

LATHAM & WATKINS LLP



THE SUKUK HANDBOOK: A Guide To Structuring Sukuk

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THE HISTORY AND DEVELOPMENT OF SUKUK

The development of modern *Shari'ah* compliant financial products is relatively new, dating back to the early 1970s and the emergence of the first Islamic banks. In recent years, *Shari'ah* scholars and market participants have worked to devise *Shari'ah* compliant products which provide many of the benefits of conventional financial products whilst at the same time remaining faithful to religious precepts. This development process is ongoing as the Islamic financial market continues to expand. The global Islamic finance market is estimated to be worth many trillions of US Dollars and most financial institutions around the world are involved in Islamic financing in some way, with many specifically engaged in the management, arrangement or trading of sukuk.

The Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) defines 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*”. Accordingly, sukuk (while sometimes referred to as ‘Islamic bonds’ because, like bonds, they are for the most part, tradable securities that can be easily rated) can be described more accurately as ‘Islamic investment trust certificates’. Whereas bonds evidence a debt the issuer owes to the bondholders, sukuk certificates evidence the investors’ ownership interest in the underlying sukuk asset, business, enterprise or project which entitles them to receive a share of the income generated thereby.

The sukuk market has grown rapidly in prominence over the last decade as demand for Islamic financial products and services has increased. According to Standard and Poor’s, approximately US\$116.4 billion of sukuk were issued by corporations, sovereign entities and government-related entities (GREs) in 2014. With constraints on liquidity in the banking sector remaining, the sukuk market is likely to be a key financing source for many corporations for the next few years.

Relevant Principles of Islamic Finance

The key principles relevant to structuring sukuk in accordance with the principles of *Shari'ah* are the same as the principles which apply to other Islamic financing structures, and can be summarised as follows:

The charging or receiving of interest (*riba*) is prohibited

Under the principles of *Shari'ah*, money is considered to be a tool for measuring value and a medium of exchange, and has no intrinsic utility. Accordingly, under *Shari'ah*, an investor should realise no profit or gain merely for the employment of money. The return to an investor must be linked to the profits of an enterprise and derived from the commercial risk assumed by that investor. Investors should therefore share in the income generated by the ownership of assets or the profits or revenues of the business in which they invest.

The underlying sukuk assets must be *Shari'ah*-compliant

The assets or businesses underlying the sukuk must be *Shari'ah*-compliant and therefore cannot be related, for example, to gambling or to the production or sale of alcohol or pork.

Prohibition on uncertainty (*gharar*), speculation (*maysir*) and exploitation of ignorance (*jahl*)

Shari'ah prohibits intentionally induced uncertainty or unnecessary risk in contracts (*gharar*), transactions in which the outcome is entirely dependent on chance or speculation (*maysir*) and transactions in which one party gains because of the other party’s ignorance (*jahl*). Transactions containing uncertainty with regards to an essential element of the underlying contracts such as price, time of delivery or subject matter may not be compliant with *Shari'ah*. All rights and obligations relating to an investment certificate must be transparent and clear.

Origins of Sukuk

The origins of sukuk can be traced back to the classical Islamic period (700-1300AD) during which papers representing financial obligations originating from trade and other commercial activities were issued in conformity with verse 2:282 of the Holy Qur'an, which encourages fixing contracts in writing:

When ye deal with each other, in transactions involving future obligations in a fixed period of time, reduce them to writing...It is more just in the sight of God, more suitable as evidence and more convenient to prevent doubts among yourselves.

During the classical Islamic period, a sakk (singular of sukuk and literally meaning ‘deed’ or ‘instrument’) was used to describe any document representing financial liability.

Development of Sukuk as Modern Financial Instruments

The Organisation of the Islamic Conference International Islamic Fiqh Academy (the Fiqh Academy), an academy for the advanced study of Islam based in Jeddah, Saudi Arabia, laid the basis for the development of the sukuk market through the issuance of a statement in 1988, holding that “[A]ny combination of assets (or the usufruct of such assets) can be represented in the form of written financial instruments which can be sold at a market price provided that the composition of the groups of assets represented by the sukuk consist of a majority of tangible assets”.

The Fiqh Academy's decisions are highly influential on most *Shari'ah*-compliant financial institutions and their *Shari'ah* committees. This statement in particular, which was seen to approve sukuk trading, was a milestone in the evolution of Islamic finance, paving the way for the introduction of sukuk as capital markets instruments. AAOIFI, established in 1991, also plays an important role in harmonising *Shari'ah* standards relating to finance. AAOIFI's *Shari'ah* Board consists of scholars representing various Muslim countries and it is therefore considered as an industry-level representative body of *Shari'ah* scholars.

The first sukuk followed shortly after the Fiqh Academy issued the statement referred to above, with Shell MDS Sdn Bhd 125 million Malaysian Ringgit *bai bithaman ajil sukuk* issued in 1990. Another 11 years passed before the issue of the first international US dollar sukuk — the Malaysian plantation company Kumpulan Guthrie Bhd's US\$150 million sukuk in 2001. The Bahrain Monetary Authority (now the Central Bank of Bahrain) was the first GRE to issue sukuk in 2001. Several sovereign sukuk followed Malaysia, The State of Qatar, The Republic of Pakistan and The Emirate of Dubai, which garnered international attention for sukuk and set the stage for unprecedented international growth. In the Gulf Cooperation Council countries (GCC), for instance, sukuk issuances almost doubled between 2005 and 2007, increasing from US\$25.5 billion to US\$48.2 billion.

The sukuk market faltered slightly between late 2007 and early 2009, mainly as a result of two distinct and separate events: the debate surrounding the *Shari'ah*-compliance of some sukuk structures and the global credit crisis, the latter of which resulted in increased borrowing costs and a lack of investor commitment to, and confidence in, capital market securities.

In late 2007, Sheikh Muhammad Taqi Usmani, chairman of AAOIFI, issued a divisive statement questioning whether the majority of sukuk instruments existing in the market were in fact compliant with *Shari'ah* principles. The ensuing market uncertainty caused by Sheikh Usmani's statement led AAOIFI's scholars to hold meetings in early 2008, following which AAOIFI issued an official statement (the AAOIFI Statement), which sought to provide some guidance in relation to sukuk structures.

A number of sukuk issuances, particularly those utilising *mudaraba* and *musharaka* structures (described below), had previously been structured to provide the issuer (typically a special purpose vehicle (SPV)) with a purchase undertaking from the asset originator/obligor, pursuant to which the asset originator/obligor would buy back the underlying assets from the issuer at the face value of the sukuk on maturity or in the event of a default. However the AAOIFI Statement clarified that, in its view, this structure was not permissible under *Shari'ah* and that *Shari'ah* required that such undertaking should only require the asset originator/obligor to purchase the underlying assets based on its net asset value, market value, cash equivalent value or any price agreed upon at the time of purchase.

The purpose and spirit behind the AAOIFI Statement was to ensure that future sukuk were structured more closely within the guidelines set out in the AAOIFI Statement and according to the AAOIFI standards themselves. Although the statement is silent on the subject, many participants in the Islamic finance market believe that AAOIFI did not intend to retrospectively review those sukuk that had already been issued prior to the AAOIFI Statement. However, the release of the AAOIFI Statement coincided with the onset of the global credit crunch and a rapid fall in the number of sukuk issuances. Consequently, the issuance of corporate sukuk in the GCC countries declined from US\$13.5 billion in 2007 to US\$5.5 billion in 2008.

Although determining the extent to which the relative decline in sukuk issuance was due to the credit crunch or to the uncertainty resulting from the AAOIFI Statement remains difficult, the fact that the AAOIFI Statement, while not binding, suppressed the market for a period of time is clear. The AAOIFI Statement also led many experts to revisit sukuk structures and to realign them in accordance with the principles prescribed in the AAOIFI Statement, while at the same time ensuring that sukuk maintained economic characteristics that are equivalent to those of conventional bonds.

Largely as a result of the AAOIFI Statement, the sukuk market has become increasingly standardised around three types of sukuk structures: *ijara*, *murabaha* and *mudaraba-wakala*. Nonetheless, this standardization has not entirely eliminated the element of uncertainty with regard to *Shari'ah*-compliant structuring.

The Sukuk Market Today

The global sukuk market has since recovered, growing rapidly since the global financial crisis with global sukuk issuances reaching US\$116.4 billion in 2014. The sukuk market is now a significant source of capital for many companies, sovereigns and GRES in Southeast Asia, the Middle East and North Africa — regions that are each home to fast-growing Muslim populations. Malaysia currently continues to dominate the sukuk issuance market, accounting for approximately 60 percent of sukuk issuances globally.

In the past, the difficulties of structuring sukuk transactions caused many entities that might have otherwise been logical sukuk issuers to continue to raise funds either through the bond market or through conventional bank loans provided by European and US banks. In addition, sukuk pricing was generally less favourable than that available in the conventional loan and bond markets. However, the credit crunch in Europe and the US, along with the Eurozone crisis, changed the landscape and caused many companies to increasingly turn to the liquid sukuk market.

In recent years, the United Arab Emirates (UAE), particularly Dubai, have relied heavily on international funding. Dubai will spend an estimated US\$8.1 billion on roads, an airport, hotels and an extension to its rail network in preparation for the World Expo 2020, which is likely to result in a surge of sukuk issuances in the Emirate. Even countries like Qatar, which historically financed much of its growth from gas revenues, are expected to require significant external funding to finance the air-conditioned stadiums and substantial infrastructure needed to stage the 2022 FIFA World Cup. The retreat of European and US banks will create a significant funding gap in this expanding regional economy.

As European and US lending markets contracted, companies in the Middle East looked closer to home at the considerable liquidity in the region, which was, at least until late 2014, being driven by high oil prices and strong regional economic growth. In 2014, the economies of Saudi Arabia and the UAE grew by an estimated 4.4 percent and 4.2 percent respectively. As a result of this strong regional economic growth, the liquidity of local and regional banks increased, with greater-than anticipated deposits and low loan-to-deposit ratios. Banks and financial institutions in the region have therefore become important investors in the growing sukuk market in the Middle East. Additionally, increasing numbers of family-owned businesses in the Middle East, after suffering considerable losses on their investments in European and US markets, now prefer to keep their investments closer to home and, where possible, to invest in *Shari'ah*-compliant instruments.

The continued liquidity within the overall Islamic investor base (in particular from Islamic banks), both in the Middle East and Asia, will likely be a key driver of global sukuk issuances. Sukuk has also typically been purchased by investors intending to hold the sukuk certificates to maturity, so the secondary market performance of sukuk has generally been more stable, despite the wider economic instability. Importantly, as the sukuk market has developed, most prospective issuers of sukuk are able to achieve more favorable pricing in the sukuk market as compared to an equivalent issue in the conventional bond market. These factors, amongst others, have lead to a number of market participants predicting that the global issuances of sukuk will reach over US\$250 billion by 2020.

In terms of structures being adopted for sukuk issuances, the market has seen a revival of structures designed to adhere more stringently to the AAOIFI principles and guidance and a shift towards hybrid structures to provide more flexibility with respect to the types of assets that can be used. These structures, for example, often offer the additional advantage of allowing a commodity *murabaha* transaction to form part of the underlying asset base, up to a pre-determined maximum percentage of the total asset value.

The Future of the Sukuk Market

Unlike conventional bond offerings, sukuk offerings allow issuers to tap into both the growing Islamic investor community as well as the Western institutional investor community. As the sukuk market has grown, it has generated increasing interest from some of the most sophisticated European and US institutional investors. Sukuk offerings are increasingly viewed by some European and US institutional investors as one of the best ways to diversify their portfolios and achieve higher returns through investment in the fast-growing emerging markets of Southeast Asia, the Middle East and North Africa.

For example, approximately 27 percent of the order book for the 30-year tranche of the Saudi Electricity Company's (SEC) 2014 sukuk issuance was sold directly to investors based in the US in compliance with Rule 144A of the US Securities Act 1933. The issuance demonstrated that US investors are becoming increasingly willing to invest in longer-term sukuk and are a potentially important investor base for sukuk.

Historically, sovereigns or GREs have issued a high percentage of international sukuk issuances with an explicit or implicit sovereign guarantee. However, as the sukuk market continues to mature and become more sophisticated, the door is opening for listed public companies and private companies across the full spectrum of the credit curve to access the sukuk market. In October 2013, Majid al-Futtaim, the owner and operator of several of Dubai's largest and most successful shopping malls, issued a US\$400 million sukuk, demonstrating that family-owned companies with no government support can successfully access the sukuk market. Majid al-Futtaim is one of the highest-rated companies in the Middle East with a Fitch rating of BBB (stable outlook) at the time of publication. Dar Al-Arkan Real Estate Development Company, despite having a non-investment grade rating, also successfully issued US\$450 million of sukuk in 2010 in a first-of-its-kind high yield sukuk offering. The same company then successfully tapped the market again in May 2013, November 2013 and May 2014, with significantly lower pricing as international investors became more familiar with both the credit and the sukuk structure. Following the trend in Malaysia, where the corporate sukuk market has traditionally been fairly strong, the success of the Majid al-Futtaim and Dar Al-Arkan offerings may open the market to other privately owned regional companies in the Middle East.

The increasing breadth and depth of the global sukuk market is also demonstrated by its ability to provide longer-term financing. While most sukuk have a maturity of three or five years, the market has shown a willingness to fund longer maturities. In April 2013, SEC issued the first international 30-year sukuk. The success and volume of interest global investors showed in this inaugural 30-year issuance (which was more than five times over-subscribed, with a total order book of over US\$5 billion) represented a milestone in the development of Islamic finance and which SEC followed with another successful international 30-year sukuk issuance in April 2014. These issuances will no doubt set a benchmark to be replicated by other companies in the Middle East seeking to obtain longer-term financing. In April 2014, the Government of Dubai issued its first ever 15-year sukuk, the longest tenor for a sukuk issuance by an unrated issuer to date. SEC, as well as other recent issuers of long-term paper, such as the Government of Dubai, opted for dual-tranche structures, issuing both short and long-term tranches in the same offering. The dual-tranche structure allows issuers to take advantage of strong regional demand for the shorter end of the maturity curve as well as the international demand for longer-dated paper.

While the sukuk market's support will continue to come primarily from investors based in the Muslim world, it is expected that sukuk increasingly will attract the attention of some of the world's largest and most important institutional investors in the US, Europe and Asia — who may view sukuk as an effective way of investing in strong companies located in some of the fastest-growing regions of the world. The globalization of the sukuk market will provide pricing benefits and other advantages to issuers of sukuk.

