsideration of the regulatory, legal, accounting and tax frameworks, because the existing ones do not accommodate for the expansion for Islamic finance as it ought to be; be it at the banking or takaful or Islamic capital market levels. Only Malaysia is willing to bring some reasonable changes, unfortunately! Hence the starting point is to work at the framework level if the world wants to see a proper contribution of the Islamic finance. At the institutional spheres there is a need for the authorities concerned to be more focused rather than adopting the "fair level plating attitude". I am not arguing in favor of giving a free reign to Islamic finance, but rather to reconsider its own risks and accordingly accommodate it so that it can contribute on a grand scale. The liquidity is present, the market is growing; there is a big scope to further develop the industry such as pension, money market etc. It has been argued to be a more stable financial system, hence it needs to be given an opportunity.

Once the necessary parameters are established for its evolution then only we shall be in a position to discuss its contribution at the individual level. Islamic finance is fundamentally Shari'ah based; some laws are immutable whereas others can fall within the ambit of ethics due to istihsan or maslaha. There is a lot of academic discussions on this issue in the Western world, i.e. the need for Islamic commercial ethics rather than Islamic commercial law. Once ethics is brought in, it opens a completely a new paradigm shift; but the only concern is whether Islamic Finance will remain Islamic finance without its law? Once these issues are ironed out, for Islamic finance to be accepted on a global level, then a good marketing strategy will be needed. To sell financial products to the public, confidence need to be created, not only in the products but also in its ethics, regulation, tax incentives etc. Without the appropriate multi-dimensional approach Islamic finance will be lagging behind.

Sh. Faizal Manjoo

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First, we are not talking about Beliefs and Prayers (Eiteqa-daat & Iba-daat) but about Islamic Economics (Fiqh-ul-Iqtisad) & commercial transactions (Fiqh-ul-Muamlaat). These are based, amongst others, on Equality (Musawat) Social justice & Equity (Al Adal) Trust (Amanah) and Accountability (Ehtesaab). Their ethical dynamics resonates in conventional moral and political philosophy. Adam Smith's Theory of Moral Sentiments, articulates principles similar to the theories of Ibn-e-Rushd. Many eminent Western economists, e.g. Schumpeter, have eloquently challenged the utility of interest.

Second, the present continuing financial crisis in conventional – and to a lesser extent in Islamic – finance is caused not because its founding principles were defective, but because they were abused in implementation. The root of this abuse is that in the last 40 years, "Greed is good" ruled the market with xenophobic zeal. It spawned market abuse, insider trading, opacity of procedures & SIVs, complexity of instruments and asymmetrical remuneration policies.

Third, at the axiomatic level, Islamic finance can offer the prohibition of Riba, short selling, excessive speculation, excessive debt, trading in debts and derivatives, excessive leverage not for adding value to the real economy, but to inflate numbers in hot air balloon of financial capital and to enlarge toxic assets and imploding governance black holes. But how do these Islamic prohibitions differ from principles of prudent risk management and deposit protection? As I said, the shameful bubbles arose not because of defective principles, but because the tsunami of market triumphalism engulfed not only markets but ripped apart the very fabric of government and social institutions.

Fourth, How can the dykes against such Tsunamis be 'exported'? Islamic and conventional Finance have to learn to co-exist and adapt acceptable strategies towards a synthesised convergence for a better tomorrow. They have to enter honest debate not so much at the micro level of nuts & bolts or innovation or replication. I am afraid, it has to be at the macro level. The leaders can no longer be deaf to the clarion call to redefine the raison d'etre of Financial Institutions, Regulators and of Government itself. Personal avarice should yield to common good. Shareholder value may be tempered with stakeholder well being. Exotic models and financial engineering have a place – only if they are well & truly understood. We need not exotic, but dull and hard working common man and women who are ever conscious that they are accountable for their acts & omissions, whether to the environment or indeed to the Almighty. Are these principles peculiar to Islam only?

Prof. Mahmood Faruqui

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Ethics and the Shariah as a root for corporate governance

By Usama DeLorenzo, Securities Commission Malaysia

Shariah compliant businesses are relatively new to the industry and there is very little documented data to help assess whether they have better corporate governance principles and practices in place. However the Shariah does provide a good source for a principles-based approach which has been argued to be more effective in achieving good corporate governance than a rules based approach. In theory, a firm engaged in Shariah compliant business should have a set of principles derived from Islam governing its approach to business and relationships with its stakeholders. This set of principles should help the activities of a firm to be good or wholesome.

