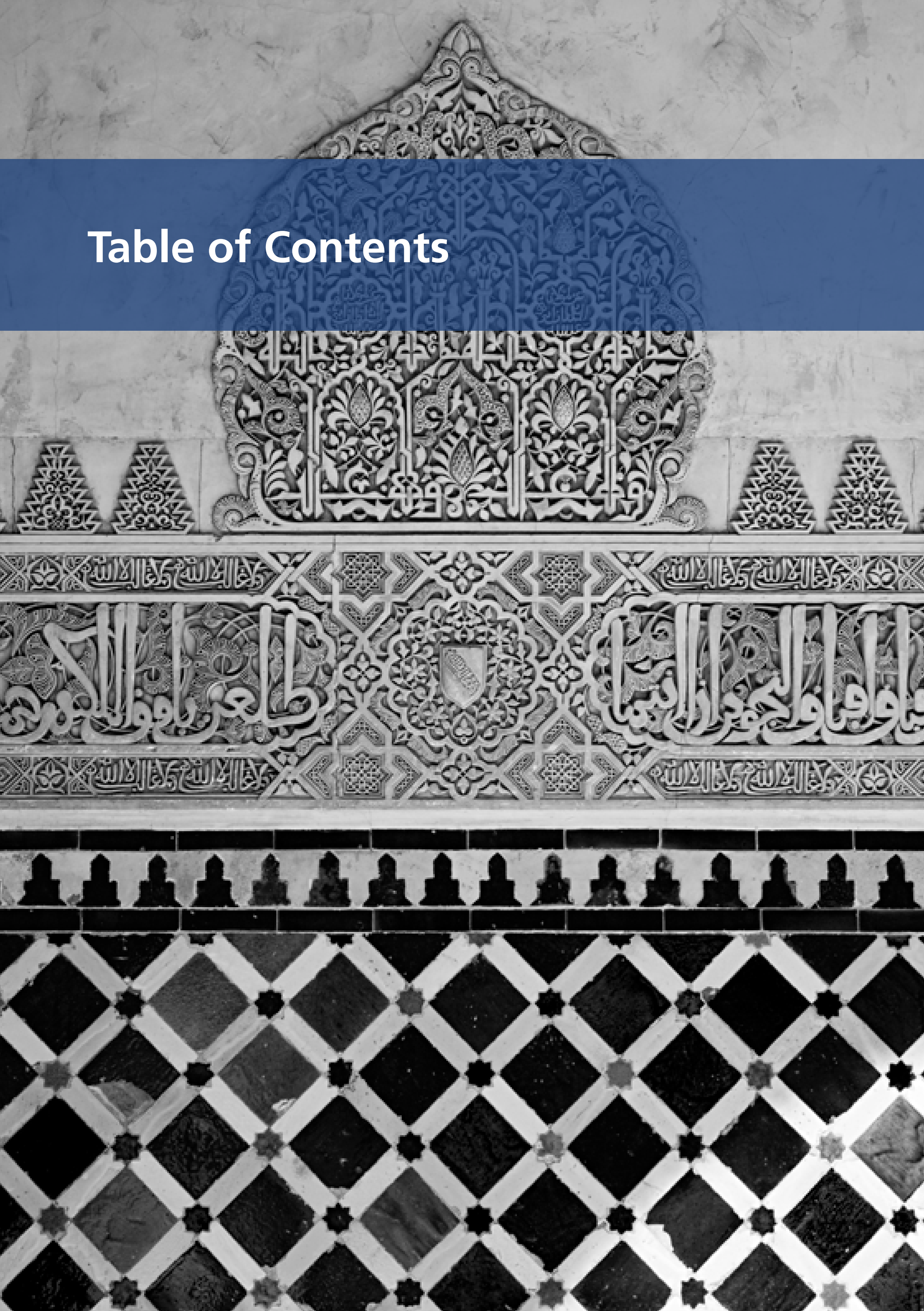
CLIFFORD CHANCE

Dubai International Financial Centre Sukuk Guidebook

Dubai International Financial Centre

Table of Contents



Disclaimer

Clifford Chance LLP has developed this Guide to assist those parties interested in learning about sukuk generally as well as to gain an understanding of Islamic Capital Markets financing. This Guide provides a summary of the underlying concepts in sukuk and examines the issues facing the sukuk industry, both in the DIFC and beyond; now and in the future.

This Guide also sets out the DSFA regulatory environment for sukuk and the scope for application of such requirements.

This Guide provides an introduction to Islamic finance as well as a summary of the regulatory requirements and the applicable operating environment for the offer of Islamic finance in or from the DIFC. This Guide is only intended to provide guidance on the Islamic aspects of sukuk, irrespective of whether the sukuk is to be used for Islamic securitisation or Islamic corporate instruments.

This document does not constitute Shari'a or financial advice, nor does it replace the regulatory requirements of the DFSA or DIFC. It should be read in conjunction with the detailed requirements of the DFSA and DIFC to form a definitive view in terms of the application of the relevant operating environment in the DIFC to each individual set of circumstances.

The contents of the Guide do not necessarily represent the views or opinions of the DIFC.

This Guide was prepared in November 2009 and to the best of the author's knowledge was based on information current and accurate at that time.

Preamble

Clifford Chance is one of the world's leading law firms, helping clients achieve their goals by combining the highest global standards with local expertise. The firm has unrivalled scale and depth of legal resources across the four key markets of the Americas, Asia, Europe and the Middle East, and focuses on the core areas of commercial activity: capital markets; corporate and M&A; finance and banking; real estate; tax; pensions and employment; litigation and dispute resolution. Clifford Chance has 29 offices in 20 countries and operates a 'best friends' arrangement with AZB & Partners in India and Lakatos, Köves & Partners in Budapest, in addition to a co-operation agreement with Al Jadaan & Partners Law Firm in Saudi Arabia.

Clifford Chance lawyers advise internationally and domestically; under common law and civil law systems; in local and cross-border transactions; on day-to-day operations and the most challenging deals.

Clifford Chance was ranked 'tier one' in more international tables than any other firm in the Chambers Global 2009 Directory. This independent analysis focuses on the Firm's legal ability, professional conduct, client service, and commercial awareness, and these rankings provide outstanding recognition for the Firm's breadth of expertise and consistency of quality across global markets.
Clifford Chance has for many years been involved in Islamic financing techniques and Islamic product development. As the Islamic financing market has expanded and become more sophisticated, Clifford Chance's involvement and expertise in this field has increased and the Firm can draw on its substantial experience of Islamic financing including Islamic tranches of project financings, Islamic funds (including infrastructure funds and principal protected funds), Islamic risk management products, acquisition, corporate and real estate finance as well as sukuk (both corporate sukuk and Shari'a compliant securitisation).

In the past year Clifford Chance has closed more than US$42 billion worth of Islamic finance transactions - groundbreaking deals that have provided innovative Shari'a compliant structures for clients in markets across the world. Clifford Chance was named as "Best Islamic Legal Advisory Firm" in the Euromoney Islamic Finance Awards for 2008 and 2009, and is consistently recognised as a leading Islamic finance practice by Chambers Global and other Islamic finance directories such as Islamic Finance News.