The expectation is to see more sukuk issuances from multi-national corporations, especially those with significant operations in the Muslim world. For example, in November 2009, General Electric, a company ranked in the top 10 of the Fortune 500, became the first global multinational corporation to tap the sukuk market, with a US\$500 million issuance to investors in the Middle East, Asia and Europe. The goal was to raise financing from alternative, non-Western sources and to diversify the company's funding base. It is believed that more and more multi-national companies will follow General Electric's lead now that the global market conditions have improved.

Challenges to the Development of the Sukuk Market

Although the sukuk market is developing at a significant pace, it still faces a number of potential challenges which could potentially impede its growth and restrict future development. Some of these potential challenges are discussed below:

- **Legal Regime:** A sukuk often requires the creation of an Special Purpose Vehicle (SPV) and the transfer of assets underlying the sukuk by the entity seeking to raise finance (the originator) to such SPV. This may give rise to additional taxes and stamp duties, putting sukuk at a disadvantage as compared with conventional bonds. One of the primary reasons that Malaysia continues to account for more than 60 percent of global sukuk issuances is because its government enacted tax, land transfer and registration laws that do not penalise sukuk issuances in comparison with conventional bond issuances. A number of countries have been eager to follow suit in their desire to develop an Islamic finance market and have been enacting legislation to pave the way for sukuk issuances. For example, the UK's Finance Act 2009, which received royal assent on 21 July 2009, removed the tax barriers which had made *Shari'ah*-compliant financial products less tax-efficient than their conventional counterparts. The enactment of this legislation has furthered the UK's ambition to be the leading international centre for Islamic finance. In July 2014, the UK Government issued a £200 million sovereign sukuk, the first of its kind by a European sovereign state. The Government of the Hong Kong Special Administrative Region of the People's Republic of China followed suit and issued a

US\$16 billion sukuk in September 2014, following legislative changes made in July 2013, which provided a taxation framework for sukuk issuances comparable to issuance of conventional bonds. Japan and Singapore, amongst others, have also enacted similar reforms in attempts to eliminate asymmetries in the tax treatment of sukuk and traditional bonds in order to level the playing field, so that sukuk can compete with conventional debt products.

- **Standardization:** As part of a sukuk transaction, a *fatwa* (or legal pronouncement) is usually procured from *Shari'ah* scholars to provide issuers and investors with comfort that a sukuk instrument is in fact *Shari'ah*-compliant. However, these endorsements are subject to different interpretations; and differences in opinion can create volatility in the market as seen with the impact of the AAOIFI Statement. Since doubts regarding *Shari'ah*-compliance are likely to affect marketability, a guiding set of principles should be developed to which the majority of *Shari'ah* advisors agree. The Malaysian government has attempted to address this problem at a national level by establishing a centralised, *Shari'ah* supervisory board, to ensure that every sukuk issued in Malaysia is in full compliance with nationally accepted *Shari'ah* principles. At the time of publication, the GCC region has not developed a similar regional supervisory body or agreed on a set of *Shari'ah* principles, but would arguably benefit from the establishment of a similar body in the near future.
- **Mechanics for Default:** The development of a mature market requires that sukuk investors understand their rights and remedies in default scenarios. Many early investors viewed sukuk as secured instruments, benefiting from security in the underlying sukuk assets. However, following some notable high-profile defaults, investors learned the hard way that most sukuk instruments are not secured in the conventional sense. While from a *Shari'ah* perspective, sukuk are considered to represent an undivided share in the ownership of a pool of tangible assets, usufructs and/or services, whether investors have a claim against these assets upon a default under the terms of the sukuk depends entirely on how the sukuk is structured. For example, sukuk may be structured so that the asset originator conducts a nominal sale but not a true sale of the underlying assets to the SPV. This sale may be accomplished by assigning rights without completing the necessary asset registration formalities. Without a true sale, sukukholders are generally treated as unsecured creditors of the SPV. Even in the case of a true sale of asset ownership to the SPV, there may be contractual arrangements to ensure that sukukholders have no legitimate claim on the underlying assets. Typically a purchase undertaking will be provided by the originator which provides that the SPV must transfer the assets back to that originator upon the redemption of the sukuk or in the event of a default. This purchase undertaking provides the SPV with a contractual claim against the originator for non-payment of the purchase price for the assets, equal to the face amount of the sukuk, but with no claim against the assets, which places the sukukholders in a position similar to that which they would be in as bondholders under a conventional unsecured bond. The level of protection afforded to investors therefore depends on the particular sukuk's structure. AAOIFI appears to encourage a movement towards asset-backed structures, in which the investors have actual recourse to the assets in the event of a default. However, most sukuk in the market are designed to treat sukukholders the same as holders of conventional unsecured bonds would be treated in a restructuring or an insolvency. Although asset-backed sukuk structures exist, they are comparatively rare.

SUMMARY OF SUKUK STRUCTURES

AAOIFI has specified 14 categories of permissible sukuk and a number of techniques that can be employed to structure a sukuk transaction. The choice of structure type will depend on various factors, including the character of the underlying assets, taxation and regulatory considerations, the targeted investor base and the views of the *Shari'ah* scholars who must approve the sukuk issuance. As a result of the AAOIFI Statement, the most commonly used sukuk structures in the current market are *ijara*, *murabaha* and *mudaraba-wakala*.

The popularity of the *musharaka* and the *mudaraba* sukuk structures has declined disproportionately when compared to other structures in recent years, as a consequence of the AAOIFI Statement, which placed restrictions on the requirement that sukuk issuers buy back the sukuk at their face value and prohibited mandatory interest-free loans or liquidity facilities that are typically used to make up for any shortfalls in income from the underlying sukuk assets.

Regardless of the structure chosen, however, the entity seeking to raise finance (the originator) will typically incorporate a wholly owned financial intermediary (an SPV) and transfer title to the underlying assets to the SPV. The SPV will then issue sukuk and use the funds raised to pay the originator for those assets. In theory, the sukuk assets are therefore separate from the originator's remaining assets. In practice, however, the originator continues to use the assets (for instance under a lease in the *ijara*), or to manage the assets (for instance under a *musharaka* or *mudaraba*).

Typically, sukuk issuances are structured as corporate credit-risk instruments and in a default and redemption scenario the sukukholders would not have recourse to the assets themselves. Redemption is typically effected by the sukukholders exercising their rights against the originator under a purchase undertaking. While sukuk certificates represent an underlying ownership interest in an asset from a *Shari'ah* perspective, the commercial and economic reality is that most issued sukuk are unsecured and equivalent to conventional bonds (*i.e.* corporate credit-risk instruments).

Sukuk Structuring Considerations

There are a number of issues to consider in selecting an appropriate sukuk structure.

- **Transfer of Title:** Depending on the relevant jurisdiction, the nature of assets to be transferred and the *Shari'ah* structure used, an issuer may need to consider local law issues pertaining to the transferability of title to the assets underlying a sukuk. These issues may include formalities necessary for the transfer of title to be effective, such as registration and the payment of any associated fees and taxes.
- **Nature of the Assets:** The assets which an issuer employs to underpin the sukuk structure must be used by the obligor for *Shari'ah*-compliant purposes. Activities or businesses relating to, for example, alcohol, pork-related products, conventional finance and gambling are prohibited. The relevant assets must be unencumbered at the issue date of the relevant sukuk and their market value on the issue date must be equal to, or exceed, the principal amount of the sukuk being issued. While, generally, a third-party valuation is not required, the valuation methodology and timing must be carefully considered.
- **Tax and Zakat:** The acquisition or purchase of assets, or other transactions under *Shari'ah*-compliant structures, may create exposure to VAT, income tax, capital gains tax, stamp duties or other forms of taxation. The ownership of an asset may also be taxable or create tax residency issues. In some jurisdictions (for example, Saudi Arabia) *Zakat* (a fixed portion of a Muslim's wealth which must be donated to charity in accordance with Islamic law) must also be paid and should be considered at the structuring phase of the sukuk when obtaining tax advice.
- **Tradability of Sukuk:** In order to enable tradability of sukuk in the secondary market in accordance with *Shari'ah* principles, sukuk must represent an interest in physical assets rather than simply representing debts or obligations. Some *Shari'ah* scholars have been comfortable with physical assets underlying sukuk structures representing at least 33 percent of the sukuk's face value; other *Shari'ah* scholars require between 51 and 70 percent of the assets underlying sukuk structures to be physical assets.
- **Regional Differences:** *Shari'ah*-compliant financing structures adopted in the Middle East can differ considerably from those adopted in Asia. Many reasons account for these distinctions, including the difference in the interpretation of the *Shari'ah* between Middle Eastern and Asian scholars. In the past, Middle Eastern investors have viewed the Asian interpretation of Islamic *Shari'ah* as less conservative than that in the Middle East. However, as the number of cross-border transactions between the regions increases, it is anticipated

that there will be greater convergence between the sukuk markets in the Middle East and Asia, bringing a more consistent approach between scholars as to the acceptability of certain sukuk structures. Other reasons for such regional divergence include different local laws and, more importantly, different tax treatments. For example, tax (such as VAT or income tax) in the Arabian Gulf countries is almost non-existent and therefore sukuk structures are typically not tax-driven. This is not the case in some countries in Asia where VAT, income tax, capital gains tax, stamp duties and other forms of taxation may significantly impact a structure.

Summary of Common Sukuk Structures

The following brief definitions provide an introduction to the eight most common sukuk structures. Each of the case studies later in this Handbook provide additional detail on these structures.

Sukuk al-ijara

Some commentators regard the *ijara* sukuk as the classical sukuk structure and it has become the most commonly used structure by issuance volume since 2008. This structure's popularity stems from its uncontested *Shari'ah*-compliance and investors' familiarity with the sale and leaseback structure. *Ijara*'s nature as a sale and leaseback agreement makes it suitable if the issuing company has unencumbered assets that are commercially leasable, such as real estate, ships or aircraft. The rental payments can be either fixed or calculated with reference to a market rate, such as LIBOR or EIBOR.

Sukuk al-wakala

The *wakala* structure is useful if the underlying assets available for use to support the issuance of the sukuk comprise a portfolio of assets or investments — in contrast to a tangible asset or assets. Thus, provided that the overall sukuk portfolio includes a minimum of 30 percent of tangible assets (or more, depending on *Shari'ah* approvals), the originator may use assets that otherwise would be considered non-tradable debt arrangements — such as *murabaha* or *istisna'a* contracts — as part of the portfolio of investments comprising the sukuk assets.

The structure is similar to the *mudaraba* structure (described below) in that the agent, or *wakeel*, selects and manages the underlying businesses or investments on behalf of the investor to ensure an agreed profit rate. However, in contrast to the *mudaraba* structure, pursuant to which the capital (*rab al-maal*) and the labour (*mudarib*) share in the profit in pre-agreed ratios, the *wakala* structure allows the investor to receive only the agreed upon profit return. The *wakeel*, on the other hand, may keep any profit in excess of this agreed upon profit return as an incentive fee.

Sukuk al-mudaraba

The *mudaraba* structure, similarly to the *musharaka* (described below), is suitable if the originator does not own an actual tangible asset or does not have sufficient funds to purchase such asset to permit an *ijara* to be structured on a sale and leaseback arrangement. *Sukuk al-mudaraba* are particularly fitting for development financing as this structure is connected to a project's profitability. The *mudaraba* was the most frequently employed structure prior to the AAOIFI Statement. However, like the sukuk *al-musharaka* structure, *mudaraba* has decreased in popularity after the AAOIFI Statement's criticism of purchase undertakings being used in this type of structure. The *mudaraba* structure has been revived recently, as it has proved particularly useful for the issuance of Tier 1/Tier 2 capital sukuk — which have become more prevalent as financial institutions prepare to implement the Basel Committee on Banking Supervision's revised rules relating to capital requirements, commonly known as Basel III.

Sukuk al-musharaka

The *musharaka* structure is also suitable if the originator does not own an actual tangible asset or does not have sufficient funds to purchase such asset to permit an *ijara* structured on a sale and leaseback arrangement. Hence, the *musharaka* structure is used to mobilise funds for establishing or developing a project or financing a business activity. Otherwise, the *musharaka* is similar to the other structures in that it requires the performance of an underlying asset to generate profits for investors. It can be implemented to provide for regular payments throughout the life of the financing arrangement and allow for a flexible tailoring of the payment profile and method of calculation. The *musharaka* was among the most commonly used sukuk structures prior to the AAOIFI Statement. The AAOIFI's criticism of purchase undertakings at face value in *musharaka*, however, has led to a decline in the usage of this structure.

Sukuk al-*istithmar*

The *istithmar* structure is an investment structure which may be instrumental if the originator's business does not comprise any or very few tangible assets, for example, Islamic financial institutions which derive their rights to receivables from various Islamic contracts with their customers. The rights under these contracts can be sold together in a portfolio which forms the underlying basis for sukuk — as long as the contracts are not construed as trading in debt.

Sukuk al-*manafa'a*

In the *manafa'a* structure, the underlying asset is the capacity of, or rights to commercial activities, allowing for the use of intangibles in sukuk. In circumstances in which the issuer does not hold unencumbered tangible assets or is commercially unable or unwilling to utilise them in a sukuk structure, the *manafa'a* structure may allow issuances based on available intangible assets. Airtime vouchers (representing minutes of airtime) are one of a number of intangible asset classes used as underlying assets for Islamic financing transactions which have been introduced into the market over the last few years. Other such asset classes include intellectual property rights, tariffs due on electricity meters and receivables due on petrochemical marketing contracts.

Sukuk al-*istisna'a*

The *istisna'a* structure is a contractual agreement for the sale of goods or commodities to be produced in the future. Hence, the *istisna'a* structure is especially suitable for financing large infrastructure projects. If a subcontractor needs to be involved, the suitability of the *istisna'a* structure will depend on the permissibility for the contractor to enter into an additional *istisna'a* agreement with the subcontractor.

Sukuk al-*murabaha*

The sukuk al-*murabaha* is an alternative structure that may be employed if no tangible underlying assets can be identified in the originator's business or operations. In a typical *murabaha* structure, the issuer acquires commodities as trustee on behalf of the sukukholders and sells those commodities to the originator on deferred payment terms. The *murabaha* structure does not enjoy great popularity because the sukuk do not constitute negotiable instruments capable of being traded in the secondary market at a premium; *Shari'ah* considers the underlying *murabaha* as representing a monetary debt receivable. The sukuk are constituted by entitlements to shares in *murabaha* receivables due from the originator, as purchaser of the *murabaha*. Therefore, trading these sukuk in the secondary market would amount to trading in debt, which the *Shari'ah* prohibits. This view is widely shared in the GCC and in Pakistan. However, due to Malaysian jurists' more liberal interpretation of *Shari'ah* on the issue of trading in debts, Malaysia allows the trading of sukuk al-*murabaha*. *Murabaha* may also be tradable in the GCC and Pakistan if they account for a small part of a larger portfolio of sukuk assets which includes tradable instruments, such as *ijara*, *musharaka* or *mudaraba*.