While the principles derived from the Shariah should help achieve good corporate governance, one must remember that the principles that are the foundation for good corporate governance are the universal principles of good ethics and responsibility. These universal principles do not exclude those businesses that are not Shariah compliant, but, if implemented correctly, would be a natural component of the guidelines of any Shariah compliant business. While many religions have general guidelines on ethics in trade, transacting, and investment, not only are the guidelines set forth in Islam very detailed, but the industry also binds itself to following them. Therefore, it is one of the few industries that follows the set of ethical principles set up by the industry in addition to the guidelines set forth by the Shariah.

The concepts of unity and stewardship prevail in all Islamic thought including that to do with business and ethics. Unity talks to the sense of being one with, and of, the world and in its simplest form conveys the importance of awareness of others. Stewardship is a trusteeship granted to a Muslim by God and invokes in us all a sense of responsibility toward resources. It is the duty of a Muslim that the resources provided by God are to be used wisely. Implicit in this use is that these resources will be used to ensure the basic needs of all are covered before those resources are allocated to the wants and the luxuries in life.

Like any other business, Islamic finance firms have a board of advisors and in this particular case they are a group of specialized scholars comprising the Shariah board. They are a unique stakeholder in the company and the governance of a board consisting of Shariah scholars would not be the same as the governance of an advisory board for any other type of institution. Since these are not your common stakeholders such as employees, partners, or customers, these groups require a different set of guidelines and principles. In the case of Shariah boards, the IFSB (Islamic Financial Services Board) has released a set of guidelines for the governance of Shariah boards.

The principal argument is that corporate governance is universal and that it finds its roots in ethics.

Usama DeLorenzo is a Project Leader with the Securities Commission Malaysia. The opinions expressed herein are those of Usama DeLorenzo, and are not reflective of the views or policies of the Securities Commission Malaysia.

Why the merger of Innovation and Social Responsibility needs to be the niche for Islamic Finance

By Sayd Farook, Dar Al-Istithmar

It is a well known, but rarely admitted fact amongst Islamic bankers and experts that Islamic Finance is not really innovative. Innovation is defined by most dictionaries as something new, a new method or practice or the act or process of inventing or introducing something new. In economic terms it is defined as something that increases value, customer value or producer value. What innovation there is in Islamic Finance was developed 1400 years back and that was the core fundamentals of Islamic commercial law. Hence, the 'innovative' value we perceive in Islamic finance exists only as a result of the fundamental governance and compliance constraints imposed on individuals and institutions, including rules prohibiting usury, gambling and ambiguity. These rules articulate very important sub-rules which form the basis of a solid contractual governance framework, including rules permitting only a first degree of separation from assets, not selling what you do not own and not trading in debt etc. Hence, this perception that there can be innovative Islamic finance products needs to be critically dissected.

By far, the majority of 'innovations' in Islamic finance have been directed towards building what the rest of the world has already developed within the boundaries of Islamic law. Whether it be structured products, derivatives or sukuk, more efficient forms have existed at least 10 years before we came to the market with an innovative "copycat" version twisted around Islamic nominate contracts producing exactly the same outcome. As a result, Islamic Finance is not really an innovative field where value is added through creative inputs to make life better for individuals. The fact that every one nowadays markets themselves as innovative is really shying from the truth. Off the top of my head, I can name two Islamic financial Institutions that utilise derivations of the word innovation in their brand name, with many more who flagrantly abuse the terms at each and every opportunity. While I personally have no issues with presenting new Islamic products to the market that attempt to replicate conventional products, (which may be crucial to the growth of Islamic finance), I have an issue with individuals and organizations trying to pass them off as "innovative".

If we are to claim we are innovative, we must start reflecting on where we can really add value and this requires us to look at what our forefathers have handed down to us as a divine message and work around that to see how that message might add value to our lives. We certainly have not added value in terms of financial innovation, nor have we come with a new asset class.

Going back to the original innovation that is Islamic Finance, our value was added as a result of our unique contractual governance and ethics requirements. The requirements to avoid usury, misrepresentations, ambiguity, zero-sum games all emanate from a broader set of principles that is conceived in Islam as a way of life to be practiced by all human beings. These include conceptions of vicegerency, commending good and forbidding wrongs and developing a spirit of brotherhood and trust. What this means for the innovation agenda in Islamic finance is a fundamental paradigm shift. Innovation in Islamic finance should be directed towards finding solutions to contemporary challenges while wearing the 'Islamic' hat and assessing how the Islamic perspective could add value. More so than everything else, it is the conception of social responsibility that is inherent in a Muslim's responsibility to his creator that can really add value to the financial system. Our research at Dar Al Istithmar and Oxford Islamic Finance is geared towards this agenda. While we acknowledge that our research may not derive immediate benefits, we are firmly of the opinion that the long term value for us and the Islamic industry can only be derived from an Islamic perspective of innovation, rather than innovation driven by the need to mimic mainstream products.