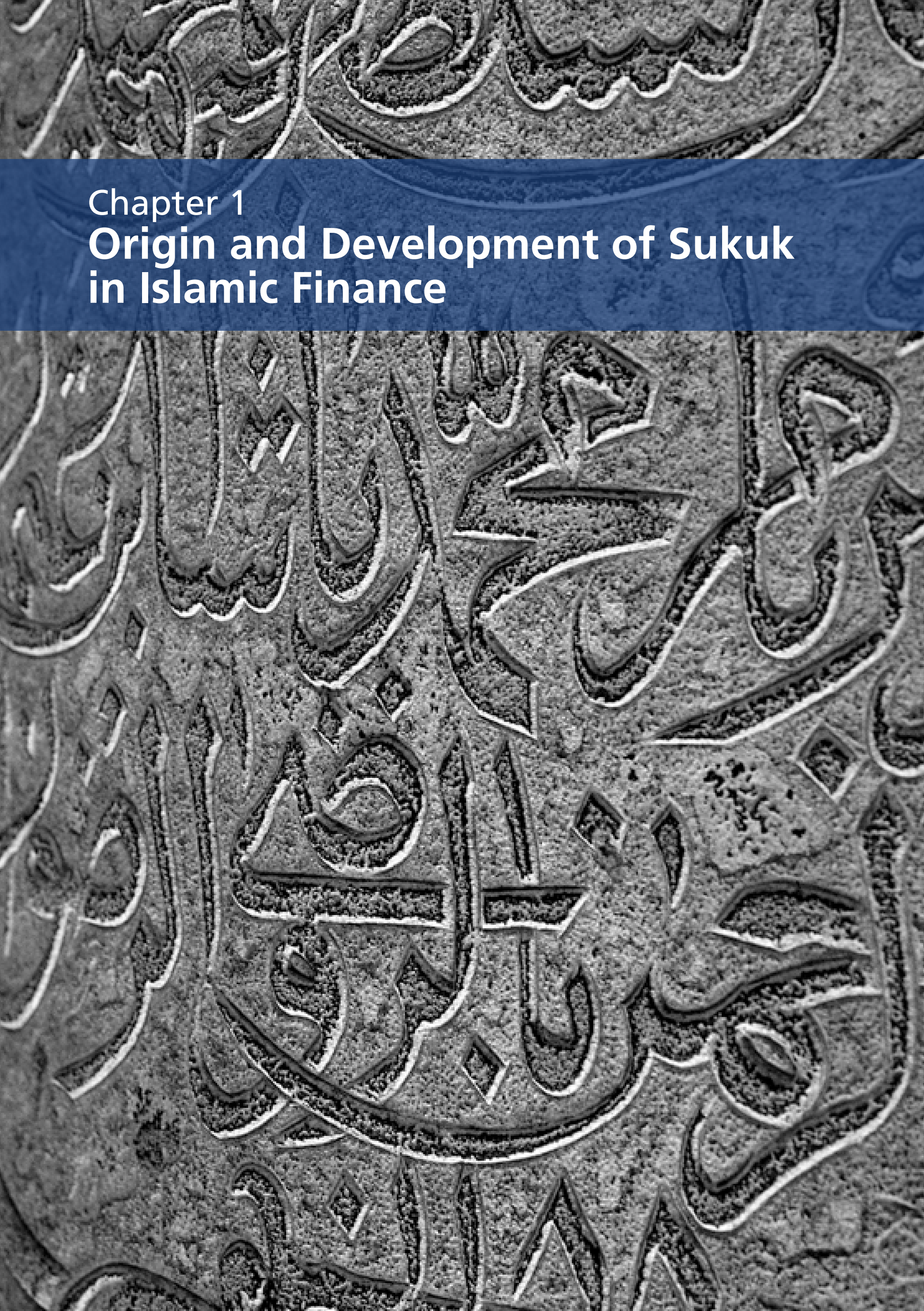
Members of the Firm's Islamic finance team, located in London, Dubai, Abu Dhabi, New York, Singapore, Hong Kong, Paris and elsewhere in our international network of offices, have extensive expertise and experience in both Islamic finance and conventional finance and are at the forefront of innovation as Islamic financing techniques and products evolve.

This Guide has been a collaborative effort between Clifford Chance, DIFC, DFSA, NASDAQ Dubai and Amanie Islamic Finance Consultancy and Education LLC. The Clifford Chance authors, led by Global Head of Islamic finance, Qudeer Latif, include Andrew Henderson, Paul McViety, Greg Man, Ferzana Haq, Shauaib Mirza and Cheuk Yin Cheung.

For further information about Clifford Chance see www.cliffordchance.com

Chapter 1

Origin and Development of Sukuk in Islamic Finance



Chapter 1

Origin and Development of Sukuk in Islamic Finance

Introduction

The high-profile growth and prevalence of sukuk in the Islamic finance industry in recent years has made the term, "sukuk", synonymous with the Islamic capital markets. This Shari'a compliant alternative to interest-bearing investment certificates or fixed income securities has led to the product being commonly referred to as "Islamic bonds" in recognition of its ability to offer Islamic investors a means of subscribing to certificates which represent a right to receive a share of profits generated by an underlying asset base and that is capable of being traded on the secondary market.

This has made sukuk an attractive product to sovereign and corporate issuers alike, who have used sukuk to tap into a wider range of financing sources for their increasingly sophisticated financing and investment purposes.

Origins of Sukuk

There is empirical evidence to suggest that sukuk structures were used within Muslim societies as early as the Middle Ages, where papers representing financial obligations originating from trade and other commercial activities were issued.

The word, "sukuk", can also be traced back to classical commercial Islamic literature, used in reference to certificates for goods or groceries ("sakk al-bada'i") as the method of paying the salaries of government officers, who would later redeem such certificates in line with their day-to-day consumption of such goods or groceries. However, the sukuk, as understood in its contemporary form, lies in a decision of the Islamic Jurisprudence Council (the "IJC") dated 6-11 February 1988 which provided that,

"any 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 group of assets represented by the sukuk consist of a majority of tangible assets."

Emergence of sukuk in contemporary Islamic finance

Although the IJC's decision is not binding on any particular party, the significance of the institution in the Muslim world saw the trading of securitised Islamic financial instruments which were approved as being Shari'a compliant in Malaysia from 1995. Although the sale of debt instruments (bai dayn) is permitted by the Shafi jurisprudence prevalent in Malaysia and Indonesia, the more conservative schools of thought prevalent in the Gulf Cooperation Council (the "GCC") countries saw the secondary trading of sukuk certificates as a conceptual hurdle as it could be interpreted as the transfer of debt at a price other than its face (or par) value, thus generating non-permitted interest (riba).

However, as trading in real assets is permitted, the Bahrain Monetary Agency (now the Central Bank of Bahrain) issued the first sovereign sukuk based on the ijara structure amounting to US$100 million in 2001. (Please refer to Part 1 (Sukuk al-Ijara) of Chapter 2 (Sukuk Structures) for further details of sukuk al-ijara). Since then, the global Islamic capital market has seen much larger sovereign and quasi-sovereign sukuk issues such as the US$600 million issuance by the Malaysian government in 2002 and the US$3.5 billion sukuk al-mudaraba by Ports & Free Zone Corporation in 2006 for the acquisition of P&O by Dubai World, which attracted GCC-based investors such as Islamic banks as well as domestic investors.

As at the time of writing, the United Arab Emirates is the GCC leader in terms of sukuk issuance by value, with a total of US$26,823 million from 34 issuances between 2000-2008 compared to US$4,543 million from 89 issuances in Bahrain over the same period[1].

Jurisprudential developments and evolution of sukuk

A standard in May 2003 on "Investment Sukuk" published by the Accounting and Auditing Organisation for Islamic Financial Institutions ("AAOIFI")[2] led to a paradigm shift in the development of Islamic financial products, which had traditionally been illiquid and had lacked the qualities of market orientation more commonly associated with their conventional counterparts. The standard was backed by 14 prominent Islamic scholars from the Middle East, Malaysia, Indian Sub-continent (especially Pakistan) and Africa (especially Sudan) and helped create cross-border convergence on sukuk across the four main schools of Islamic jurisprudence.

Since then, the sukuk industry has seen unprecedented growth as a viable alternative to mobilising long term savings and investment from Islamic investors as well as providing a liquidity management tool for Islamic financial institutions such as pension and zakat funds and insurance (takaful) institutions, particularly given the negotiable nature of the product and its listing on recognised stock exchanges: NASDAQ Dubai being one of the prominent exchanges. For corporates wishing to reduce their dependence on bank facilities or who wish to seek alternative (and often cheaper) sources of funding, a sukuk issuance is increasingly becoming a feasible option.

---

1 The Centre for the Study of Global Governance, "The Development of Islamic Finance in the GCC", London, May 2009.

2 AAOIFI Shari'a Standard No.17.

Facilitation Through Legal and Regulatory Infrastructures

The continued growth and development of the sukuk market also requires support from parallel developments in legal and regulatory infrastructures, both in domestic markets and beyond. A number of well-recognised institutions have already played significant roles and are likely to attract increasing focus from sukuk investors and issuers:

- AAOIFI: in addition to its ongoing annual publication of Shari'a and accounting standards and guidelines on Islamic financial products, it has also announced its intention to screen products for Shari'a compliance in the future;

- International Islamic Financial Market (IIFM): based in Bahrain and responsible for the development of a secondary market including standardisation of documents; and

- Islamic Financial Services Board (IFSB): based in Malaysia and responsible for the development of prudential standards for Islamic financial institutions.