Even though *murabaha* account for a small fraction of the total number of sukuk issued, the structure is favoured for smaller deals involving buy-to-hold investors who are more likely to accept uncertainties with regards to the negotiability of their certificates.

SUKUK AL-IJARA

“the transfer of ownership for an agreed upon consideration” | AAOIFI

Ijara is the transfer of the usufruct of an asset to another person in exchange for a rent claimed from that person. *Sukuk al-ijara* is the most commonly used sukuk structure (based on volume of issuances) and is regarded by some commentators as the classical sukuk structure from which all other sukuk structures developed. *Ijara* is popular because it is simple and widely accepted and understood by both conventional and sukuk investors as well as by the international rating agencies.

Sukuk al-ijara involves the transfer of ownership or benefit/usufruct of tangible assets such as real estate, aircraft or ships from an originator to an SPV, which then issues to investors sukuk certificates representing undivided ownership interests in such assets. The asset is then leased back to the originator by the SPV for a specified term, which is typically commensurate with the term of the certificates. Each sukukholder is entitled to receive the rentals generated under the lease pro rata to its ownership interest in the underlying asset. The amount of these rentals is equal to, and used by the SPV to pay, the periodic distribution amount payable under the sukuk at that time. This amount therefore may be calculated by reference to a fixed rate or variable rate (e.g. LIBOR or EIBOR) depending on the type of sukuk issued.

On the issuance date, the originator will enter into a purchase undertaking which gives the right to the SPV to oblige the originator to purchase the assets following a sukuk dissolution event or on scheduled maturity, at an exercise price equal to the principal amount plus any accrued but unpaid periodic distribution amounts. The money received by the SPV will be used to pay the dissolution amount due to investors under the sukuk.

Since the payments under the sukuk are dependent on payments to the SPV by the originator under the relevant *ijara* contract and purchase undertaking, in a similar manner to a corporate bond, the sukukholders are assuming the credit risk of the originator. Unless the sukuk is asset-backed, the documentation will typically provide that the only recourse available to the sukukholders in a default scenario is a contractual claim against the originator for non-payment of the purchase price for the assets in accordance with the purchase undertaking, which puts the sukukholders in a position similar to that of bondholders under a conventional unsecured bond.

Shari’ah requirements applicable to underlying ijara

The lease in an *ijara* must comply with all of the following general *Shari’ah* requirements applicable to leases:

- The lessor must have ownership of the asset or the usufruct right in that asset before entering into a lease contract.
- The benefit from an *ijara* must be lawful under *Shari’ah*, e.g. leasing property to a shopkeeper selling alcohol would be unlawful.
- The leased assets must continue to exist throughout the period of the lease and any assets which are consumed during that period cease to be leasable.
- The period of the lease and amount payable therefor must be specified in advance.
- The lessee must use the leased asset only for the purpose specified in the lease, or, absent a specified purpose, in conformity with common practice.
- The lessor must maintain and insure the leased assets during the lease period, provided that the lessor may, if it so wishes, delegate such obligation to an agent.
- The liabilities arising from the ownership of the asset, such as any harm or loss, are borne by the SPV, as lessor.

CASE STUDY: GOVERNMENT OF DUBAI

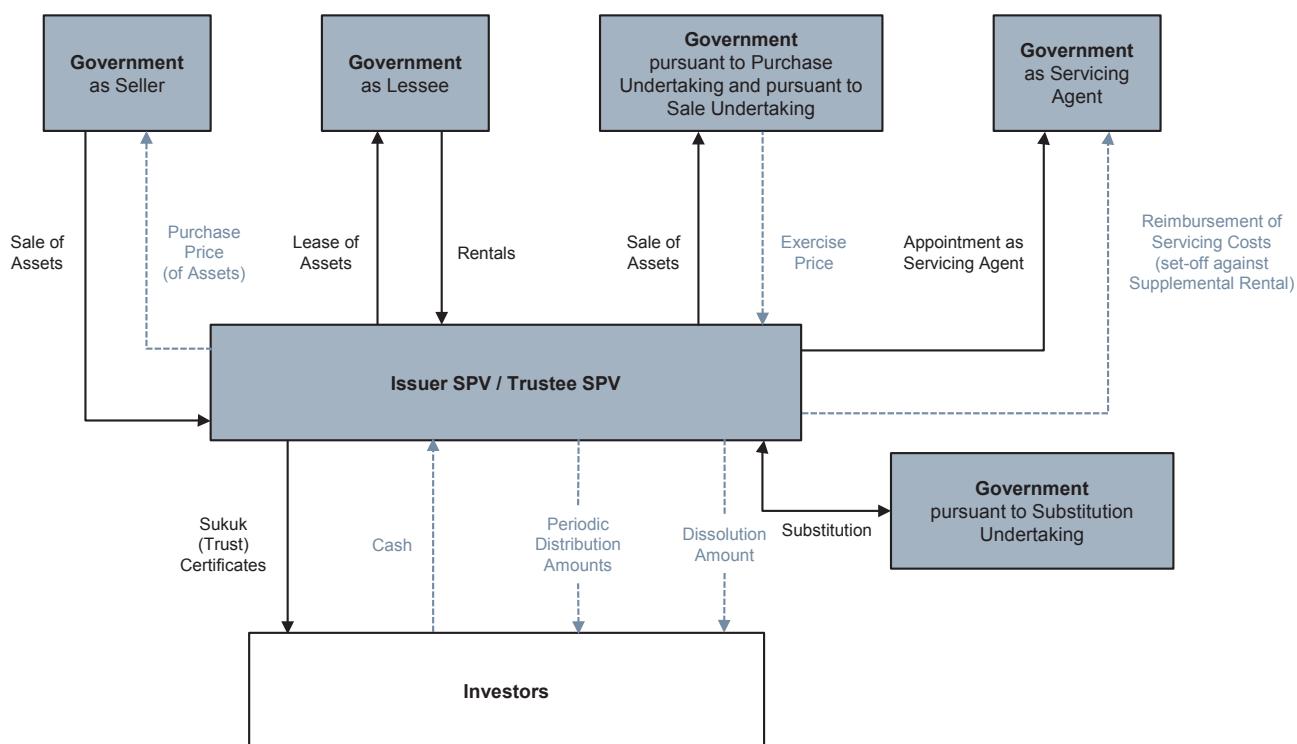
DUBAI DOF SUKUK LIMITED

(INCORPORATED IN THE CAYMAN ISLANDS WITH LIMITED LIABILITY)

US\$5 BILLION TRUST CERTIFICATE ISSUANCE PROGRAMME

In April 2014, Latham & Watkins advised the Government of Dubai (the Government) on the update of its US\$5 billion Trust Certificate Issuance Programme and the subsequent issuance of US\$750 million *sukuk al-iжara* due 2029, the Government's first 15-year issuance and the longest tenor for a sukuk issued by an unrated issuer to date.

Dubai Islamic Bank PJSC, Emirates NBD PJSC, HSBC Bank plc, National Bank of Abu Dhabi P.J.S.C. and Standard Chartered Bank acted as joint lead managers on the transaction. The issuer, trustee and lessor in this case was Dubai DOF Sukuk Limited, a limited liability company incorporated under the laws of the Cayman Islands for the sole purpose of issuing sukuk under the trust certificate issuance programme. The tangible asset underlying the *iжara* was real estate located in the UAE.



The sukuk *al-iжara* structure consisted of the following transactions:

- Incorporation of financial intermediary:** The Government incorporated an SPV, Dubai DOF Sukuk Limited, under the laws of the Cayman Islands, to act as issuer, trustee and lessor.
- Issuance of sukuk:** The SPV, as issuer, issued the sukuk, representing an undivided ownership interest in the underlying real estate and a right against the SPV for periodic distribution amounts and a dissolution amount.
- Subscription to sukuk and creation of a trust:** The investors subscribed for the sukuk and paid the proceeds to the SPV, as issuer. The sum total of the issuance proceeds made up the aggregate face amount of the Trust Certificates. The SPV declared a trust over the proceeds and began acting as a trustee for the investors.
- Sale and Purchase Arrangement of Underlying Asset:** The Government, as seller, entered into a Sale and Purchase Arrangement with the SPV, as trustee, and transferred the underlying asset to it. The SPV,

as trustee, paid the purchase price of the asset, as consideration for the sale, to the Government using the proceeds from the issuance of the sukuk.

- **Ijara (Lease back) Arrangement:** The SPV, as lessor, then leased the assets back to the Government under *ijara* arrangements for a fixed term of 10 years.
- **Rental Payments and Periodic Distribution Amounts:** The Government, as lessee, agreed to make semi-annual Rental payments to the SPV, as lessor and trustee. The amount of a rental payment is equal to the agreed periodic distribution amount due to the investors, in this case, a fixed rate of five percent, payable semi-annually.
- **Payment of Distribution Amount:** The SPV, as issuer, uses the rental payments from the Government to pay the periodic distribution amounts to the investors.
- **Sale and Purchase Agreement of the Underlying Asset at Maturity:** At maturity or upon an option call, the SPV, as trustee, will sell and the Government will buy back, the underlying asset at the exercise price, which will equal the face amount plus accrued but unpaid periodic distribution amounts owing to investors.
- **Payment of the Dissolution Amount:** The SPV, as issuer, will then use the exercise price it has received to pay the dissolution amount due to the investors under the terms and conditions of sukuk Trust Certificates.
- **Reimbursement of Servicing Costs:** The SPV, as trustee, appointed the Government as its servicing agent to carry out or procure performance of the lessor's obligations under the *ijara* arrangement (since the SPV itself is a shell company with no real assets or operations), such as undertaking, obtaining or paying any major maintenance, insurance, and proprietorship taxes relating to the asset. In the event that the Government, as Servicing Agent, claims reimbursements for servicing costs paid by it, the rental for the subsequent *ijara* period will be increased by an amount equivalent to the servicing costs.

Additional Latham & Watkins Experience with Sukuk Al-Ijara

Saudi Electricity Company: In April 2013, Latham & Watkins advised the joint lead managers in connection with the Saudi Electricity Company's issuance of US\$1 billion sukuk *al-ijara* due 2043 and US\$1 billion sukuk *al-ijara* due 2023. The sukuk, which was sold to US investors pursuant to Rule 144A, represented the world's first international 30-year sukuk and its success can partly be attributed to the use of the *ijara* structure being more familiar to international investors. The structure was also used in April 2014 on the Saudi Electric Company's issuance of US\$1.5 billion sukuk *al-ijara* due 2024 and US\$1 billion sukuk *al-ijara* due 2044.

State of Qatar: In July 2012, Latham & Watkins advised the State of Qatar, acting through the Ministry of Economy and Finance, on the issuance of US\$2 billion sukuk *al-ijara* due 2018 and US\$2 billion sukuk *al-ijara* due 2023. The transaction was awarded "Qatari Deal of the Year" by *Islamic Finance News* and "Deal of the Year" by *Asian-MENA Counsel*.

SUKUK AL-WAKALA

“mobilization of capital to acquire certain goods that are entrusted to an agent” | AAOIFI

A *wakala* is an agreement between two parties whereby one party agrees to act on the other party's behalf, in a manner akin to an agency arrangement. The principal (investor) appoints an agent (the *wakeel*) to invest funds in a pool of investments or assets that are purchased by the *wakeel* as agent and trustee of the sukukholders. The *wakeel* then uses its expertise to manage the investments for an agreed period of time in order to generate an agreed profit return. The principal (which is usually an SPV) will then use the profit return to fund the periodic distribution amounts payable to the investors by the issuer. Any profit in excess of the periodic distribution amounts is typically paid to the *wakeel* as an incentive fee. On the maturity date, the investment manager liquidates the sukuk portfolio and pays the proceeds of the liquidation to the principal to fund the dissolution amounts payable to the investors by the issuer.

Shari'ah Requirements Applicable to Underlying Wakala

The agency agreement in a *wakala* must comply with all of the following general *Shari'ah* requirements applicable to *wakala* agreements:

- The principal may only require the *wakeel* to perform *Shari'ah*-compliant tasks.
- The principal can only receive the expected profit, any excess will be held by the *wakeel* for its benefit.
- The *wakala* agreement must be clear and unambiguous as to the duration of the *wakala*, the type of investments to be entered into by the *wakeel* and the conditions for termination of the *wakala* agreement.
- The *wakala* assets must comply with certain eligibility criteria. For example, at least 30 percent of the underlying assets must be tangible.
- A mechanism for replacing assets that cease to be *Shari'ah*-compliant must be in place.

CASE STUDY: DAR AL-ARKAN REAL ESTATE DEVELOPMENT COMPANY

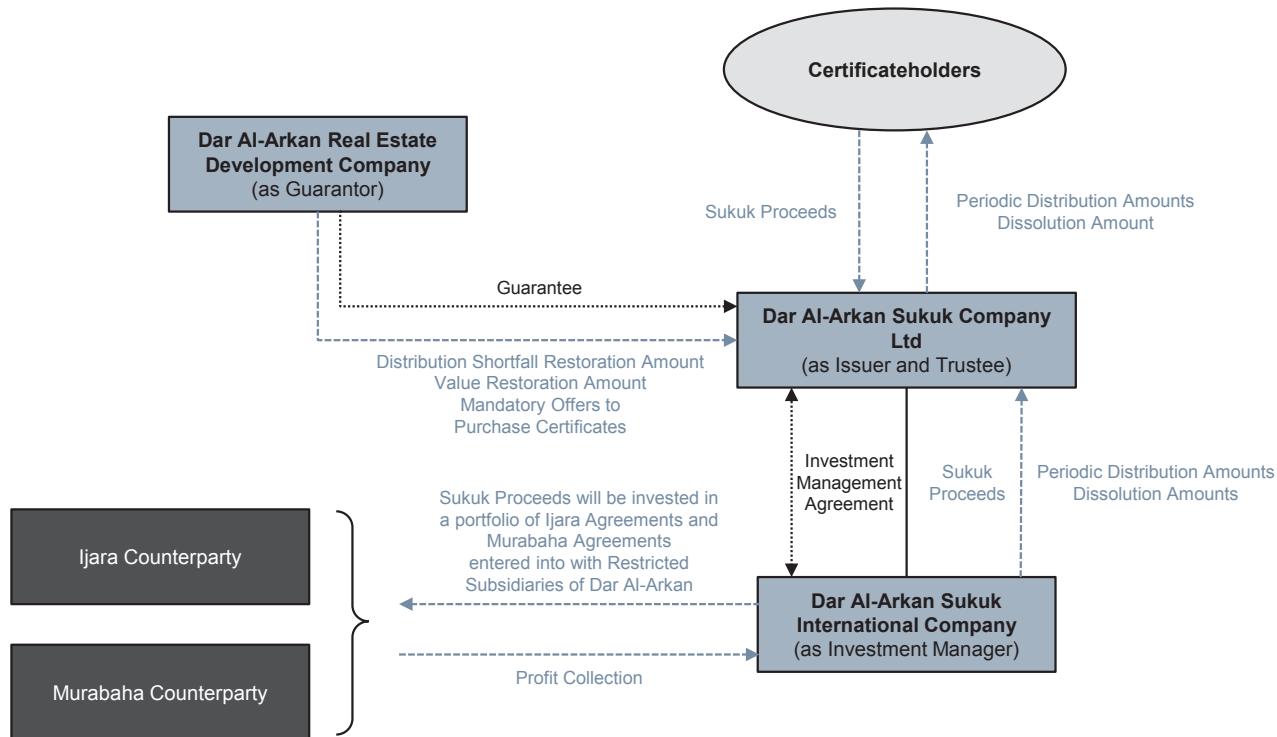
DAR AL-ARKAN SUKUK COMPANY LTD. (INCORPORATED IN THE CAYMAN ISLANDS WITH LIMITED LIABILITY)

US\$1.2 BILLION TRUST CERTIFICATE ISSUANCE PROGRAMME

Latham & Watkins advised Dar Al-Arkan Real Estate Development Company (Dar Al-Arkan) in relation to its US\$1.2 billion Sukuk Issuance Programme together with the first issuance of US\$450 million under such programme in May 2013 and subsequent issuances of US\$300 million in November 2013 and US\$400 million in May 2014.