Sayd Farook is Senior Consultant (Structuring and Legal) with Dar Al-Istithmar, based in London. The opinions expressed herein are those of Sayd, and are not reflective of the views or policies of Dar Al-Istithmar.

A Walk Thru the Graveyard

By Bernardo Vizcaino, CAIA

A 2003 paper by Ross Barry, from Macquarie University in Sydney, once explored the extensive 'graveyard' of alternative investment products, not for morbid curiosity but rather to identify the reasons for their closure, potential indicators for investors (i.e. early signals), as well as to determine the impact of such data (or lack thereof) in portfolio modelling. Such analysis can yield equally important information as it pertains to the construction of Shariah compliant portfolios and the effective monitoring of individual investment vehicles.

The key difference however is the dataset available is far more constrained, the fund universe being much smaller and publicly available data on obsolete funds being very difficult to find (in fact there is but one database that has attempted to include obsolete funds in its coverage, wherever possible). One must wonder if such type of analysis (or at least sincere attempts) are being made at all. We are left with a rather unlegant option of analyzing individual cases. This is certainly useful (better than no analysis at all) but the caveat here is that specific cases will be full of idiosyncracies and therefore generalizations would be much more difficult to make.

Barry explored issues such as survivorship bias and instant history bias on a fund universe of 2,200 products. In contrast, the casualties in the Islamic finance arena are few and far in between, but we can identify some of the root causes for their demise:

- The expensive ETF syndrome

The adjunct figure tells the story, it outlines a sample track record for a Shariah complaint long/short equity hedge fund (now defunct) and as a matter of comparison we plot an Islamic equity index (DJIM US index). While the very essence of alternative products is uncorrelation (i.e. it is absolutely incorrect to compare them against a long-only index) we pair them together so as to highlight how similar the hedge fund behaves versus the passive benchmark. To add insult to injury, the exotic actually underperforms the broad based index. This would have little relevance if it were not for the fact that alternatives don't come cheap. In this case the classic '2 and 20' fee structure meant that even with zero performance the management costs would have been at least twice as high as those of a typical mutual fund and certainly higher if compared to that of an ETF (which would have yielded a very similar risk-return profile).

The end result being that of an expensive beta product, when a much more straight forward solution would have been equally feasible. Oddly enough the problem is not with the product itself, but rather the fact that a cheaper alternative would have delivered a very similar outcome to investors. Perhaps this meant foregoing the award for innovative deal of the year, but then again there is no award for cheaper solution of the year.



Source: Amsar Partners, Dow Jones.

- The isolated incident

It is no secret that many institutions have tried to introduce Islamic products to the marketplace, certainly recognized brands such as Pictet, Credit Suisse, Man Investments and others have tried. While their solutions have little to do with each other (from eastern European equities to global fund of funds) they all share a unifying factor: having been developed outside of company-wide initiatives, instead being the output of limited or one-off exercises.

They all have contributed to the graveyard at one point or another, and their risk-return performance should be analyzed in full. However, it is the success/failure of the strategic approach taken by these firms that must be scrutinized as well. Increasingly, the 'commitment level' of institutions is coming into play, with investors today trying to identify (and avoid) one-man shows or compartmentalized solutions that lack the full backing of the parent enterprise. This in turn helps discern between entities ready to deploy multiple products on a long-term basis and those merely keeping legacy products in the institutional basement.

- The dark horse of capital raising

Al Khwarizmi, Al Qayyim, Al Crescent, Al Noor.... these are likely not your household names and for good reason. All of these barely saw the light of day. While their structure and performance require separate study, it is their limited capital (or reliance on a specific key seed investor) that carved their names in the tombstone of ill-fated products. One of these actually conceded that they discontinued their offering to "explore other opportunities in the market" but it was clear that their capital raising efforts were either ineffective or not sufficient (their product averaged US\$20 million)

Many others have tried this same approach, creating the product first whilst deferring the critical capital raising efforts for later. In fact in recent years there have been some attempts at addressing the lack of effective distribution networks (and the overall lack of effective capital raising services), although the various efforts have yielded mixed results. The fact is that the Shariah compliance costs (both the setup and ongoing fees) increase the threshold required to reach a critical mass in terms of the product's asset size. This is much more relevant for exotics (where setup costs can be quite substantial), so if a certain level of assets under management cannot be reached within a reasonable timeframe the ability to run the product just can't be justified (regardless of performance).

The list is admittedly very short, but their experiences (whether of success or failure) can provide valuable lessons for those willing and able to pick where these first-movers might have left off.

Your feedback and comments are very important to us, please feel free to contact the author [via email](#).

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