Facilitation through Capital Market Infrastructures

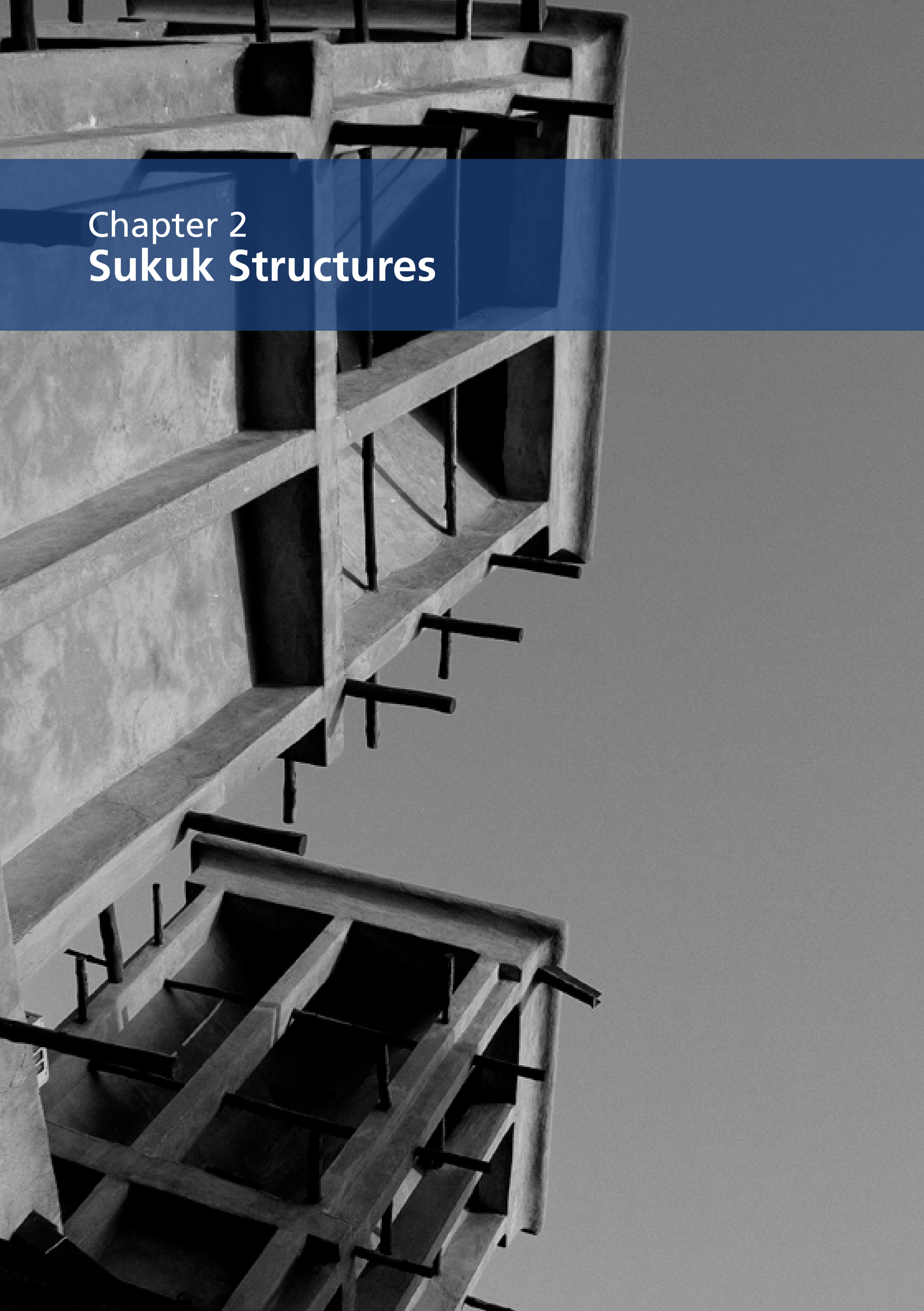
In addition, a number of other capital markets-based institutions are likely to play a prominent role in achieving the required nexus between sukuk issuers and investors to establish an attractive trading platform:

- DIFC: already enables the registration of special purpose companies for sukuk issuers wishing to seek a more domestic alternative to incorporation in jurisdictions such as the Cayman Islands or other traditional off-shore jurisdictions;

- NASDAQ Dubai: already enables public listing of sukuk issuances to help issuers to attract the maximum number of investors; and

- Rating Agencies: who can assist with providing more transparency on the credit risk of a sukuk product and, comparable to a conventional bond issuance, a recognised rating of the originator can improve the marketability of the relevant sukuk certificates. Sukuk ratings have already been provided by the prominent rating agencies and the International Islamic Rating Agency was also established with similar aims.

From its origins as papers representing remittances from trades in the Middle Ages to the investment and liquidity management tool it is today, the evolution of sukuk is a testimony to the ability of Islamic jurisprudence to move with the times to meet the increasingly sophisticated financing needs of both Muslims and non-Muslims seeking to participate in the Islamic financial markets. The development of regulatory, legal and capital market infrastructures will assist in seeing the sukuk market through sustainable growth into the future.



Chapter 2
Sukuk Structures

Chapter 2

Part 1: Sukuk al-Ijara

Introduction

The most commonly used sukuk structure (based on volume of issuances during 2008)[3] is that of sukuk al-ijara. The popularity of this structure can be attributed to a number of different factors; some commentators have described it as the classical sukuk structure from which all other sukuk structures have developed, whilst others highlight its simplicity and its favour with Shari'a scholars as the key contributing factors. In the Islamic finance industry, the term "ijara" is broadly understood to mean the 'transfer of the usufruct of an asset to another person in exchange for a rent claimed from him' or, more literally, a "lease".

In order to generate returns for investors, all sukuk structures rely upon either the performance of an underlying asset or a contractual arrangement with respect to that asset. The ijara is particularly useful in this respect as it can be used in a manner that provides for regular payments throughout the life of a financing arrangement, together with the flexibility to tailor the payment profile - and method of calculation - in order to generate a profit. In addition, the use of a purchase undertaking is widely accepted in the context of sukuk al-ijara without Shari'a objections. These characteristics make ijara relatively straightforward to adapt for use in the underlying structure for a sukuk issuance.

Examples of recent sukuk al-ijara issuances advised upon by Clifford Chance LLP and listed by originators on NASDAQ Dubai are:

- Nakheel, US$3,520 million issued in December 2006, followed by subsequent issuances of US$750 million in January 2008 and AED3,600 million in May 2008; and

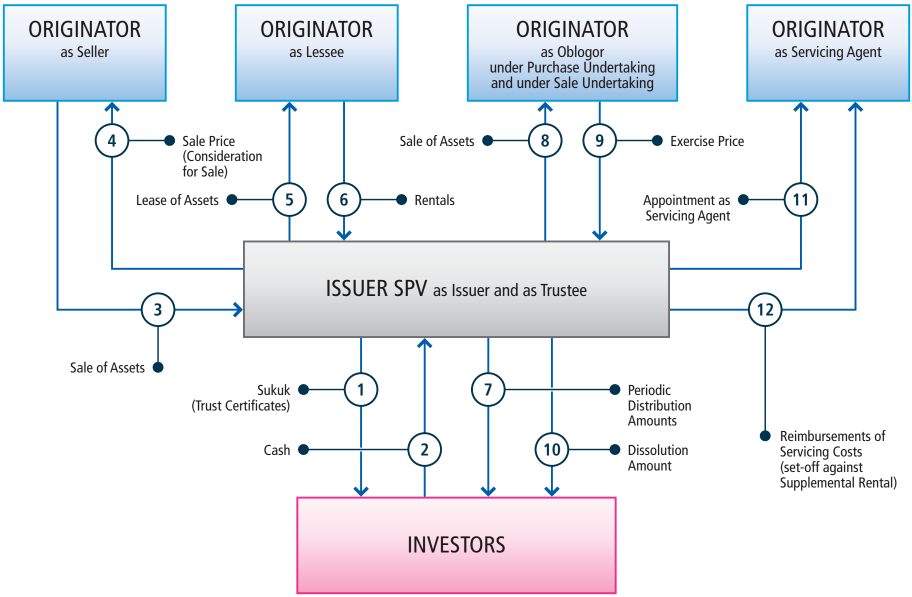
- Dubai Electricity & Water Authority (DEWA), AED3,200 million issued in June 2008.

Set out below is an example of a sukuk al-ijara structure, based upon a sale and leaseback approach.

---

3 Source: Moody's Investors Service – Special Report January 2009.

Figure 1: Structure of Sukuk al-Ijara



Overview of Structure

(Using the numbering from Figure 1 above)

1. Issuer SPV issues sukuk, which represent an undivided ownership interest in an underlying asset or transaction. They also represent a right against Issuer SPV to payment of the Periodic Distribution Amount and the Dissolution Amount.

2. The Investors subscribe for sukuk and pay the proceeds to Issuer SPV (the "Principal Amount"). Issuer SPV declares a trust over the proceeds (and any assets acquired using the proceeds – see paragraph 3 below) and thereby acts as Trustee on behalf of the Investors.

3. Originator enters into a sale and purchase arrangement with Trustee, pursuant to which Originator agrees to sell, and Trustee agrees to purchase, certain assets (the "Assets") from Originator.

4. Trustee pays the purchase price to Originator as consideration for its purchase of the Assets in an amount equal to the Principal Amount.

5. Trustee leases the Assets back to Originator under a lease arrangement (ijara) for a term that reflects the maturity of the sukuk.

6. Originator (as Lessee) makes Rental payments at regular intervals to Trustee (as Lessor). The amount of each Rental is equal to the Periodic Distribution Amount payable under the sukuk at that time. This amount may be calculated by reference to a fixed rate or variable rate (e.g. LIBOR or EIBOR) depending on the denomination of sukuk issued and subject to mutual agreement of the parties in advance.

7. Issuer SPV pays each Periodic Distribution Amount to the Investors using the Rental it has received from Originator.

8. Upon:
   (i). an event of default or at maturity (at the option of Trustee under the Purchase Undertaking); or

   (ii). the exercise of an optional call (if applicable to the sukuk) or the occurrence of a tax event (both at the option of Originator under the Sale Undertaking),

   Trustee will sell, and Originator will buy-back, the Assets at the applicable Exercise Price, which will be equal to the Principal Amount plus any accrued but unpaid Periodic Distribution Amounts owing to the Investors.