The structure of the issuances replicated Dar Al-Arkan's successful offering (on which Latham also advised) of US\$450 million in 2010 — which was the first transaction of its type to combine an innovative *wakala* structure with a 'high yield' covenant package and has therefore been regarded as the first-ever 'high yield' sukuk. This 'high yield' covenant package was designed to replicate features typically found in conventional high yield real estate transactions in emerging markets. The success of the transaction encouraged Dar Al-Arkan to utilise a programme structure for its subsequent issuances, thus allowing for repeat issuances with minimal cost.

Dar Al-Arkan incorporated an SPV, Dar Al-Arkan Sukuk Company Ltd., under the laws of the Cayman Islands, for the purpose of serving as the issuer of the sukuk and as the investors' trustee. In addition, Dar Al-Arkan Sukuk International Company, a wholly owned subsidiary of Dar Al-Arkan incorporated under the laws of Saudi Arabia, served as *wakeel*, or investment manager in connection with sukuk. Bank Alkhair B.S.C.(c), Deutsche Bank AG, London Branch and Goldman Sachs International served as arrangers and dealers under the Programme and joint lead managers on the issuances.



The *wakala* consisted of the following transactions:

- **Issuance of Sukuk:** the SPV, as issuer, issued the sukuk, which represent an undivided ownership interest in the underlying *wakala* assets or transactions and a right against the issuer for payment of the periodic distribution amount and the dissolution distribution amount.
- **Subscription to Sukuk:** The certificateholders subscribed for sukuk and paid the sukuk proceeds to the issuer.

- **Investment Management (*Wakala*) Agreement:** The sukuk proceeds were provided by the issuer to the investment manager to invest in a portfolio of investments comprising an *ijara* agreement and a *murabaha* agreement entered into between the investment manager and certain restricted subsidiaries of Dar Al-Arkan. A minimum amount corresponding to 51 percent of the face amount of the certificates outstanding was required to be invested by the investment manager in tangible *ijara* agreements at all times, except during periods necessary for replacing any *ijara* agreement.
- **Investment Plan:** The investment manager agreed to invest the sukuk proceeds into a portfolio of sukuk contracts (which generate returns at least equal to the periodic distribution amount for a period which is equal to or greater than the remaining duration of the certificates which are outstanding at the time of the relevant investment) and to ensure the preservation of the value of the sukuk portfolio. The investment manager is not entitled to commingle its own assets with the sukuk portfolio and must meet the certain investment conditions contained in an investment management agreement.
- **Profit Collections and Distribution to Certificateholders:** Prior to each periodic distribution date, the investment manager collects all sums due from the counterparties to the *ijara* agreements and *murabaha* agreements and on the same date pays such collections to the principal paying agent on behalf of the issuer. The principal paying agent in turn applies such amounts to pay the periodic distribution amount to the certificateholders on the relevant periodic distribution date. Dar Al-Arkan, as guarantor, is under an obligation to make up any shortfall between the profit collections and the periodic distribution amount due under the sukuk, by paying a shortfall restoration amount.
- **Liquidation:** Prior to the maturity date, the investment manager shall liquidate the sukuk portfolio and pay the proceeds to the principal paying agent. The principal paying agent will in turn apply such amount to pay the dissolution distribution amount to the certificateholders. Dar Al-Arkan, as guarantor, is under an obligation to make up any shortfall between the sukuk portfolio liquidation proceeds and the dissolution distribution amount due under the sukuk by paying a shortfall restoration amount.

Additional Latham & Watkins Experience with Sukuk *Al-Wakala*

AI Bayan Group Holding Company: In April 2013, Latham & Watkins advised the joint lead managers in connection with AI Bayan Group Holding Company's establishment of a RM1 billion Sukuk *Al-Wakala* Programme and the first issuance of RM200 million *sukuk al-wakala* due 2016 thereunder. The sukuk represented the first sukuk issuance in Malaysian Ringgit by a Saudi issuer (and the first Malaysian Ringgit sukuk programme established by a Saudi issuer). The issuance by AI Bayan Group Holding Company and other GCC issuers is part of a growing trend of foreign companies accessing the Malaysian market as the Ringgit becomes a growing, credible alternative to the US Dollar for non-Malaysian issuers. Latham & Watkins also advised the joint lead managers in November 2013 in connection with AI Bayan Group Holding Company's subsequent issuance of RM120 million *sukuk-al-wakala* due 2014.

SUKUK AL-MUDARABA

“a partnership in profit whereby one party provides capital (*rab al-maal*) and the other provides labour (*mudarib*)” | AAOIFI

Mudaraba refers to a form of equity-based partnership in which one party (the *rab al-maal*) provides the other party (the *mudarib*) with capital and the *mudarib* uses its expertise and labour to invest the capital in return for a pre-agreed share of the profit generated.

In the context of sukuk, an SPV is usually established to issue the sukuk and contribute the proceeds raised from the investors as *mudaraba* capital (and therefore the SPV issuer becomes the *rab al-maal*). The originator of the sukuk contributes expertise, labour and possibly cash, serves as *mudarib* and manages the capital. Any profits generated by the *mudaraba* are divided between the *rab al-maal* and the *mudarib* in accordance with agreed profit-sharing ratios set out in the *mudaraba* agreement. The SPV uses the profits it receives from the *mudaraba* to make payments of the periodic distribution amounts due under the sukuk.

Prior to the AAOIFI Statement, sukuk *al-mudaraba* structures typically included a purchase undertaking in favor of the SPV, allowing for the purchase of the *rab al-maal*'s interest in the *mudaraba* for a pre-agreed exercise price. This exercise price was structured to ensure that the *rab al-maal* received the amount required to pay the dissolution distribution amount due to investors under the sukuk. Since the AAOIFI Statement, scholars have taken the view that an originator may not grant a purchase undertaking for any amount other than the market value of the *rab al-maal*'s interest in the *mudaraba* assets at the time of sale (on the basis that determining the value by reference to the value of the sukuk is akin to a guarantee of profit and principal which, unless given by an independent third party, is not permitted under *Shari'ah*).

While the inability to grant such a purchase undertaking has contributed to the decline of the *mudaraba* structure for sukuk, the structure recently has experienced a revival with the introduction of the sukuk as a method of increasing Tier 1 and Tier 2 regulatory capital for banks and financial institutions.

Shari'ah Requirements Applicable to the Underlying Mudaraba

The arrangement in a *mudaraba* structure must comply with the general *Shari'ah* requirements applicable to *mudaraba* agreements:

- A *mudaraba* contract may be unrestricted or restricted. Under an unrestricted *mudaraba* contract, the *rab al-maal*, the issuer SPV, permits the *mudarib*, the originator, to administer the *mudaraba* capital without any restrictions. The *mudarib* must exercise this freedom in accordance with the interests of the parties and the business contract, hence, with a view to making profit. Under a restricted contract, the *rab al-maal* imposes certain restrictions on the *mudarib*, however, not to the extent that the *mudarib* will be unduly constrained in his operations.
- In principle, the capital for the *mudaraba* must be provided in cash; however, it may be provided in the form of tangible assets with the value of such assets constituting the *mudaraba* capital. At least 33 percent of the capital should be invested in actual tangible assets in accordance with *Shari'ah*.
- The *mudarib* must have free access to the capital for the *mudaraba* to be considered valid.
- The profit-sharing ratio should be determined in advance and must be a percentage of the actual profit, not a percentage of the capital or a lump sum.
- However it is permissible to stipulate that if the profit is above a certain ceiling (up to which the profits are shared according to pre-agreed ratios) one party may take that additional profit.
- Any losses of the *mudaraba* enterprise will be borne by the *rab al-maal* but the *rab al-maal* is liable only to the extent of the proceeds invested. Sukuk investors will therefore be liable only for their invested proceeds.

CASE STUDY: ABU DHABI ISLAMIC BANK

ADIB CAPITAL INVEST 1 LTD.

(INCORPORATED WITH LIMITED LIABILITY UNDER THE LAWS OF THE CAYMAN ISLANDS)

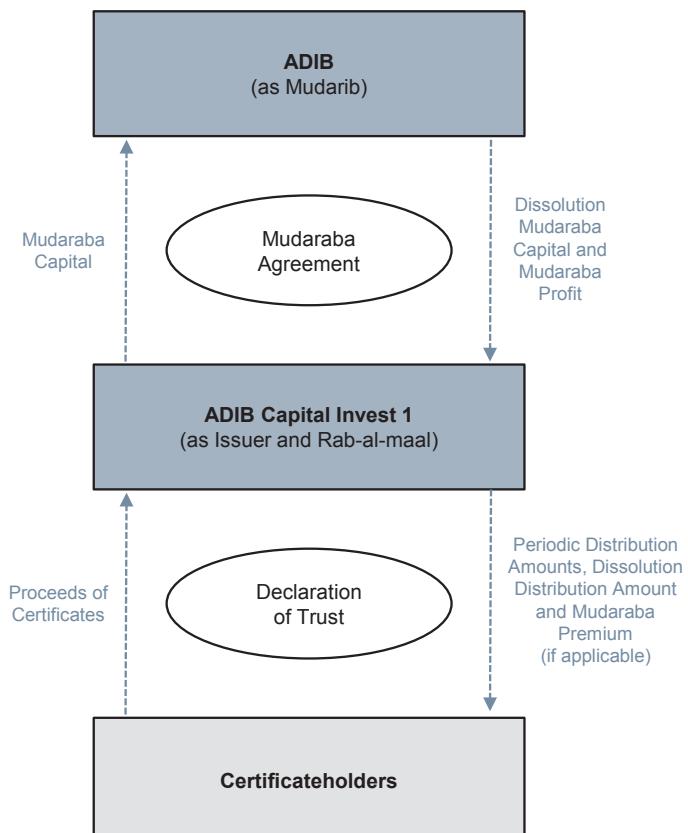
US\$1 BILLION ADDITIONAL TIER 1 CAPITAL CERTIFICATES

In November 2012, Latham & Watkins advised Abu Dhabi Islamic Bank PJSC (ADIB) on the successful issuance of US\$1 billion Additional Tier 1 Capital Sukuk, the world's first Basel III compliant Tier 1 Sukuk issuance. The sukuk, which was based on a *mudaraba* structure, was more than 15 times over-subscribed (with an order book of US\$15.5 billion) and was able to price with an expected profit rate of 6.375 percent, the lowest-ever coupon for an instrument of this type. This sukuk was awarded "Mudaraba Deal of the Year" and "UAE Deal of the Year" by *Islamic Finance News*, as well as "Middle East Deal of the Year" by *The Banker*.

ADIB, HSBC Bank plc, Morgan Stanley & Co. International plc, National Bank of Abu Dhabi P.J.S.C. and Standard Chartered Bank acted as joint lead managers and Barwa Bank P.Q.S.C. and Sharjah Islamic Bank P.J.S.C. acted as co-lead managers on the initial issuance.

While a number of conventional banks have issued Additional Tier 1 capital instruments, incorporating the required characteristics of these instruments into a *Shari'ah*-compliant structure presents a number of additional challenges, as the instrument must be structured in a way that allows it to be classified as (non-dilutive) 'equity' rather than 'indebtedness', so that the instrument can be booked as capital rather than a liability on the issuer's balance sheet.

A *mudaraba* sukuk provides an ideal *Shari'ah*-compliant structure to accommodate the features of Additional Tier 1 capital, such as the discretionary profit payments. While the structure of the transaction follows closely the structure of a typical *mudaraba* sukuk, a few key differences allow the sukuk to comply with Basel III.



The *mudaraba* consisted of the following transactions:

- **Issuance of Sukuk and Creation of a Trust:** On the issue date, the certificateholders paid the issue price to the SPV issuer. The issuer, in its capacity as trustee, declared a trust in favor of the certificateholders over the proceeds of the issuance of the certificates, its rights, title, benefits and interests under the transaction documents and certain related rights.
- **Mudaraba Agreement:** The issuer (as trustee) applied the proceeds of the issuance of the certificates towards the capital of the *mudaraba* pursuant to the *mudaraba* agreement. ADIB (as *mudarib*) invested the *mudaraba* capital into the business activities of ADIB in accordance with the agreed investment plan set out in the *mudaraba* agreement.
- **Mudarib's Responsibilities:** ADIB, as *mudarib*, agreed to contribute its expertise and labour to managing the *mudaraba* enterprise, with responsibility for managing the *rab al-maal*'s cash contribution in accordance with the *mudaraba* agreement with a view to generating profit on the principal amount.
- **Distribution of the Profits Generated:** Unlike on previous *mudaraba* sukuk issuances, payments of *mudaraba* profit by ADIB (as *mudarib*) are made at the sole discretion of ADIB and may only be made if ADIB meets certain conditions. On each periodic distribution date, ADIB (as *mudarib*) will distribute the profit generated by the *mudaraba* to both the issuer and the *mudarib* in accordance with an agreed split (90 percent to the issuer (as *Rab-al-maal*) and 10 percent to ADIB (as *mudarib*)) only if neither a non-payment event¹ or a non-payment election² has occurred. ADIB (as *mudarib*) has no obligation to make any subsequent payment in respect of any *mudaraba* profit that is not paid in accordance with the *mudaraba* agreement. To the extent that ADIB exercises its discretion not to distribute profits under the *mudaraba*, ADIB will not be able to declare or pay any distribution or dividend on any ordinary shares issued by ADIB until two consecutive payments due under the *mudaraba* have been paid in full (or equivalent amounts have been set aside for the benefit of the issuer (as trustee)).
- **Distribution to Certificateholders:** The issuer applies its share of the profit (if any) generated by the *mudaraba* on each periodic distribution date to pay the periodic distribution amount due to certificateholders on such date.
- **Maturity:** The certificates are perpetual securities in respect of which there is no fixed redemption date and accordingly, the *mudaraba* is a perpetual arrangement with no fixed end date. Subject to certain conditions set out in the *mudaraba* agreement, ADIB (as *mudarib*) may, at its option, liquidate the *mudaraba* in whole, but not in part, on the basis of an actual liquidation of the *mudaraba* in the following circumstances:
 - (a) on the first call date or any periodic distribution date after the first call date³; or
 - (b) on any date on or after the issue date (whether or not a periodic distribution date): (i) upon the occurrence of a tax event⁴; or (ii) upon the occurrence of a capital event⁵.