9. Payment of Exercise Price by Originator (as Obligor).

10. Issuer SPV pays the Dissolution Amount to the Investors using the Exercise Price it has received from Originator.

11–12 Trustee and Originator will enter into a service agency agreement whereby Trustee will appoint Originator as its Servicing Agent to carry out certain of its obligations under the lease arrangement, namely the obligation to undertake any major maintenance, insurance (or takaful) and payment of taxes in connection with the Assets. To the extent that Originator (as Servicing Agent) claims any costs and expenses for performing these obligations (the "Servicing Costs") the Rental for the subsequent lease period under the lease arrangement will be increased by an equivalent amount (a "Supplemental Rental"). This Supplemental Rental due from Originator (as Lessee) will be set off against the obligation of Trustee to pay the Servicing Costs.

Key Features of the Underlying Structure

Set out below is a summary of the basic requirements that should be considered when using ijara as the underlying structure for the issuance of sukuk:

- The consideration (Rentals) must be at an agreed rate and for an agreed period;
- The subject of the ijara must have a valuable use (i.e. things without a usufruct cannot be leased);
- The ownership of the asset(s) must remain with the Trustee and only the usufruct right may be transferred to the

originator (therefore anything which can be consumed cannot be leased by way of an ijara);

- As ownership of the asset(s) must remain with the Trustee, the liabilities arising from the ownership must also rest with the Trustee (as owner) - an asset remains the risk of the Trustee throughout the lease period (in the sense that any harm or loss caused by the factors beyond the control of the Originator is borne by the Trustee);

- Any liabilities relating to the use of the asset(s), however, rest with the Originator (as lessee);

- The Originator (as lessee) cannot use an asset for any purpose other than the purpose specified in the ijara (or lease) agreement (if no purpose is specified, the Originator can use such asset for the purpose it would be used for in the normal course of its business);

- The asset(s) must be clearly identified in the ijara (and identifiable in practice);

- Rental must be determined at the time of contract for the whole period of the ijara. Although it is possible to split the term of the ijara into smaller rental periods where different amounts of rent may be calculated for each such rental period, the amount of rental must be fixed at the start of each such rental period and Shari'a will consider each rental period as a separate lease;

- If an asset has totally lost the function for which it was leased, and no repair is possible, the ijara shall terminate on the day on which such loss (a "Total Loss") has been caused. If there has been a Total Loss, the Trustee may have the right/ability to substitute or replace the affected asset - although, in reality, it would only look to do so if the Originator (as service agent) is able to use the insurance (or takaful) or any other total loss proceeds to procure substitute or replacement assets;

- If a Total Loss is caused by the misuse or negligence of the Originator, the Originator will be liable to compensate the Trustee for depreciation in the value of the affected asset, as it was immediately before such Total Loss; and

- In the event that an asset has only suffered partial loss or damage, the ijara will continue to survive with respect to that asset.

The above requirements are based on the principles set out in Accounting and Auditing Organization for Islamic Financial Institutions (the "AAOIFI") Shari'a Standard No. 9 (Ijarah and Ijarah Muntahia Bittamleek) and other established principles relating to Ijara.

Required Documentation

In addition to the offering, trust and listing documentation (the requirements of which are discussed in more detail in Chapter 3 (Issuing Sukuk from the DIFC) and Chapter 4 (Listing Sukuk on NASDAQ Dubai)), the following documentation is typically required for a sukuk al-ijara transaction:

Table 1

Document	Parties	Summary / Purpose
Sale and Purchase Agreement	Originator (as Seller) and Trustee (as Purchaser)	From Trustee's (and the Investors') perspective, this is the document that gives ownership of revenue-generating assets (i.e. the Assets). From Originator's perspective, this is the document under which it receives funding.
Lease (Ijara) Agreement	Trustee (as Lessor) and Originator (as Lessee)	Trustee leases the Assets back to Originator in a manner that: i. gives Originator possession and use of the Assets so that its principal business can continue without interruption; and ii. through Rentals it generates a return for Trustee (and the Investors).
Service Agency Agreement	Trustee (as Lessor / Principal) and Originator (as Servicing Agent)	Allows Trustee to pass responsibility for major maintenance, insurance (or takaful) and payment of taxes (i.e. an owner's obligations) back to Originator. Any reimbursement amounts or service charges payable to Servicing Agent are set off against (i) a corresponding 'supplementary rental' under the Ijara or (ii) an additional amount which is added to the Exercise Price (payable under the Purchase Undertaking or the Sale Undertaking, as applicable).
Purchase Undertaking (Wa'd)	Granted by Originator (as Obligor) in favour of Trustee	Allows Trustee to sell the Assets back to Originator if an event of default occurs or at maturity, in return for which Originator is required to pay all outstanding amounts (through an Exercise Price) so that Trustee can pay the Investors.

Continued…

Document	Parties	Summary / Purpose
Sale Undertaking (Wa'd)	Granted by Trustee in favour of Originator (as Obligor)	Allows Originator to buy the Assets back from Trustee in limited circumstances (e.g. the occurrence of a tax event), in return for which Originator is required to pay all outstanding amounts (through an Exercise Price) so that Trustee can pay the Investors.
Substitution Undertaking (Wa'd) - OPTIONAL	Granted by Trustee in favour of Originator (as Obligor)	Allows Originator to substitute the Assets (which it may need to sell or otherwise dispose of) for some other assets having at least the same value and revenue-generating properties.

Related Structures / Structural Developments

The growth of the sukuk market has led to the development of a number of 'hybrid' structures around the sukuk al-ijara model in order to provide additional flexibility - particularly when selecting underlying assets. A few of these developments are summarised below:

- In order to enable investors to receive compensation where an asset is still under construction, certain Shari'a scholars have permitted the use of the forward lease arrangement (known as ijara mawsufah fi al-dimmah). This forward lease agreement is normally combined with an istisna contract (or procurement agreement), under which construction of the asset is commissioned. This structure is discussed in more detail later in this Chapter 2 (Sukuk Structures) at Part 5: Sukuk al-Istisna; and

- If legal and/or registered title to a particular asset exists and (due to, by way of example, the prohibitive cost implications or tax implications of registering such a transfer of title) it is not possible to transfer that legal / registered title, certain structures have been approved that allow an ijara to be put in place despite the fact that the trustee does not have outright legal ownership of that asset. For example:

  (i) it may be possible, depending on the asset type and the view taken by the relevant Shari'a scholars, to rely upon the concept of beneficial ownership in structuring a sukuk al-ijara transaction. The sale and purchase agreement (in the sale and leaseback structure discussed above) would document the sale and transfer to the trustee of the beneficial ownership interest in the underlying asset - and such beneficial ownership interest would be sufficient to enable the trustee's entry into the leaseback arrangements contemplated in the example above;

  (ii) where the usufruct of an asset is recognised by the underlying legal and regulatory regime, it may be possible to create different categories of usufruct and for the sale of a usufruct to be relied upon for the purposes of structuring a sukuk al-ijara transaction. An example of this is through the grant of a musataha interest (a right in rem), the holder (or musatahee) is given the right to use and develop land with such rights over that land in a manner that allows the holder to be the outright owner of the buildings constructed on that land during the period of the musataha. It should however be noted that a musataha provides an interest less than freehold or absolute ownership. The musataha right, when created, is granted by the owner of the freehold property to the holder. The right, while not a leasehold interest, is quite similar to a leasehold interest. Certain Shari'a scholars consider this sufficient to enable the holder (or musatahee), in turn, to lease the land and any buildings thereon to the originator under an ijara arrangement. Basically, a musataha contract replaces the sale and purchase agreement in the sale and leaseback structure discussed above; and

(iii) it is also possible for a head-lease arrangement to be used instead of the sale and purchase agreement (in the sale and leaseback structure discussed above), such that the trustee is granted a long-term right to use an asset under the head-lease, thus allowing the trustee to enter into a sub-lease (the ijara).

Part 2: Sukuk al-Musharaka

Introduction

Prior to the AAOIFI statement in 2008 (the "AAOIFI Statement"), one of the more commonly used sukuk structures was that of sukuk al-musharaka. However, following on from the AAOIFI Statement criticising the use of purchase undertakings in sukuk al-musharaka structures (as further discussed below under the heading "AAOIFI's Statement of 2008"), the popularity of this structure has declined in recent times.

The term musharaka is derived from the word shirkah, which means partnership. In its simplest form, a musharaka arrangement is a partnership arrangement between two (or more) parties, where each partner makes a capital contribution to the partnership (i.e. to the musharaka), in the form of either cash contributions or contributions in kind. Essentially, a musharaka is akin to an unincorporated joint venture but may, if required, take the form of a legal entity. The musharaka partners share the profits of the musharaka in pre-agreed proportions and share the losses of the musharaka in proportion to their initial capital investment.

Musharaka arrangements can be structured in a number of different ways; however, in practice the following two structures are utilised for the purposes of issuing sukuk. These are:

a. Shirkat al-'Aqd – commonly referred to as the 'business plan' musharaka; it is an arrangement pursuant to which the Originator and the Trustee agree to combine their efforts and resources (typically in the form of cash and/or other asset from the Originator and the Trustee) towards a common objective; and

b. Shirkat al-Melk – commonly referred to as the 'co-ownership' musharaka; it is an arrangement pursuant to which either (i) the Originator and the Trustee contribute cash to the musharaka to purchase an asset together or (ii) the Originator sells an ownership interest in an asset to the Trustee as a result of which the Originator and the Trustee become co-owners of that asset.

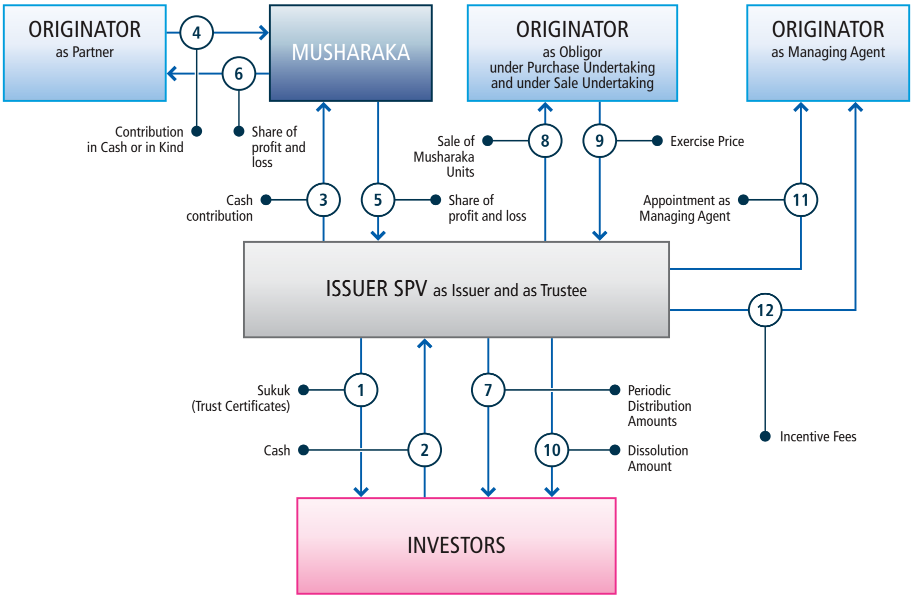
When structuring a sukuk issuance pursuant to a shirkat al-melk structure, the first step is often to analyse what exactly the business of an originator entails and what assets (if any) are available to support the issuance of sukuk. At the outset, if it is not possible to identify a tangible asset that is capable, from a legal and Shari'a perspective, of being contributed to the musharaka itself, it will be necessary to consider the shirkat al-'aqd structure (as well as those outlined in the rest of this Chapter 2 (Sukuk Structures)).

All sukuk structures rely upon the performance of an underlying asset or arrangement in order to generate returns for investors. The musharaka is no different in this respect and can be implemented in a manner that provides for regular payments throughout the life of the sukuk, together with the flexibility to tailor the payment profile - and method of calculation - in order to generate a profit. These characteristics make musharaka relatively straightforward to adapt for use in the underlying structure for a sukuk issuance.

One example of a sukuk al-musharaka issuance listed by an originator on NASDAQ Dubai is the Jebel Ali Free Zone FZE AED7,500 million sukuk issued in November 2007, where Clifford Chance LLP acted as legal counsel to the originator.

Set out below is an example of a sukuk al-musharaka structure, based upon a shirkat al-'aqd arrangement.

Figure 2: Structure of Sukuk al-Musharaka (based upon a shirkat al-'aqd arrangement)



Overview of Structure

(Using the numbering from Figure 2 above)

1. Issuer SPV issues sukuk, which represent an undivided ownership interest in an underlying asset, transaction or project. They also represent a right against Issuer SPV to payment of the Periodic Distribution Amount and the Dissolution Amount.

2. The Investors subscribe for sukuk and pay the proceeds to Issuer SPV (the "Principal Amount"). Issuer SPV declares a trust over the proceeds (and any assets of the musharaka – see paragraph 4 below) and thereby acts as Trustee on behalf of the Investors.

3. Trustee enters into a musharaka arrangement with Originator, pursuant to

which Trustee contributes the proceeds from the issuance of the sukuk into the musharaka and is allocated a number of units in the musharaka in proportion to its capital contribution.

4. Originator enters into a musharaka arrangement with Trustee, pursuant to which Originator makes a contribution in cash or in kind into the musharaka and is allocated a number of units in the musharaka in proportion to its capital contribution to the musharaka. The contributions by the Trustee and the Originator collectively form the musharaka assets (the "Musharaka Assets").

5. On each periodic distribution date Trustee shall receive a pre-agreed percentage share of the expected profits generated by the Musharaka Assets and, where the Musharaka Assets generate a loss, Trustee shall share that loss in proportion with its capital contribution to the musharaka. Trustee's share of profits will typically be a percentage high enough to at least equal the Periodic Distribution Amounts payable under the sukuk.

6. On each periodic distribution date Originator shall receive a pre-agreed percentage share of profits generated by the Musharaka Assets and, where the Musharaka Assets generate a loss, Originator shall share that loss in proportion with its capital contribution.

7. Issuer SPV pays each Periodic Distribution Amount to the Investors using the profit it has received from the Musharaka Assets.

8. Upon:

   (i). an event of default or at maturity (at the option of Trustee under the Purchase Undertaking); or

   (ii). the exercise of an optional call (if applicable to the sukuk) or the occurrence of a tax event (both at the option of Originator under the Sale Undertaking),

Trustee will sell, and Originator will buy, all of Trustee's units in the musharaka at the applicable Exercise Price, which will be an amount equal to the Trustee's share in the fair market value of the Musharaka Assets at the time of sale. The Exercise Price will be used to pay the Principal Amount plus any accrued but unpaid Periodic Distribution Amounts owing to the Investors.

Pre-AAOIFI's Statement, the Exercise Price was often fixed at the outset to be an amount equal to the Principal Amount plus any accrued but unpaid Periodic Distribution Amounts owing to the Investors. However, following on from the AAOIFI Statement the general Shari'a position is that where the Originator and the purchaser under the Purchase Undertaking are the same entity, the Exercise Price cannot be fixed in this manner and must instead be determined by reference to the market value of the Musharaka Assets at the time of sale (please see the section below under the heading "AAOIFI's Statement of 2008" for further information). As a result of this, there is a risk that the Exercise Price will be less than the amount required to pay the Principal Amount and all accrued but unpaid Periodic Distribution Amounts owing to the Investors. In order to mitigate this risk, additional structural enhancements can be incorporated into the structure including (i) the maintenance of a reserve account into which excess profits from time to time during the life of the sukuk are held and used to make up any shortfalls in any payments due to Certificateholders; and/or (ii) the option of a third party providing Shari'a-compliant liquidity funding to fund any shortfalls in any payments due to Certificateholders (see the section below headed "Key features of the Underlying Structure" for further detail). These mitigants do not however address all the risks associated with an exercise price linked to market price of the assets.

9. Payment of Exercise Price by Originator (as Obligor).

10. Issuer SPV pays the Dissolution Amounts to the Investors using the Exercise Price it has received from Originator.

11–12 Trustee and Originator will enter into a management agreement whereby Trustee shall appoint Originator as Managing Agent to manage the musharaka in accordance with an agreed business plan. To the extent that the profit received by Trustee in any period is greater than the Periodic Distribution Amounts for that period, the Managing Agent shall be entitled to such excess as an advance performance fee. Under Shari'a, all payments made under the musharaka are deemed to be "on account" and will be adjusted on the musharaka end date to reflect the actual and final profits / losses of the musharaka. As a result of this, any excess profit paid to the Managing Agent is considered to be an advance performance fee that is refundable at all times until the musharaka end date. Typically, in the event that on any periodic distribution date there is a shortfall between the profit received by Trustee and the Periodic Distribution Amount then due, Managing Agent will be obliged to return such advance performance fees to remedy the shortfall. However, on the musharaka end date, any advance performance fees not required to be returned can be conclusively retained by the Managing Agent.

Key Features of the Underlying Structure

Set out below is a summary of the basic requirements based on established principles and the AAOIFI Shari'a Standards No.12 (Sharika (Musharaka) and Modern Corporations), which should be considered when using musharaka as the underlying structure for the issuance of sukuk:

- Managing Agent must operate the musharaka business and invest the Musharaka Assets in accordance with the musharaka business plan that will have been agreed between the partners and will have been tailored in accordance with the principles of Shari'a;
- The ratio of profit sharing must be agreed at the outset and, unlike losses, does not

have to be in proportion to each partner's capital contribution. However, it is not permissible to agree a fixed profit amount for either Originator or Trustee;

- Losses of the musharaka must be shared by the partners in proportion to their capital contributions to the musharaka;

- Any profit distributed prior to maturity or termination of the musharaka is deemed to be in advance and is treated as an "on account" payment which shall be adjusted to the actual profit Originator and Trustee are entitled to at that time;

- The musharaka must have a degree of tangibility and this tangibility (or asset-backing ratio) can vary between 33% and 50%, depending on the Shari'a scholars involved;

- There is a possibility that the profits received by Trustee on or prior to any periodic distribution date are less than the relevant Periodic Distribution Amounts. Appropriate mechanical enhancements can be incorporated into the musharaka structure to mitigate this risk. For example, surplus profits on any Periodic Distribution Dates can be held in a reserve account and amounts held in such reserve account can be drawn to fund any shortfalls in future Periodic Distribution Amounts or in the Exercise Price (as discussed above). Secondly, the provision of third-party, Shari'a-compliant liquidity funding can be accommodated into the structure to also cover any such shortfalls; although, it is important to note that any such third-party provider can only have the right, and must not be obliged, to provide such Shari'a-compliant liquidity funding. The Trustee will be under an obligation to repay the Shari'a-compliant liquidity funding from any proceeds remaining after the sukuk have been redeemed in full; and

- Both Originator and Trustee can, from a Shari'a perspective, terminate the musharaka at any time after giving notice. On termination of the musharaka, and provided that the Purchase Undertaking has not been exercised by Trustee, the tangible assets comprised in the musharaka will be liquidated and, together with the intangible assets, be distributed between Originator and Trustee in proportion to the units (or capital contribution) held by each party in the musharaka.