ADIB (as *mudarib*) agreed that it will only liquidate the *mudaraba* to the extent that, on a dissolution, the *mudaraba* capital would be equal to the nominal amount of the sukuk to be repaid. To the extent that ADIB (as *mudarib*) breaches this obligation, it is required to indemnify the issuer in respect of this shortfall.

Additional Latham & Watkins Experience with Sukuk Al-Mudaraba

Saudi International Petrochemical Company: Latham & Watkins advised Deutsche Securities Saudi Arabia LLC and Riyad Capital, as joint lead managers and joint bookrunners, in the issuance of an SAR1.8 billion *mudaraba* by Saudi International Petrochemical Company's (Sipchem). Established in 1999, Sipchem is one of the largest petrochemical holding companies in Saudi Arabia. The deal involved an innovative *mudaraba* structure that centred around the intangible rights that sit between a holding company and its subsidiaries.

Dana Gas: Latham & Watkins advised Dana Gas PJSC, the largest independent oil and gas company in the UAE, in relation to the restructuring of its US\$1 billion convertible *sukuk al-mudaraba*, originally issued in 2007. The restructuring was effected by way of cancelling the existing sukuk and issuing two new instruments with a five-year maturity. Following the AAOIFI Statement and the subsequent movement of the sukuk market away from the *mudaraba* structure, the parties worked closely with the Islamic scholars in order to implement a novel structure which would retain the *mudaraba* element and enable a *fatwa* to be obtained, given that Dana Gas did not, at the time, hold significant fixed assets which would be suitable for use in, for example, an *ijara* structure.

Additional Latham & Watkins Experience with Hybrid *Mudaraba-Murabaha* Structures

Banque Saudi Fransi: Latham & Watkins advised Saudi Fransi Capital, as lead manager and bookrunner, in relation to Banque Saudi Fransi private placement of an SAR2 billion sukuk due in 2024. The transaction was based on a hybrid *mudaraba-murabaha* structure under which 49 percent of the proceeds from the sukuk issue were applied towards profit generating *murabaha* agreements and 51 percent of the sukuk proceeds were invested in assets constituting the originator's business under a *mudaraba* agreement. The sukuk was structured to classify as Tier 2 Capital and was issued in order to further increase the bank's capital adequacy ratio.

National Industrialization Company (TASNEE): Latham & Watkins advised Riyadh-based National Industrialization Company, or Tasnee, in its issuance of an SAR2 billion *mudaraba/al-murabaha* sukuk due in 2020 under an SAR5.575 billion programme. The sukuk was privately placed with investors resident in Saudi Arabia and was arranged by HSBC Saudi Arabia, which also acted as the *Shari'ah* advisor.

Advanced Petrochemicals Company: In November 2014, Latham & Watkins advised Riyad Capital Company and HSBC Saudi Arabia Limited on the debt issuance of an SAR1 billion sukuk due 2019 by Advanced Petrochemical Company. The sukuk was privately placed with investors in Saudi Arabia.

Endnotes

- 1 A non-payment event would occur if: (i) the payments required to be made by ADIB under the *mudaraba* agreement, when aggregated with any other obligations ranking senior to, or pari passu therewith, exceeds ADIB's non-consolidated retained earnings and reserves; (ii) on the date of payment, ADIB is in breach of its applicable regulatory capital requirements or the making of such payment would cause it to be in breach thereof; (iii) the financial regulator requires ADIB not to make the relevant payment; or (iv) on the relevant date of payment ADIB is not solvent, or would not be solvent if the relevant amount was paid.
- 2 A non-payment election would occur if ADIB, in its sole discretion, elects not to pay the *mudaraba* profit.
- 3 As a regulatory requirement, the first call date must be at least five years from the issue date.
- 4 A tax event would occur if there was a change in the tax laws which resulted in additional amounts becoming payable under the *mudaraba* agreement and/or the certificates.
- 5 A capital event is deemed to have occurred if ADIB is notified in writing by the financial regulator that the notional amount of the certificates would cease to qualify as Tier 1 Capital.

SUKUK AL-MUSHARAKA

“A form of partnership between the Islamic bank and its clients whereby each party contributes to the capital of the partnership in equal or varying degrees to establish a new project or share in an existing one, and whereby each of the parties becomes an owner of the capital on a permanent or declining basis and shall have his due share of profits” | AAOIFI

Musharaka is derived from the Arabic word *Shirakah*, which means partnership. A *musharaka* arrangement entails the contribution of capital (either in cash or in kind) by two or more partners to the partnership. The *musharaka* partners share the profits in prearranged ratios. Any profits generated in excess of the level of profits required to enable the issuer to make the relevant payments to sukukholders are typically paid into a cash reserve for disbursement to sukukholders in the event that profits for a period are insufficient to cover the periodic distribution amount.

Shari’ah generally recognises two broad categories of partnerships; (i) *sharikat al-’aqd* (a contractual partnership) and (ii) *sharikat al-melk* (a property partnership). In the context of sukuk issuances, the *sharikat al-’aqd* entails an agreement between the originator and the trustee to combine their assets, labor or liabilities, while the *sharikat al-melk* entails a transaction that results in the originator’s and the trustee’s joint ownership of an asset.

When deciding between structuring a sukuk based on *sharikat al-’aqd* or *sharikat al-melk*, it is necessary to identify the nature of the originator’s business and whether any assets exist to support the issuance of a sukuk. If no tangible asset exists that could be contributed to the partnership in compliance with *Shari’ah*, the *sharikat al-’aqd* structure may be the better choice.

While sukuk *al-musharaka* was previously one of the more commonly used structures, use of the *musharaka* has declined since the AAOIFI Statement, since *Shari’ah* scholars now take the view that it is not permissible for an originator to grant a purchase undertaking to the trustee to purchase the *musharaka* assets for any amount other than the market value of the trustee’s interest in the *musharaka* assets at the time of sale (on the basis that both partners should take the risk of both profit and loss). This inability to guarantee the return of the sukukholders’ initial investment through an undertaking to redeem the sukuk at face value has reduced the popularity of the structure.

Shari’ah Requirements Applicable to the Underlying Musharaka

The underlying *musharaka* in a sukuk *al-musharaka* structure must comply with the general *Shari’ah* requirements applicable to partnerships:

- The profit-sharing ratios of each partner must be determined in advance.
- The profit-sharing ratios may be in proportion to the percentages of each partner’s capital contribution but partners may also agree to share profits in a manner that is not proportionate to their capital contributions, provided that an additional percentage of profit beyond the percentage of the contribution is not in favour of a sleeping partner.
- Stipulations to the effect that any partner’s profit will constitute a lump sum or a percentage of the capital of the partnership are void.
- It is permissible to set aside surplus profit in a reserve account to fund any shortfalls in future periodic distribution amounts or in the exercise price.
- Any losses of the partners must be proportionate to their respective capital contributions.
- The *musharaka* assets must comprise between 33 percent and 50 percent tangible assets, depending on the consulting *Shari’ah* scholars’ views.
- Any partner may terminate the *musharaka* by giving notice to the other partner.
- Upon termination, any tangible assets that form part of the *musharaka* will be liquidated and distributed together with the intangible assets to the originator and the trustee in proportion to their respective capital contributions, or units held in the *musharaka*.

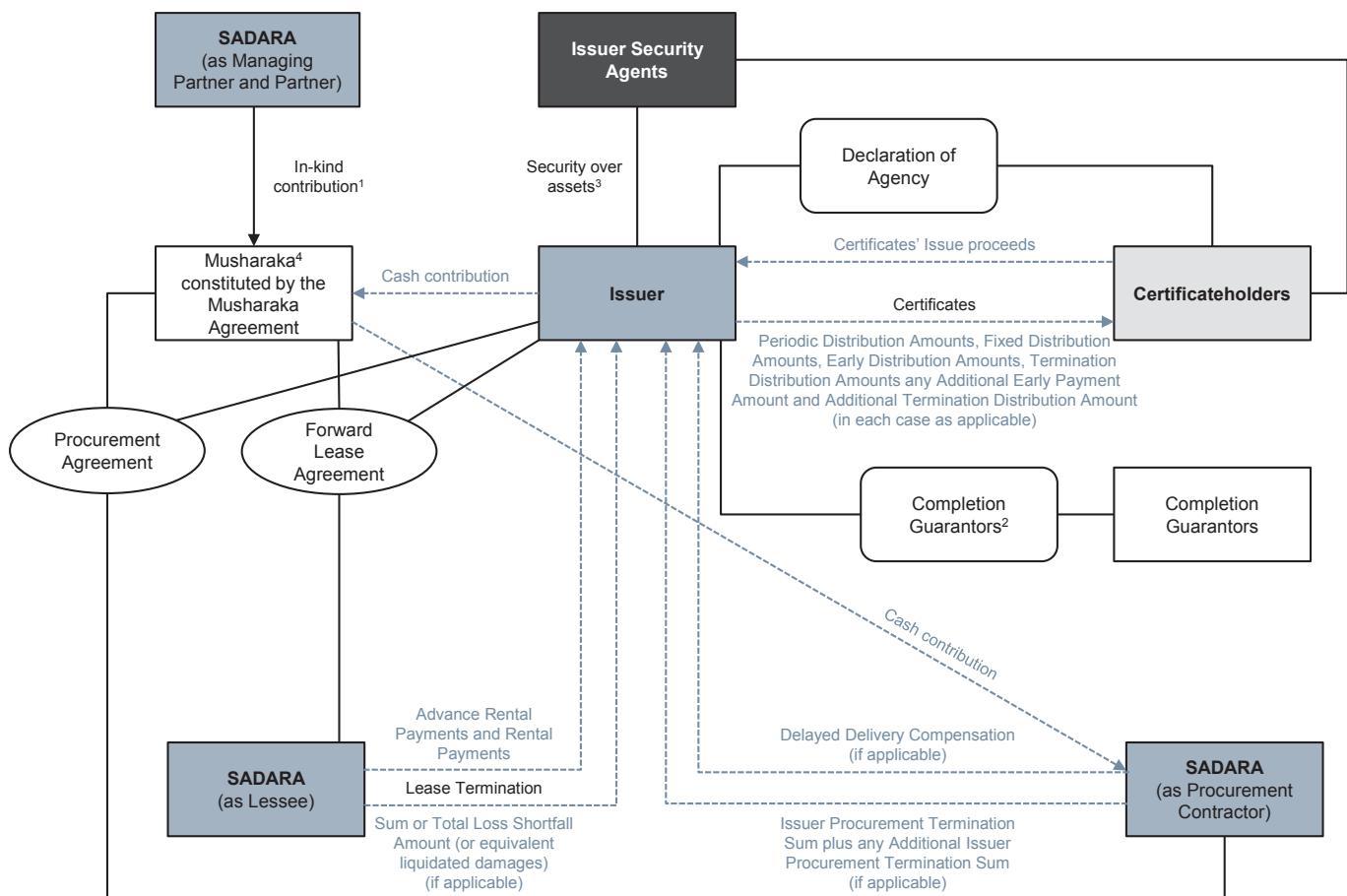
CASE STUDY: SADARA CHEMICAL COMPANY (SADARA)

SADARA BASIC SERVICES COMPANY

(A JOINT STOCK COMPANY INCORPORATED UNDER THE LAWS OF SAUDI ARABIA)

SAR7.5 BILLION SUKUK AL-MUSHARAKA DUE 2028

In March 2013, Sadara Basic Services Company issued an SAR7.5 billion *sukuk al-musharaka* due in 2028. The proceeds of the sukuk issuance were used to fund the construction and delivery of certain parts of the Sadara project facilities located at Jubail Industrial City II in the Eastern Province of Saudi Arabia, which will be the world's largest chemical complex ever built in a single phase. AlBilad Investment Company, Alinma Investment Company, Deutsche Securities Saudi Arabia LLC and Riyad Capital acted as joint lead managers and joint book runners on the issuance.



¹ Assignment of Sadara's rights, benefits and entitlements in, to and under the Industrial Land Lease Contract.

² Prior to the Project Completion, Saudi Aramco guarantee the obligations of Sadara to the Issuer under (inter alia) the Sukuk Transaction Documents.

³ The Issuer's assets will primarily consist of its contractual rights under the Sukuk Facility Documents and the other Transaction Documents to which it is a party.

⁴ The Partners and Managing Partner of the Musharaka have appointed the Musharaka Authorised Agent to enter into the Procurement Agreement, the Forward Lease Agreement and the Service Agency Agreement on their behalf and in their name.