Required Documentation

In addition to the offering, trust and listing documentation (the requirements of which are discussed in more detail in Chapter 3 (Issuing Sukuk from the DIFC) and Chapter 4 (Listing Sukuk on NASDAQ Dubai)), the following documentation is typically required for a sukuk al-musharaka transaction:

Table 2

Document	Parties	Summary / Purpose
Musharaka Agreement	Originator (as Partner) and Trustee (as Partner)	From Trustee's (and the Investors') perspective, this is the document that creates the musharaka, gives it an ownership interest in the Musharaka Assets and entitles it to a share of the profits generated by those Musharaka Assets. From Originator's perspective, this is the document under which it receives funding.
Management Agreement	Trustee (as Partner) and Originator (as Managing Agent)	Allows Trustee to appoint Originator to manage the Musharaka Assets in accordance with an agreed business plan. Allows Originator to implement the funding received from Trustee (and the Investors) in accordance with its business plan.
Purchase Undertaking (Wa'd)	Granted by Originator (as Obligor) in favour of Trustee	Allows Trustee to sell all of its units at market value in the musharaka to Originator if an event of default occurs or at maturity, in return for which Originator is required to pay the market value of those units (through an Exercise Price - please also see the section below under the heading "AAOIFI's Statement of 2008") which is then used to service all outstanding amounts owing to the Investors.
Sale Undertaking (Wa'd)	Granted by Trustee in favour of Originator (as Obligor)	Allows Originator to buy Trustee's units in the musharaka from Trustee in limited circumstances (e.g., the occurrence of a tax event), in return for which Originator is required to pay all outstanding amounts (through an Exercise Price) so that Trustee can pay the Investors.

Related Structures / Structural Developments

Shirkat al-Melk

An alternative to the shirkat al-'aqd musharaka arrangement described above is the shirkat al-melk arrangement, which broadly operates as follows:

- Either (i) Originator and Trustee both contribute cash to the musharaka for the purposes of jointly acquiring an asset, or (ii) Originator sells a portion of its ownership interest in an asset to Trustee;

- Originator and Trustee become co-owners of the relevant asset, each with an ownership interest in the whole of the asset. As a result of this, shirkat al-melk arrangements cannot be divided or unitised in the manner that shirkat al-'aqd arrangements can (as described above);

- On maturity or early dissolution due to an event of default, optional call or tax event, Trustee would sell its ownership interest back to Originator for an Exercise Price. Similar to the shirkat al-'aqd structure, pre-AAOIFI's Statement, the Exercise Price was often fixed at the outset to be an amount equal to the Principal Amount plus any accrued but unpaid Periodic Distribution Amounts owing to the Investors. However, following on from the AAOIFI Statement the general Shari'a position is that where the Originator and the purchaser under the Purchase Undertaking are the same entity, the Exercise Price cannot be fixed in this manner and must instead be determined by reference to the market value of the Musharaka Assets at the time of sale (please see the section below under the heading "AAOIFI's Statement of 2008" for further information). Again, as a result of this, there is a risk that the Exercise Price will be less than the amount required to pay the Principal Amount and all accrued but unpaid Periodic Distribution Amounts owing to the Investors. This risk can be mitigated by integrating additional structural enhancements into the structure including (i) the maintenance of a reserve account (as discussed above); and (ii) the option of a third party providing Shari'a compliant liquidity funding to fund any shortfalls in any payments due to Certificateholders (see the section above headed "Key features of the Underlying Structure" for further detail); and

- For the purposes of such an arrangement, it will also be necessary to consider what interest is being sold to Trustee (i.e. legal or beneficial).

  As an additional structural enhancement, the Trustee could lease its ownership interest in the Musharaka Asset(s) to the Originator in return for periodic rental payments. If such an enhancement is implemented, the points highlighted in Part 1 (Sukuk al-Ijara) of this Chapter 2 (Sukuk Structures) will also need to be considered.

Diminishing Musharaka

Where a sukuk is structured to be amortising, a diminishing musharaka arrangement can be implemented. Pursuant to this arrangement, both the Originator and Trustee must jointly own the asset and on any date on which the amortisation is to occur, Trustee would sell some of its units or part of its co-ownership interest in the musharaka asset(s) to Originator. As a consequence of such sale, Trustee's units or ownership interest (as the case may be) in the Musharaka Asset(s) decreases over the life of the sukuk.

AAOIFI's Statement of 2008

Before the AAOIFI Statement it was possible for the Originator to grant a purchase undertaking to the Trustee and for the Exercise Price to be a fixed amount determined in accordance with a formula (and not by reference to the market value of the Musharaka Assets). The Exercise Price would therefore typically have been, in the event of a default or maturity, equal to the face amount of the sukuk plus any accrued but unpaid Periodic Distribution Amounts. The Investors were therefore 'guaranteed' to receive their principal investment and profit (subject to the usual risks, such as insolvency, present in any sukuk or conventional bond structure).

However, under the AAOIFI Statement, Shari'a scholars have taken 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 Trustee's share of the market value of the Musharaka Assets at the time of sale. The premise for this ruling has been that sukuk al-musharaka are analogous to equity-based instruments and therefore the partners in the musharaka must take the risk of both profit and loss. Determining the value of the Musharaka Assets by reference to the face amount of the sukuk (or by reference to a shortfall amount) is akin to a guarantee of profit and principal, which, unless given by an independent third party (i.e. anyone other than the Originator), is not permitted under Shari'a. This ruling has resulted in a significant decline in the number of sukuk al-musharaka issuances in 2008 and 2009.

Chapter 2

Part 3: Sukuk al-Mudaraba

Introduction

When structuring a sukuk issuance, the first step is often to analyse what exactly the business of an originator entails and what assets (if any) are available to support the issuance of sukuk. If at the outset, it is not possible to identify a specific tangible asset for investment, the sukuk al-mudaraba (or a sukuk al-musharaka, please refer to Part 2 of Chapter 2) may be a viable alternative to the sukuk al-ijara structure.

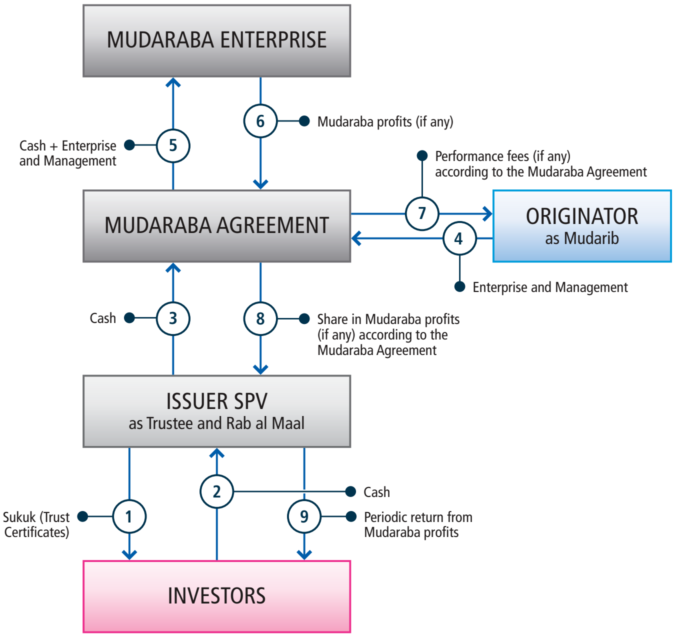
In the Islamic finance industry, the term mudaraba is broadly understood to refer to a form of equity-based partnership arrangement whereby one partner provides capital (the Rab al-Maal) and the other provides managerial skills (the Mudarib).

The same characteristics of the mudaraba structure can also be adapted for use as the underlying structure in a sukuk issuance as each Investor's purchase of sukuk would represent units of equal value in the mudaraba capital, and are registered in the names of the sukuk certificateholders on the basis of undivided ownership of shares in the mudaraba capital. The returns to the Investors would represent accrued profit from the mudaraba capital at a pre-agreed ratio between the Rab al-Maal and the Mudarib, which would then pass to the Investors according to each Investor's percentage of investments in sukuk mudaraba. Examples of recent sukuk al-mudaraba issuances and advised upon by Clifford Chance LLP are:

- SAR1 billion issuance by Purple Island/Bin Laden in November 2008 (no purchase undertaking)
- Abu Dhabi Islamic Bank's AED2 billion Tier I issuance issued in February 2009 (no purchase undertaking);
- DP World, US$1.5 billion issued in July 2007, which was part of a US$5 billion global medium term note programme; and
- IIG Funding Limited, US$200 million issued in July 2007 and listed on NASDAQ Dubai.

Set out on the following page is an example of a typical sukuk al-mudaraba structure.

Figure 3: Structure of Sukuk al-Mudaraba



Overview of Structure

(Using the numbering from Figure 3 above)

1. Issuer SPV issues sukuk, which represent an undivided ownership interest in an underlying asset, transaction or project. They also represent a right against Issuer SPV to payment of expected periodic return from Mudaraba profits.

2. The Investors subscribe for sukuk and pay the proceeds to Issuer SPV (the "Principal Amount"). Issuer SPV declares a trust over the proceeds (and any assets or Mudaraba interests acquired using the proceeds) and thereby acts as Trustee on behalf of the Investors.

3. Issuer SPV and Originator enter into a Mudaraba Agreement with Originator as Mudarib and Issuer SPV as Rab al-Maal, under which Issuer SPV agrees to contribute the Principal Amount for the purpose of a Shari'a compliant Mudaraba enterprise.

4. Originator, as Mudarib under the Mudaraba Agreement, agrees to contribute its expertise and management skills to the Shari'a compliant Mudaraba enterprise, with responsibility for managing the Rab al-Maal's cash contribution in accordance with specified investment parameters.

5. Issuer SPV and Originator enter into the Mudaraba enterprise with the purpose of generating profit on the Principal Amount.

6. Profits generated by the Mudaraba enterprise are divided between Issuer SPV (as Rab al-Maal) and Originator (as Mudarib) in accordance with the profit sharing ratios set out in the Mudaraba Agreement but accrued for the duration of the Mudaraba enterprise.

7. In addition to its profit share, Originator (as Mudarib) may be entitled to a performance fee for providing its expertise and management skills if the profit generated by the Mudaraba enterprise exceeds a benchmarked return. This performance fee (if any) would be calculated at the end of the Mudaraba term and upon liquidation of the Mudaraba.

8. Issuer SPV receives the Mudaraba profits and holds them as Trustee on behalf of the Investors.

9. Issuer SPV (as Trustee) pays each periodic return to Investors using the Mudaraba profits it has received under the Mudaraba Agreement.

On maturity of the sukuk al-mudaraba, the Mudaraba enterprise would be dissolved in accordance with the terms of the Mudaraba Agreement and the Trustee would exercise a purchase undertaking to call on Originator to buy the Mudaraba interests from the Trustee at market value so that the proceeds can be used to service the outstanding amounts due to the Investors. The Investors would be entitled to a return comprising their pro rata share of the market value of the liquidated Mudaraba capital and the profit generated by the Mudaraba enterprise and accrued during the term of the sukuk issuance.

Upon maturity, the assets of the Mudaraba enterprise would be liquidated and the proceeds would be applied: firstly, in the return of the capital initially contributed by Issuer SPV; and secondly, in the distribution of any remaining dissolution returns between Issuer SPV and Originator in accordance with the same profit sharing ratios. Issuer SPV (as Trustee) then pays such dissolution returns to the Investors redeeming the sukuk certificates.

Although the profits generated during the term of the Mudaraba enterprise are accrued for distribution on dissolution at maturity, periodical distributions to Investors may nonetheless be achieved during the term of the sukuk issuance through payments of "advance profits". This would typically be effected by way of a constructive liquidation of the Mudaraba assets at specified intervals whereby the amounts of advance profit would represent the difference between:

(i) the market value of the Mudaraba assets on the relevant constructive liquidation date; and

(ii) the par value of the Mudaraba assets.

Key Features of the Underlying Structure

Set out below is a summary of the basic requirements that should be considered when using mudaraba as the underlying structure for the issuance of sukuk:

- Originator (as Mudarib) discharges and performs its obligations under the Mudaraba Agreement with the degree of skill and care that it would exercise in respect of its own assets;

- An investment plan in respect of the Mudaraba enterprise will be tailored within Shari'a parameters to meet the financing objectives of the sukuk al-mudaraba as set out in the Mudaraba Agreement (the terms of which would also be specified in the sukuk prospectus);

- The Mudaraba would be entered into on a restricted basis (an al-mudaraba al-muqayyadah) in which Originator (as Mudarib) must invest the sukuk proceeds in accordance with the specified investment plan. For Shari'a purposes, at least 33% of the capital of the Mudaraba enterprise should be invested in tangible assets (also known as the asset-backing ratio or tangibility requirement) at all times;

- The profit sharing ratio between Issuer SPV (as Rab al-Maal) and Originator (as Mudarib) must be agreed at the time of the conclusion of the Mudaraba Agreement, but this cannot be expressed as a rate based on each party's contribution in the Mudaraba enterprise nor as a pre-agreed lump sum;

- Any losses of the Mudaraba enterprise would be borne by Issuer SPV (as Rab al-Maal), although its liabilities are limited to proceeds invested (therefore, Investors would not be liable for more than their investment into the sukuk al-mudaraba); and

- The risk of passing any losses of the Mudaraba enterprise to Investors may be mitigated through the use of a purchase undertaking granted by Originator (as Promissor) in favour of Issuer SPV (as Promisee) so that in the event that proceeds from the Mudaraba enterprise are insufficient in meeting any amounts payable by Issuer SPV to Investors, Issuer SPV may call on Originator to purchase its Mudaraba interests for a price which represents their market value.

Required Documentation

In addition to the offering, trust and listing documentation (the requirements of which are discussed in more detail in Chapter 3 (Issuing Sukuk from the DIFC) and Chapter 4 (Listing Sukuk on NASDAQ Dubai)), the following documentation is typically required for a sukuk al-mudaraba transaction:

Table 3

Document	Parties	Summary / Purpose
Mudaraba Agreement	Originator (as Mudarib) and Trustee (as Rab al-Maal)	Sets out the terms of the Mudaraba enterprise under which the Trustee shall invest the Principal Amount and prescribes the profit sharing ratios between the parties.
Purchase Undertaking (Wa'd)	Granted by Originator (as Obligor) in favour of Trustee	Allows Originator to buy the Mudaraba interests from Trustee for an exercise price which is equal to the market value of such interests on the exercise date if an event of default with respect to the Originator occurs during the term of the Mudaraba enterprise or on the date of the dissolution of the Mudaraba enterprise so that Trustee may apply the proceeds to pay Investors.

Structural Developments/AAOIFI's Statement of 2008

Before the AAOIFI Statement it was possible for the Originator to grant a purchase undertaking in favour of the Trustee whereby the exercise price would be a fixed amount determined in accordance with a formula that would ensure that the exercise price would:

- in the event of a default or on maturity of the sukuk, be equal to the par value of the sukuk plus any accrued but unpaid Mudaraba profits; or
- in the event of a shortfall between any amount actually received by the Trustee from the Mudaraba enterprise and the profits received by the Trustee and the distribution amount due to the Investors, be equal to the shortfall,

rather than a formula would reference the market value of the assets of the Mudaraba enterprise. The use of such purchase undertakings, in effect, ensured that the Investors were almost certain to receive their principal sukuk investment and profit (subject to the usual risks such as insolvency present in any sukuk or conventional bond structure).

However, under the AAOIFI Statement, Shari'a scholars have taken the view that it is not permissible for an Originator to grant a purchase undertaking to the Trustee to purchase the Mudaraba assets for any amount other than the Trustee's share of the market value of the Mudaraba assets at the time of sale. The premise for this ruling has been that sukuk al-mudaraba are analogous to equity-based instruments and therefore the partners in the Mudaraba must take the risk of both profit and loss. Determining the value of the Mudaraba assets by reference to the par value of the sukuk (or by reference to a shortfall amount) is akin to a guarantee of profit and principal which, unless given by an independent third party (a party other than the Originator), is not permitted under Shari'a. This ruling is another reason why the sukuk market has not seen a revival of the sukuk al-mudaraba structure.

Chapter 2

Part 4: Sukuk al-Salam

Introduction

Generally, in order for a sale to be valid under Shari'a the object forming the subject matter of the sale must be in existence and in the physical or constructive possession of the seller. The exceptions to this general position are sales effected pursuant to salam and istisna contracts.

In its simplest form, a salam contract involves the purchase of assets by one party from another party on immediate payment and deferred delivery terms. The purchase price of the assets is typically referred to as the salam capital and is paid at the time of entering into the salam contract. The assets sold under the salam contract are referred to as al-muslam fihi, delivery of which is deferred until a future date.

A salam contract may be construed as being synonymous with the objective of a forward sale contract. Forward sale contracts are generally forbidden under Shari'a unless the element of uncertainty (gharar) inherent in such contracts is effectively eradicated. For this reason, certain criteria must be met in order for a salam contract to be Shari'a compliant. These requirements are discussed in more detail below under the heading "Key Features of the Underlying Structure".