The *musharaka* consisted of the following transactions:

- **Issuance of Sukuk:** Sadara Basic Services Company issued the sukuk, representing an undivided ownership interest in the underlying sukuk assets and a right against Sadara Basic Services Company for periodic distribution amounts and a termination distribution amount.
- **Subscription to Sukuk and Declaration of Agency:** The certificateholders subscribed for sukuk and paid the proceeds to Sadara Basic Services Company, as issuer. Pursuant to a declaration of agency, Sadara Basic Services Company covenanted to hold the sukuk assets as agent for the benefit of the certificateholders.
- **Musharaka Agreement:** Sadara entered into a *musharaka* arrangement with Sadara Basic Services Company. Sadara Basic Services Company contributed the proceeds of the sukuk issuance as an in-cash contribution to the *musharaka* (the Contribution). Simultaneously, Sadara made an in-kind contribution of all of its rights, benefits and entitlements in and to certain assets (the Contribution Assets) to the *musharaka* in its capacity as a partner of the *musharaka*. Sadara (as Managing Partner of the *musharaka*) paid the Contribution to the order of the Procurement Contractor by deposit into a specified project account. Using the Contribution in accordance with the Procurement Agreement, the Procurement Contractor then engaged certain contractors to procure the construction and delivery of the relevant project assets (in this instance, certain industrial plants and facilities located in the Kingdom) (the ‘Project Assets’)
- **Lease Arrangements:** An authorised agent entered into a Forward Lease Agreement with Sadara as Lessee, under which the Co-Lessors agreed to lease the Issuer’s proportional interest in, and entitlement to, the Project Assets (the ‘Lease Assets’) to Sadara on a forward basis prior to the Lease Commencement Date in return for payment of the Advance Rental Payments on each Advance Rental Payment Date, and on an actual basis with effect from the Lease Commencement Date in return for payment of the Rental Payments on each Rental Payment Date. Sadara is required to pay Sadara Basic Services Company the Advance Rental Payments and the Rental Payments paid under the Forward Lease Agreement.
- **Certificateholders’ Agent’s Distribution to Certificateholders:** The Advance Rental Payments and Rental Payments made by Sadara to the Issuer fund the payment by the Issuer to Certificateholders of the Periodic Distribution Amounts due on the Certificates.
- **Sale and Purchase Agreement of Certificateholders’ Agent’s Units at Maturity:** On the Scheduled Termination Date, Sadara will have paid all of the Advance Rental Payments and Rental Payments on a “lease to own” basis and will, as a result (taking into account various other payments made under the structure), acquire the Issuer’s remaining ownership interest in the Lease Assets. Upon redemption of the certificates in full, the Issuer has no further rights and / or entitlements in and to the *musharaka* assets, and the *musharaka* assets then in existence will vest in Sadara without further formality and the *musharaka* will be dissolved.

SUKUK AL-ISTITHMAR

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

The term *Istithmar* is understood to mean broadly “investment” and the sukuk *al-istithmar* is therefore sometimes referred to as an investment agency sukuk. Under a sukuk *al-istithmar* structure, rights under Islamic contracts (including rights under *iJara* contracts and *murabaha* or *istisna'a* receivables) can be packaged together and sold to form the underlying assets for a sukuk issuance. The income generated from such an investment package can then be utilised to make the relevant payments to the investors under the sukuk. On the issuance date, the originator enters into purchase undertaking which gives the right to the entity acting as sukukholders' agent to oblige the originator to purchase the investment package following a sukuk dissolution event or on scheduled maturity at an exercise price that is equal to the principal amount plus any accrued but unpaid periodic distribution amounts. The money received by the SPV will be used to pay the dissolution amount due to investors under the sukuk.

Shari'ah Requirements Applicable to the Underlying Al-Istithmar

The *Al-Istithmar* structure must comply with the following general *Shari'ah* requirements:

- To ensure that the sukuk are not debt instruments and therefore tradable, the net asset value of *iJara* contracts, shares and asset-based sukuk comprised in the sukuk assets as at any given date may not be less than 30 percent of the net asset value of the sukuk assets taken as a whole as at the closing date.
- A custodian may need to be involved to ensure sufficient separation of the originator's assets from the sukuk assets.
- Principal amounts from the underlying assets must not be used to service coupon payments under the sukuk.

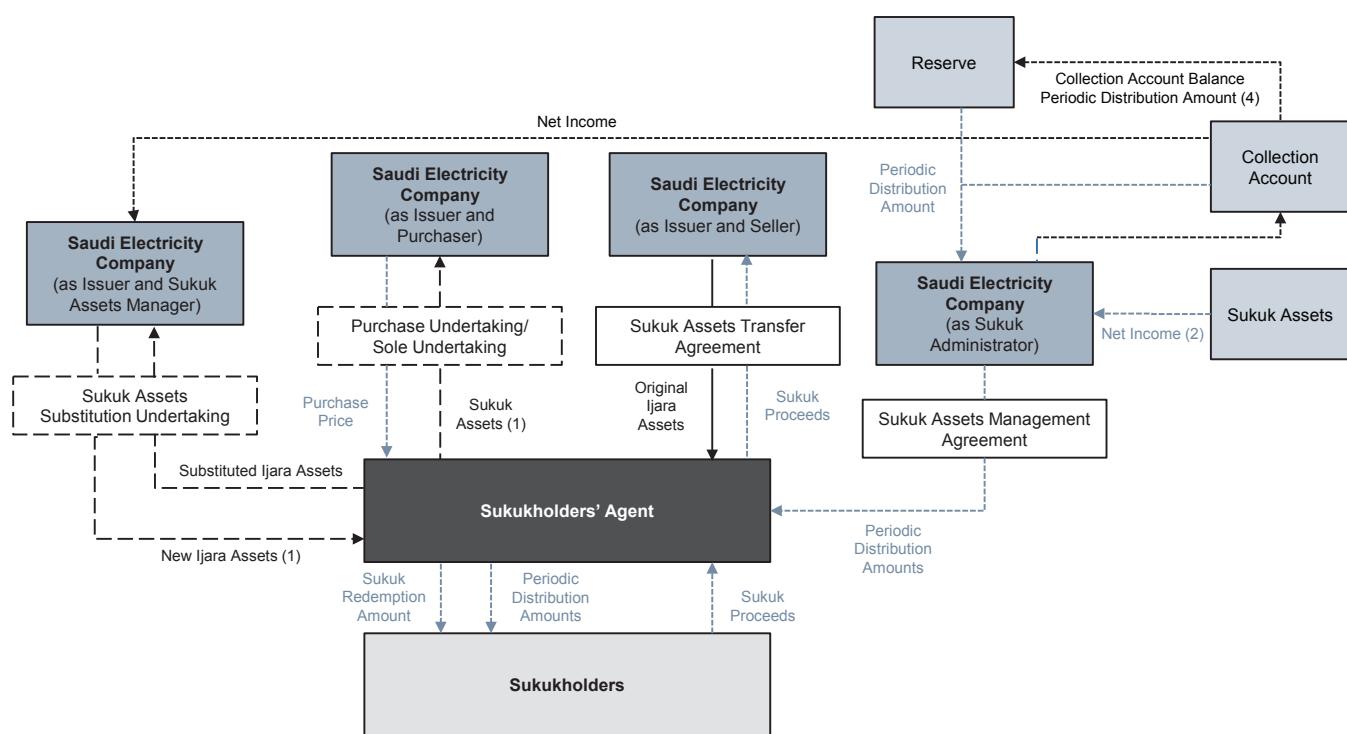
CASE STUDY: SAUDI ELECTRICITY COMPANY

SAUDI ELECTRICITY COMPANY

(A CLOSED JOINT STOCK COMPANY INCORPORATED UNDER THE LAWS OF SAUDI ARABIA)

SAR4.5 BILLION SUKUK AL-ISTITHMAR EXPIRING 2054G

In January 2014, Latham & Watkins advised HSBC Saudi Arabia, Limited and Saudi Fransi Capital Company — in their capacity as the joint lead managers, joint bookrunners and joint underwriters — in connection with the Saudi Electricity Company's (SEC) issuance of a SAR4.5 billion *sukuk al-istithmar* expiring 2054G. This was the only public sukuk issued in Saudi Arabia in 2014.



(1) Sukuk Assets to consist of the "Original Ijara Assets" and the "New Ijara Assets"

(2) "Net Income" equals (All monies accumulated from the Sukuk Assets) less (Sukuk Assets Management Administration Fee and Agency Fees)

(3) If any Reinvestment Income is not applied to interest in New Ijara Assets, then the Excess Reinvestment Income shall be credited to the Collection Account

(4) If the Retained Income received from the Sukuk Assets in any Periodic Distribution Period, together with any Excess Reinvestment Income, which has been credited to the Collection Account (as per 3 above), exceeds the Periodic Distribution Amount, the surplus shall be retained as a Reserve

The *istithmar* consisted of the following transactions:

- Issuance of Sukuk:** The certificateholders paid the issue price in respect of the relevant certificates to SEC as issuer.
- Purchase of Assets:** Pursuant to the sukuk assets transfer agreement, upon payment of the proceeds of the sale of the sukuk, the issuer sold and transferred to a custodian, for a period of 40 years, certain of SEC's specified rights and entitlements to provide metering services. The custodian received a fee in relation to such services from SEC's residential and commercial customers.
- Accrual of Income:** Pursuant to the sukuk assets administration agreement, SEC as the sukuk administrator agreed to provide certain services in respect of the sukuk assets. The sukuk administrator's responsibilities include accumulating all monies (net of certain fees) accruing under the sukuk assets (the net income). The sukuk administrator pays into the sukukholders' agent's account, which the payments administrator maintains (the transaction account) the lesser of (a) such accumulated amount and (b) the periodic distribution amount. If the net income received under the sukuk assets in any periodic distribution period exceeds the periodic distribution amount, the sukuk administrator retains any surplus as a reserve for the benefit of the

sukukholders. The sukuk administrator records the reserve through a book-entry notional account and not through a separate defined bank account. The sukuk administrator has the right to use and invest the reserve for its own account and records such use a sukuk administrator's liability.

If, in relation to any periodic distribution period or other period, the net income received in relation to the sukuk assets (the actual income) is less than the amount of net income which should otherwise have been received (the specified income) as a result of, amongst other things: (a) the tariff charged for metering services being reduced or amended, or (b) any of the customers changing its electricity supplier to an entity other than the issuer, then the issuer shall add to the reserve an amount equal to the difference between the actual income and the specified income.

- **Purchase Undertaking:** Under a purchase undertaking, the issuer agreed to purchase the custodian's ownership interests, rights, title and other entitlements in and to the sukuk assets at a specified purchase price, plus any applicable extra amount, on the periodic distribution dates falling in January 2024, January 2034 and January 2044, on the expiry date or following the occurrence of a dissolution event.

The purchase price is specified to be 100 percent of the aggregate nominal amount of the sukuk outstanding if the sukuk assets are purchased before the periodic distribution date falling in January 2024, 95 percent of the aggregate nominal amount of the sukuk outstanding if purchased on the periodic distribution date falling in January 2024, 60 percent of the aggregate nominal amount of the sukuk outstanding if purchased on the periodic distribution date falling in January 2034 and 30 percent of the aggregate nominal amount of the sukuk outstanding if purchased on the periodic distribution date falling in January 2044.

In addition, an extra amount equal to five percent of the aggregate nominal amount of the sukuk, funded from the reserve, will be payable on the purchase dates falling in January 2024, January 2034 and January 2044.

This therefore ensures that the sukukholders' agent receives 100 percent of the aggregate nominal amount of the sukuk outstanding if the sukuk is redeemed, as intended, on the periodic distribution date in January 2024.

Given that the applicable extra amount is payable from the reserve, the sukukholders may request the early purchase of the sukuk assets by the issuer pursuant to the purchase undertaking if, by the date falling 60 days immediately prior to the periodic distribution date falling in October 2023, the sukuk administrator notifies the sukukholders' agent that the amount allocated to the reserve (as at the date of such notification) is less than five percent of the aggregate nominal amount of the sukuk as are current on such date in the reserve. Since this purchase will take place prior to the periodic distribution date falling in January 2024, in such a situation, the sukukholders' agent will still receive 100 percent of the aggregate nominal amount of the sukuk outstanding.

In the investor application form signed when subscribing for the sukuk, the investors give an irrevocable instruction directing the sukukholders' agent to request the purchase of the asset on January 2024 or earlier, in the event that the relevant reserve requirement is not met.

Additional Latham & Watkins Experience with *Sukuk Al-Istithmar*

Power and Water Utility Company for Jubail and Yanbu (MARAFIQ): Latham & Watkins advised HSBC Saudi Arabia Limited, as lead manager on the debut, on the SAR2.5 billion sukuk issuance of MARAFIQ. The sukuk utilised a unique structure based on a transfer of rights to charge for the sale of electricity.

Saudi Electricity Company: Latham & Watkins also advised HSBC Saudi Arabia Limited and Samba Capital & Investment Management Company, as joint lead managers and joint bookrunners, in relation to the private placement of an SAR7 billion *sukuk al-istithmar* due in 2030 (with an early redemption right in 2017, 2020 and 2025).

Saudi Orix: In 2012, Latham & Watkins advised Samba Capital & Investment Management Company, in its capacity as the lead manager and bookrunner, in connection with the issuance of an SAR240 million *sukuk al-istithmar* expiring 2015 issued by Saudi ORIX. This was the only public sukuk issued in Saudi Arabia in 2012.

SUKUK AL-MANAFA'A

In the *manafa'a* structure, the underlying asset is the capacity or rights of commercial activities, allowing for the use of intangibles. The grant of these rights can take a number of forms depending on the nature of the asset involved. In circumstances in which the issuer does not hold unencumbered tangible assets or is commercially unable or unwilling to utilise them in a sukuk structure, the *manafa'a* structure may allow issuances based on available intangible assets. Mobile 'airtime' vouchers are one of a number of intangible asset classes used as underlying assets for Islamic financing transactions which have been introduced into the market over the last few years. Other such asset classes include intellectual property rights, tariffs due on electricity meters and receivables due on petrochemical marketing contracts.

The 'airtime' structure was first used in 2007 by the Saudi Arabian telecommunications company, Etihad Etisalat Company (Mobily), for the purpose of a syndicated financing. At that time, the airtime structure represented a novel Islamic finance instrument specifically designed for telecommunications operators, which often have limited physical assets, but significant value in their telecommunications license. Then, in 2010, Emirates Telecommunications Corporation (Etisalat), Mobily's principal shareholder, adopted the airtime structure for its sukuk programme, although no issuance has yet taken place under Etisalat's programme. In December 2013, Ooredoo, the Qatari telecommunications company, issued a five-year US\$1.25 billion 'airtime' sukuk under its US\$2 billion trust certificate issuance programme, the first time a sukuk utilising the airtime structure had been issued in the Middle East.

In addition, during the course of 2013, UAE-based air carrier, Emirates Airlines, utilised passenger revenues as the underlying asset for its US\$1 billion, 10-year amortising sukuk, while the Saudi Arabian General Authority of Civil Aviation issued an SAR15 billion (US\$4 billion) sukuk which was partly based on a sale of its rights to charge and collect fees from airlines. The use of the *manafa'a* structure indicates growing innovation in structuring sukuk and the increasing flexibility of *Shari'ah* advisers in recognising the legitimate use of those assets.

CASE STUDY: OOREDOO

OOREDOO TAMWEEL LIMITED

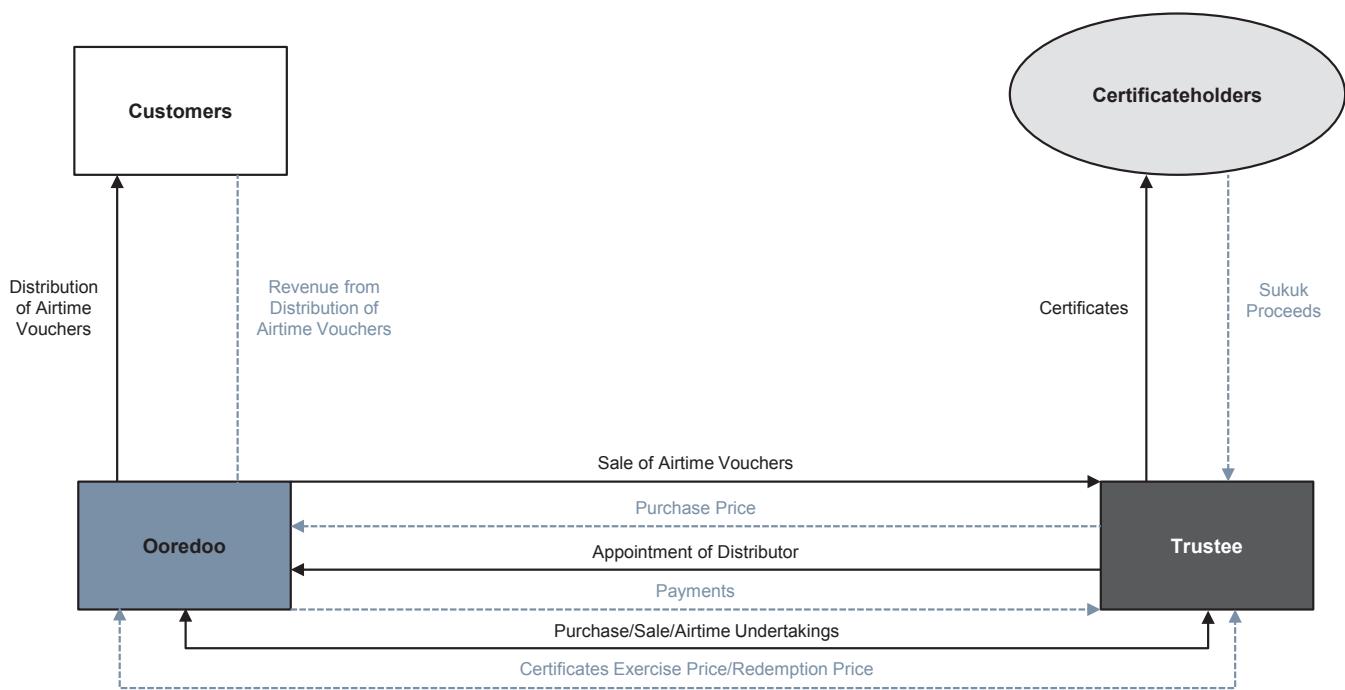
(INCORPORATED IN THE CAYMAN ISLANDS AS AN EXEMPTED COMPANY WITH LIMITED LIABILITY)

US\$2 BILLION TRUST CERTIFICATE ISSUANCE PROGRAMME

In December 2013, Latham & Watkins acted for Ooredoo Q.S.C. in connection with its inaugural US\$1.25 billion *sukuk al-manafa'a*. The five-year instrument was issued under Ooredoo Tamweel Limited's US\$2 billion trust certificate issuance programme, established in November 2013. This issuance represented the first time a sukuk utilising the airtime structure was issued in the Middle East.

The airtime structure enables a telecommunications operator, such as Ooredoo, to utilise minutes of airtime as the underlying asset for the purposes of a sukuk issuance. Most telecommunications operators are tangible-asset poor but have significant value residing in intangible assets, such as a mobile license and the right to sell airtime. A key advantage of the airtime structure is that it allows the telecommunications operator to release the value of its most abundant (though intangible) asset, the airtime on its network.

The structural development of Ooredoo's airtime sukuk required close collaboration between Ooredoo, its *Shari'ah* advisers, the arranger banks and their respective legal counsels, in order to meet the challenge of accommodating *Shari'ah* requirements without compromising the structure's robustness from an English law perspective. Given Qatar's heavily regulated telecommunications sector, the development of the sukuk structure, based on airtime minutes as the underlying asset, also required cooperation and interaction with Qatar's telecommunications regulator, ictQATAR. Ooredoo and its advisors devoted significant time and effort to refine and simplify the sukuk structure, in order to chart a smoother course through the required *Shari'ah*, shareholder and regulatory approvals and to maximise the sukuk's appeal to local, regional and international investors.



The *manafa'a* consisted of the following transactions:

- **Issuance of Sukuk:** On the issue date of the sukuk, the investors paid the issue price to the trustee, an SPV established for the purposes of the sukuk. The trustee then issued the sukuk to the investors.
- **Declaration of Trust:** The trustee declared a trust in favour of the investors over the proceeds of the issuance of the sukuk and certain other rights. The trustee then applied the proceeds of the issuance of the sukuk for the purchase of airtime vouchers from Ooredoo. Each airtime voucher represents an entitlement to a specified number of minutes of airtime on Ooredoo's mobile telecommunications network.
- **Appointment of Distributor:** Ooredoo was appointed to act as the distributor on behalf of the trustee to sell the minutes of airtime to its customers. The airtime vouchers cannot be redeemed for airtime minutes unless sold by a duly licensed provider of mobile telecommunications services in Qatar.
- **Distribution and Sale of Vouchers:** A specified number of airtime vouchers are designated for distribution and sale by Ooredoo (in its capacity as distributor) on behalf of the trustee in respect of each periodic distribution period, for a minimum sale price, which will be sufficient to allow the trustee to pay the periodic distribution amount due under the sukuk on each periodic distribution date.
- **Purchase of Surplus Vouchers and Indemnity:** If less than the specified number of airtime vouchers are sold during a periodic distribution period, Ooredoo will, pursuant to the exercise of a purchase undertaking provided by the trustee, purchase the surplus airtime vouchers from the trustee at the price at which such airtime vouchers should have been sold under the relevant distribution agreement (which incorporates both a cost element and a profit element). Or, if airtime vouchers are sold for less than the minimum-agreed price, the distributor will indemnify the trustee for the shortfall amount, so that the proceeds of the sale of airtime vouchers during each periodic distribution period will always be sufficient to pay the relevant periodic distribution amounts due under the sukuk.
- **Airtime Voucher Sale Undertaking:** Pursuant to an airtime voucher sale undertaking, Ooredoo has undertaken, upon exercise thereof, to sell additional airtime vouchers to the trustee (at the cost price) on each periodic distribution date.
- **Purchase Undertaking:** Pursuant to a purchase undertaking, Ooredoo has irrevocably granted to the trustee the right to require Ooredoo to purchase and accept the transfer of all of the trustee's interest in the airtime vouchers, on maturity of the relevant series, or prior thereto following the occurrence of a dissolution event.

SUKUK AL-ISTISNA'A

"a contract of sale of specified items to be manufactured or constructed, with an obligation on the part of the manufacturer or builder (contractor) to deliver them to the customer upon completion" | AAOIFI

The word *istisna'a* is derived from the Arabic term *sina'a*, meaning to manufacture a specific commodity, and is a financing method used for the production of specific goods. The structure has thus developed to be particularly useful for raising funds for the construction phase of a project, with the proceeds from the sukuk issuance being used to pay the contractor, who will deliver the project in the future. Upon issuance of the sukuk, the originator enters into an *istisna'a* contract with the trustee, pursuant to which the originator agrees to manufacture or construct certain assets and undertakes to deliver those assets at a future date in return for which the trustee makes a payment of the sukuk proceeds. The trustee undertakes to lease the assets to the originator under a forward lease (known as an *ijara mawsufah fi al-dimmah*) for an overall term that reflects the maturity of the sukuk. The trustee uses the rental received from this advance rental (or actual rental following the delivery of the asset) to pay the periodic distribution amounts to investors under the sukuk.

On the issuance date, the originator enters into a purchase undertaking which gives the right to the trustee to oblige the originator to purchase the assets following a sukuk dissolution event or on scheduled maturity at an exercise price that is equal to the principal amount plus any accrued but unpaid periodic distribution amounts. In the event that the sukuk dissolution event happens prior to the delivery of the assets to the issuer, a refund and compensation amount will be paid in order to leave the trustee with an amount sufficient to cover the face values of the certificates plus any accrued but unpaid periodic distribution amounts. The money received by the trustee will be used to pay the dissolution amount due to investors under the sukuk.

Shari'ah Requirements Applicable to the Underlying Istisna'a

The underlying *istisna'a* structure in a Sukuk *al-istisna'a* must comply with the following general *Shari'ah* requirements:

- The subject matter of the *istisna'a* contract must be items that can be transformed by manufacture or construction. Items such as products of nature, such as animals, fruits and vegetables are not included.
- The price and features of the item to be manufactured need to be specified in advance.
- The purchaser may split the purchase price into staged payments that correspond to certain milestones in the building process, as long as these are agreed upon with the contractor in advance.
- The purchaser may fix a maximum time for delivery, even though specifying the delivery time is not necessary under the *istisna'a* agreement. Specifying the time in the contract allows the purchaser to decline accepting the goods and paying the purchase price.
- Liquidated damages provisions are also permissible and can help to ensure that the contractor delivers on time.
- A majority of *Shari'ah* scholars hold that forward leasing, *ijara mawsufa al-dimma*, is permissible. Under this view, advance rentals must be taken into account and refunded in full in case the asset is never actually delivered for leasing.

Despite these apparent advantages of the *istisna* structure, it is rarely used because market participants widely hold that *istisna'a* are not tradable during the construction phase. Additionally, *Shari'ah* scholars differ greatly in their opinions on advance rentals and *istisna'a* termination payments. Therefore, this structure is less attractive than other more flexible structures, such as the *musharaka* structure.

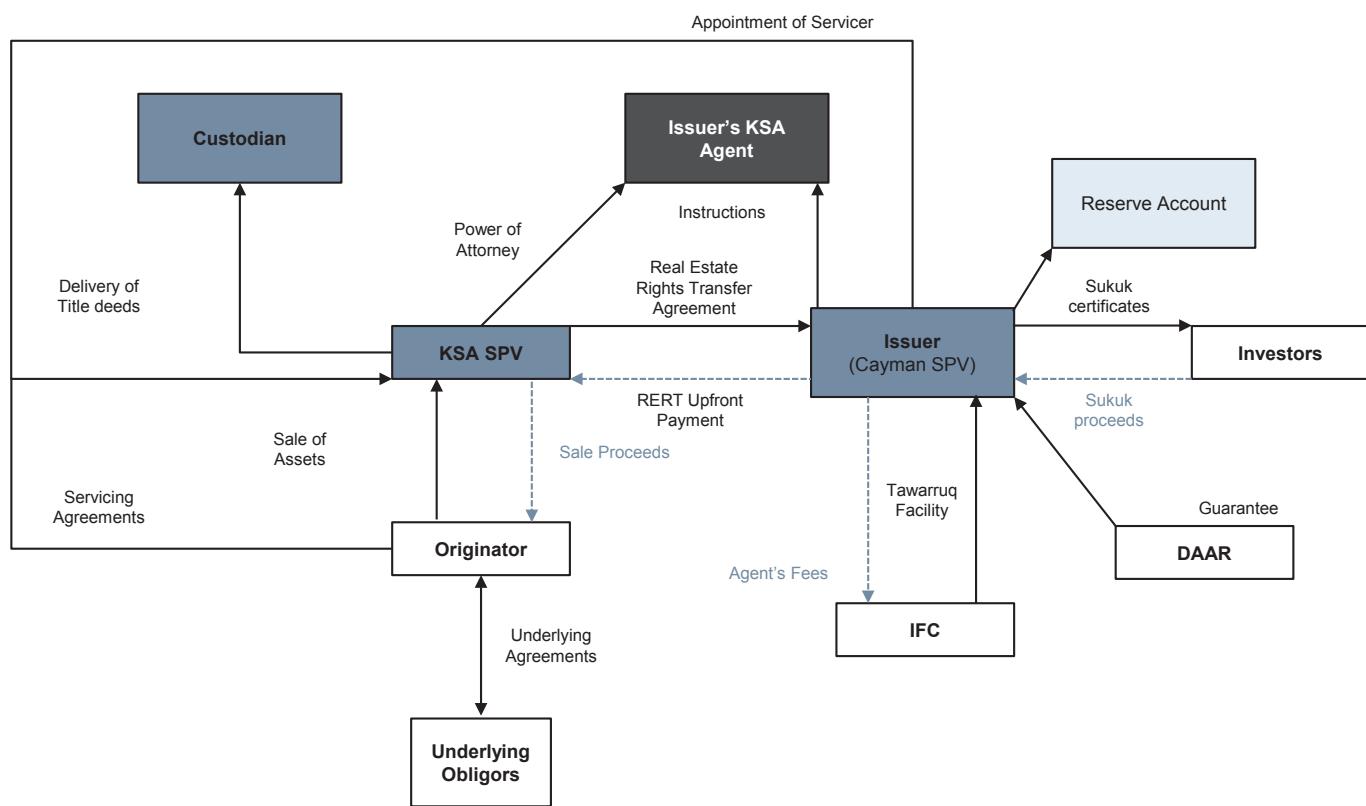
CASE STUDY: KINGDOM INSTALLMENT COMPANY LLC

KSA MBS I INTERNATIONAL SUKUK COMPANY LIMITED (INCORPORATED WITH LIMITED LIABILITY IN THE CAYMAN ISLANDS)

US\$18 MILLION FIXED RATE SUKUK CERTIFICATES

Latham & Watkins lawyers (while at a previous firm) were involved in advising on the structuring of a US\$18.3 million issue of a *wakala* sukuk with an *istisna/ijara* sukuk by Kingdom Installment Company LLC (KIC), a private finance company in Saudi Arabia. KIC issued the sukuk through KSA MBS I International Sukuk Company Limited, a special purpose vehicle (SPV) incorporated in the Cayman Islands. Unicorn Investment Bank served as lead arranger, *Shari'ah* advisor and, together with Standard Bank Plc, as joint bookrunner to the transaction. The sukuk, which attracted investors mainly from Europe and Asia, was backed by real estate lease contracts entered into by Dar Al-Arkan Real Estate Development Company (DAAR). It was the first mortgage-backed sukuk issued by a GCC company in the international capital markets. The sukuk's purpose was to leverage the company's financing capabilities to provide home-buyers in Saudi Arabia with funds to purchase their homes, in return for affordable monthly instalments.

The *istisna/ijara* consisted of the following transactions:



- Issuance of Sukuk:** The SPV, as issuer, issued the sukuk, representing an undivided ownership interest in the underlying assets and a right against the SPV for periodic distribution amounts and a dissolution amount.
- Subscription to Sukuk and Creation of a Trust:** The investors subscribed for the sukuk and paid the proceeds to the SPV. The entirety of the proceeds made up the principal amount. The SPV declared a trust over the proceeds and acted as a trustee for the investors.
- Istisna'a Arrangement:** KIC, as originator, entered into an *istisna'a* arrangement with the SPV, as trustee. The SPV, as trustee, commissioned certain assets to be delivered at a future date and KIC, as originator, agreed to manufacture or construct certain assets and deliver them. The Trustee paid the contract price in phase payments set against certain milestones, in return for the assets. These phase payments in the aggregate made up the principal amount.

- **Ijara Mawsufa fi al-Dimma Arrangement:** The SPV, as trustee, agreed to lease the acquired assets to KIC, as originator, for a term reflecting the maturity of the sukuk. KIC, as originator and lessor, paid advance rentals prior to delivering the assets and actual rentals after delivering the assets to the SPV, as trustee and lessor. The rentals were equal to the periodic distribution amount due to the investors under the sukuk. While such payments could have been calculated with reference to a fixed rate or a variable rate, such as LIBOR or EIBOR, in this case, they were based at a fixed rate of 6.55 percent.
- **Periodic Distribution to Investors:** On September 30, December 30, March 30 and June 30 of each year up to, the SPV used the rental payments received to pay periodic distribution amounts to the investors.
- **Sale and Purchase Agreement of Assets:** Upon an optional call and after delivering the asset, the SPV as trustee, sold, and KIC as obligor, purchased, the assets at the exercise price, which equalled the principal amount plus any accrued but unpaid distribution amounts.
- **Payment of the Dissolution Amount:** The SPV, as issuer, used the exercise price it received to pay the dissolution amount to the investors.
- **Servicing Agreement:** The SPV, as trustee, appointed KIC as its servicing agent to administer the underlying assets under the *ijara mawsufa fi al-dimma* agreement, including maintenance, insurance and payment of taxes in connection with the underlying assets. KIC, as servicing agent, was entitled to the reimbursement of servicing costs.

SUKUK AL-MURABAHA

“sale of goods with an agreed upon profit mark up on the cost” | AAOIFI

A *murabaha* contract is an agreement between a buyer and seller for the delivery of an asset; the price includes the cost of the asset plus an agreed upon profit margin for the seller. The buyer can pay the price on the spot or establish deferred payment terms (paying either in instalments or in one future lump sum payment).

Under a *murabaha* sukuk, the issuer of the sukuk will utilise the proceeds of the sukuk issuance to purchase commodities from a commodity supplier. The trustee will then on-sell the commodities to the originator of the sukuk at a deferred price, which reflects the purchase price plus profit for the trustee as compensation for its involvement in the transaction. The period for the deferred payments reflects the maturity of the sukuk. The instalments of the deferred price received from the originator are then used to make payment of the periodic distribution amount due to investors under the sukuk.

Although the sukuk *al-murabaha* is less commonly used as a stand-alone sukuk structure in comparison to some other sukuk structures described in this guidebook, it has proved to be popular in the hybrid sukuk market, with an increasing number of sukuk being issued with *mudaraba-murabaha* structures. The *al-murabaha* is also commonly used as investments underlying a *sukuk al-wakala* structure, as utilised on the Dar Al-Arkan US\$750 million sukuk issuance programme described in more detail in the Dar-Al Arkan case study above.

Shari'ah Requirements Applicable to the Underlying Murabaha

The underlying *murabaha* structure in a Sukuk *al-murabaha* must comply with the following general *Shari'ah* requirements:

- The rate and time period of the deferred price must be fixed in advance and agreed upon by both parties.
- The trustee's profit must be clearly stated and agreed upon by both parties in advance. Mention of the total selling price is not sufficient.
- The trustee, as seller, must acquire title to the commodities before it may sell them on to the purchaser. A sale by a seller who has not acquired title will be void.
- Commodities must be in the physical or constructive possession of the seller. The seller is considered to have constructive possession when control, rights and liabilities have passed on to it from the supplier. For instance, such passing may arise when the seller appoints an agent to take the delivery of the goods.
- The seller must assume the risks of ownership before selling the commodities to the purchaser, including the transportation risks. The point when the risk of the commodities is passed on from the SPV to the purchaser must be clearly identified.
- The trustee may appoint the purchaser as its agent in the purchase of the commodities from the supplier. However, all documents and contracts relating to the sale of the commodities must be in the name of the trustee, not that of the purchaser.
- The commodities purchased must exist. Non-existent commodities make the *murabaha* contract void. In addition, the commodities must be *Shari'ah*-compliant, e.g. not an item, such as alcohol or pork, that could be used for an un-Islamic purpose.

CASE STUDY: GOLDMAN SACHS INTERNATIONAL

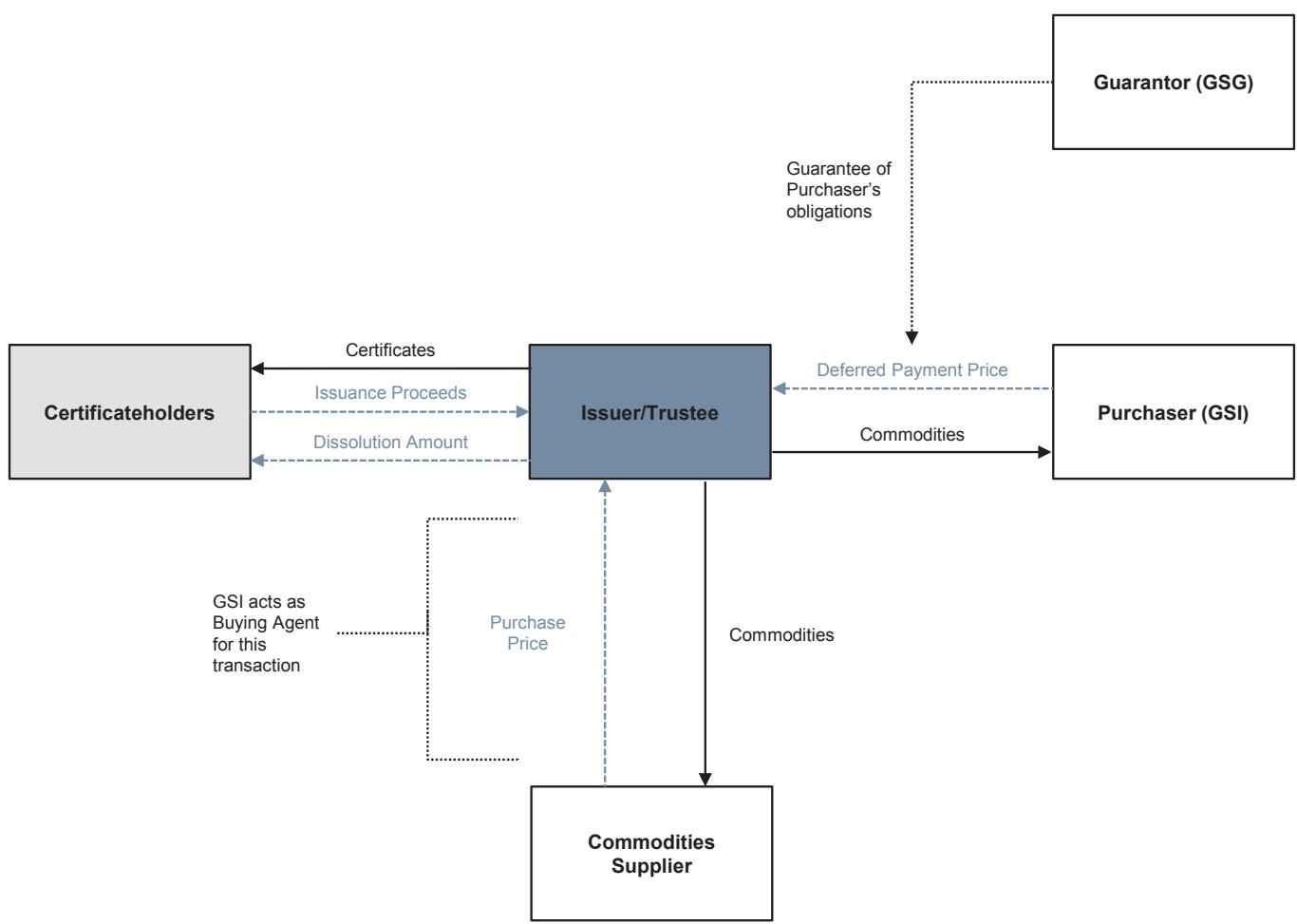
GLOBAL SUKUK COMPANY LIMITED

(INCORPORATED IN THE CAYMAN ISLANDS AS AN EXEMPTED COMPANY WITH LIMITED LIABILITY)

US\$2 BILLION TRUST CERTIFICATE ISSUANCE PROGRAMME

In 2011, Goldman Sachs International (GSI) established a programme for the issuance of *murabaha* in a maximum aggregate face amount of US\$2 billion. GSI acted as both arranger and dealer on the programme.

Global Sukuk Company Limited (GSC) was incorporated under the laws of the Cayman Islands as a financial intermediary to issue the sukuk and act as trustee for the investors and as seller of the commodities involved in the *murabaha* agreement.



The *murabaha* consisted of the following transactions:

- Issuance of Sukuk:** GSC, as issuer, issued sukuk representing an undivided ownership interest in the underlying trust assets and a right against the issuer to payment of the deferred payment price and a dissolution amount.
- Subscription to Sukuk and Creation of a Trust:** The investors subscribed for sukuk and paid the issuance proceeds to the GSC, as issuer. GSC declared a trust over the proceeds and began acting as a trustee for the investors.
- Murabaha Agreement:** GSI, as purchaser, entered into a *murabaha* agreement with GSC, as seller. GSI agreed to purchase and GSC agreed to sell certain commodities on immediate delivery in return for a deferred payment price, which is equal to the principal amount plus a profit amount due to GSC, as trustee.

- **Buying Agency Agreement:** GSC, as principal, appointed GSI to act as its disclosed buying agent in connection with the purchase of commodities from the supplier. Upon completion of the purchase by the buying agent, GSC, as the seller, concluded the sale of the commodities to GSI, as purchaser, on deferred payment terms and the title to the commodities passed to GSI, as purchaser.
- **Payment of Deferred Payments:** GSI, as purchaser, makes instalments towards the deferred price payment, which is equal to the returns payable to the investors at the time.
- **Distribution of Returns to Investors:** GSC, as issuer, distributes instalments received from GSI, the purchaser, to the investors.

Latham & Watkins Experience with Hybrid *Mudaraba-Murabaha* Structures

The Saudi British Bank: Latham & Watkins advised HSBC Saudi Arabia Limited, as lead manager and bookrunner, in relation to the Saudi British Bank's private placement of a SAR1.5 billion sukuk due in 2025. The transaction was based on a hybrid *mudaraba-murabaha* structure under which 49 percent of the proceeds from the sukuk issue are applied towards profit generating *murabaha* agreements and 51 percent of the sukuk proceeds are invested in assets constituting the originator's business under a *mudaraba* agreement. The sukuk was structured to classify as Tier 2 Capital and was issued in order to further increase the bank's capital adequacy ratio.

Banque Saudi Fransi: Latham & Watkins advised Saudi Fransi Capital, as lead manager and bookrunner, in relation to Banque Saudi Fransi's private placement of an SAR2 billion sukuk due in 2024. The transaction was based on a hybrid *mudaraba-murabaha* structure under which 49 percent of the proceeds from the sukuk issue are applied towards profit generating *murabaha* agreements and 51 percent of the sukuk proceeds are invested in assets constituting the originator's business under a *mudaraba* agreement. The sukuk was structured to classify as Tier 2 Capital and was issued in order to further increase the bank's capital adequacy ratio.

National Industrialization Company (TASNEE): Latham & Watkins advised Riyadh-based National Industrialization Company, or Tasnee, in its issuance of an SAR2 billion *mudaraba/al-murabaha* due in 2020 under an SAR5.575 billion programme. The sukuk was privately placed with investors resident in Saudi Arabia and is solely arranged by HSBC Saudi Arabia, which acted as the *Shari'ah* advisor, as well.

Advanced Petrochemicals Company: In November 2014, Latham & Watkins advised Riyad Capital Company and HSBC Saudi Arabia Limited on the debt issuance of Advanced Petrochemical Company's SAR1 billion sukuk due 2019. The sukuk was privately placed with investors in the Saudi Arabia.

OTHER SUKUK STRUCTURES | SUKUK AL-SALAM

“purchase of a commodity for deferred delivery in exchange for immediate payment according to specified conditions or sale of a commodity for deferred delivery in exchange for immediate payment” | AAOIFI

Another very rarely employed structure, the *salam* structure comprises the sale of a commodity to be delivered to the purchaser in the future. The purchaser, however, pays the full purchase price immediately. To avoid the prohibition on uncertainty, the commodity must be a standardised one and its quality, quantity, place, date and time of delivery must be well defined and agreed upon by both parties in advance.

The purchase price paid upfront is also referred to as the *salam* capital. The commodities to be delivered in the future are referred to as *al-muslam fihi*. The originator of sukuk is the seller of *al-muslam fihi* and the issuer SPV purchases *al-muslam fihi* on behalf of the investors. The funds realised from the sale constitutes the *salam* capital.

Because re-selling commodities before actual possession would amount to selling debt, *salam* cannot be traded, rendering the *salam* instrument illiquid, which in turn means that this structure is used infrequently. In addition, the requirement that the originator delivers certain ‘standardised’ assets to the issuer is very difficult for many originator companies to satisfy.

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- Banking
- Capital markets
- Investment funds and dispute resolution
- Mergers and acquisitions
- Project finance
- Restructuring

Our Clients, Our Track Record

We advise governments, banks, sponsors, export credit agencies, investment funds and other investors on *Shari'ah*-compliant transactions in the Middle East, Europe, the US and Asia. The firm has a reputation for innovation and has been involved in the development of ground-breaking Islamic finance transactions globally, including the first Sukuk restructuring, the first ever *Shari'ah*-compliant exit facility under Chapter 11 of the United States' Bankruptcy Code, and the first ever Sukuk issued under a Sukuk programme that utilises an innovative airtime Sukuk structure.

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Our lawyers are recognized in leading legal directories as world-class practitioners in the Islamic finance field. We can structure, document and negotiate the key Islamic structures of *Ijara*, *Istisna*, *Modaraba*, *Murabaha*, *Musharaka*, *Salam*, *Sukuk*, *Tawarruq* and *Wakala*.

- Transactional experience includes:
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- Islamic mezzanine and structured finance
- M&A transactions including *Shari'ah*-compliant entities
- Project finance (either on a wholly Islamic or multi-tranche basis)
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- *Shari'ah*-compliant investment funds, such as private equity, venture capital and real estate funds
- Restructurings

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Latham & Watkins' Middle East practice advises some of the most active strategic and financial dealmakers in the region. Combining regional knowledge and experience with the firm's international network, Latham lawyers provide comprehensive service to clients with interests in the Middle East and Africa, Asia and beyond.

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