Although the use of salam has been, and is, utilised by some institutions for short-term liquidity purposes, its use as the platform for issuing sukuk, as an alternative to conventional bonds, is rare in comparison to some of the more prevalent structures like sukuk al-ijara. The limited use of this structure can be attributed to a number of factors, namely the non-tradability of the sukuk and the requirement that the Originator must be able to deliver certain 'standardised' assets to the Issuer at certain future dates which may be difficult where the Originator's business model does not provide for this.

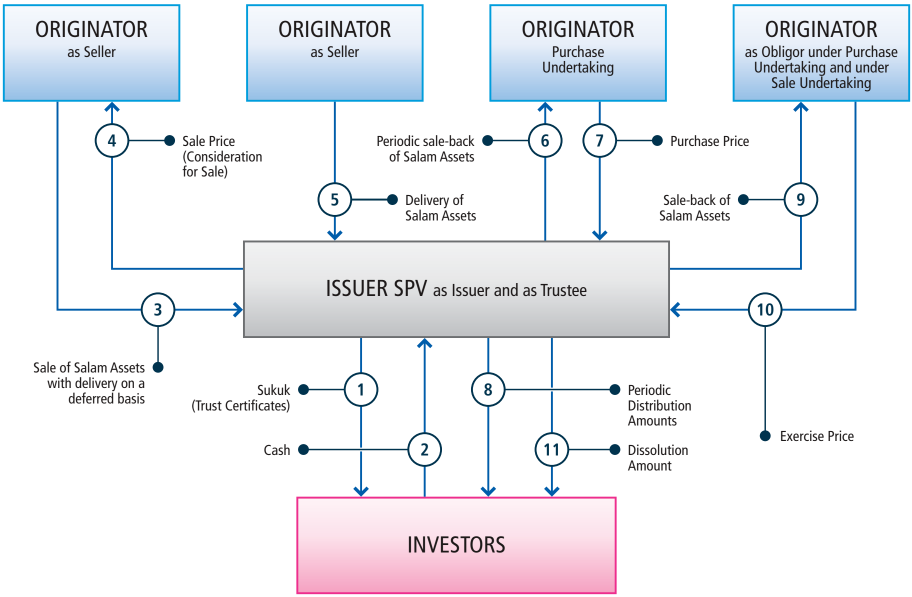
When structuring a sukuk issuance as a sukuk al-salam, the first step will involve analysing what exactly the business of the Originator entails and what 'standardised' assets (if any) the Originator is able to deliver to support the issuance of the sukuk. At the outset, if it is not possible to identify any such assets, it will be necessary to consider other possible structures (including those outlined in the other parts of this Chapter 2 (Sukuk Structures)).

As with the other sukuk structures, it is possible to structure a sukuk al-salam in a manner that provides for regular payments throughout the life of a financing arrangement, together with the flexibility to tailor the payment profile - and method of calculation - in order to generate a profit. The AAOIFI Shari'a Standards perceive debt securitisation and tradability as non-Shari'a compliant. As such, although the characteristics of salam make it relatively straightforward to adapt for use in the underlying structure for a sukuk issuance, its use remains rare in practice as the salam contract creates indebtedness on the part of the seller thereby rendering these sukuk non-tradable in nature.

As at the date of this Guide no sukuk al-salam issuances have been listed by originators on NASDAQ Dubai.

Set out on the following page is an example of a sukuk al-salam structure.

Figure 4: Structure of Sukuk al-Salam



Overview of Structure

(Using the numbering from Figure 4 above)

1. Issuer SPV issues sukuk, which represent an undivided ownership interest in certain assets (the "Salam Assets") to be delivered by Originator. They also represent a right against Issuer SPV to payment of the Periodic Distribution Amount and the Dissolution Amount.

2. The Investors subscribe for sukuk and pay the proceeds to Issuer SPV (the "Principal Amount"). Issuer SPV declares a trust over the proceeds (and any assets acquired using the proceeds – see paragraph 3 below) and thereby acts as Trustee on behalf of the Investors.

3. Originator enters into a sale and purchase arrangement with Trustee, pursuant to which Originator agrees to sell, and Trustee agrees to purchase, the Salam Assets from Originator on immediate payment and deferred delivery terms. The quantity of the Salam Assets sold will typically be engineered at the outset to be an amount that is sufficient to make periodic deliveries of a proportion

of the Salam Assets during the life of the sukuk (in order to allow for payments of Periodic Distribution Amounts, see below for further information) and to make a single delivery of the remaining proportion of Salam Assets on maturity or an early redemption of the sukuk (in order to allow for payments of the Exercise Price, see below for further information).

4. Trustee pays the sale price to Originator as consideration for its purchase of the Salam Assets in an amount equal to the Principal Amount.

5. Prior to each date on which Periodic Distribution Amounts are due to the Investors, Originator delivers a proportion of the Salam Assets to Trustee.

6. Originator (as Obligor) purchases a proportion of the Salam Assets from Trustee for an agreed Purchase Price.

7. Originator pays the Purchase Price as consideration for purchasing a proportion of the Salam Assets. The amount of each Purchase Price is equal to the Periodic Distribution Amount payable under the sukuk at that time. This amount will be calculated by reference to a fixed rate or variable rate (e.g. LIBOR or EIBOR) depending on the denomination of sukuk issued and subject to mutual agreement of the parties in advance.

8. Issuer SPV pays each Periodic Distribution Amount to the Investors using the Purchase Price it has received from Originator.

9. Upon:
   (i). An event of default or at maturity (at the option of Trustee under the Purchase Undertaking); or

   (ii). The exercise of an optional call (if applicable to the sukuk) or the occurrence of a tax event (both at the option of Originator under the Sale Undertaking),

   Originator will be obliged to deliver all of the Salam Assets (which have not yet been delivered) to Trustee and Trustee will sell, and Originator will buy, the Salam Assets at the applicable Exercise Price which will be equal to the Principal Amount plus any accrued but unpaid Periodic Distribution Amounts owing to the Investors.

10. Payment of Exercise Price by Originator (as Obligor).

11. Issuer SPV pays the Dissolution Amount to the Investors using the Exercise Price it has received from Originator.

Key Features of the Underlying Structure

Set out below is a summary of the basic requirements based on established principles and the AAOIFI Shari'a Standards No.10 (Salam and Parallel Salam), which should be considered when using salam as the underlying structure for the issuance of sukuk:

- There must be no uncertainty between

the Originator and the Issuer as to the currency, amount and manner of payment of the salam capital;

- Payment of the salam capital must be made immediately at the time of entry into the salam contract;

- The Salam Assets can only be (i) fungible goods that can be weighed, measured or counted and the individual articles of which do not differ significantly, or (ii) assets manufactured by companies that can be identified by standardised specifications and are regularly and commonly available at any time;

- The Salam Assets cannot be (i) a specific asset; (ii) gold, silver or any currency if the salam capital was paid in gold, silver or any currency; (iii) any asset or item for which the Originator may not be held responsible (e.g. land or trees); and (iv) any asset or item whose value can change according to subjective assessment (e.g. precious stones);

- The Salam Assets must be assets for which a specification can be drawn up at the time of sale so that the Originator can be held to that specification;

- The quality, quantity and time of delivery of the Salam Assets must be clearly known to the Originator and the Trustee in a manner that removes any uncertainty or ambiguity which may lead to a dispute;

- Provided that the salam capital is paid at the time the salam contract is entered into, the delivery of the Salam Assets can occur periodically by way of instalments;

- The Trustee cannot sell the Salam Assets before it has taken delivery of the Salam Assets as this would amount to the sale of a debt, which is forbidden under Shari'a. However, delivery of the Salam Assets prior to the agreed delivery date is permissible;

- The sukuk certificates held by the Investors are generally non-tradable as they represent a debt (the debt being the future delivery of the Salam Assets). This is, however, the general position. In principle, once the Salam Assets (or a proportion thereof) have been delivered and provided that as a result of such delivery the tangibility of the pool of sukuk assets at that time (i.e. the Salam Assets delivered) is sufficient to satisfy Shari'a requirements (which can vary between 33% and 50%) the sukuk can be traded at that time; and

- The liabilities associated with the Salam Assets remain with the Originator and only once the Salam Assets have been delivered to the Trustee do the liabilities pass to the Trustee.

Required Documentation

In addition to the offering, trust and listing documentation (the requirements of which are discussed in more detail in Chapter 3 (Issuing Sukuk from the DIFC) and Chapter 4 (Listing Sukuk on NASDAQ Dubai)), the following documentation is typically required for a sukuk al-salam transaction:

Table 4

Document	Parties	Summary / Purpose
Salam Agreement	Originator (as Seller) and Trustee (as Purchaser)	From the Trustee›s (and the Investors') perspective, this is the document which gives the right to receive delivery of the Salam Assets, which once delivered to the Trustee will be sold by the Trustee in order to generate revenue to service the sukuk. From the Originator's perspective, this is the document under which it receives the funding.
Purchase Undertaking (Wa'd)	Granted by Originator (as Obligor) in favour of Trustee	Allows the Trustee to sell the Salam Assets back to the Originator*: (i) periodically, prior to the date on which a Periodic Distribution Amount is due in return for which the Originator is required to pay an amount equal to the Periodic Distribution Amount (through the Purchase Price) so that the Trustee can pay the Periodic Distribution Amount to the Investors; and (ii) if an event of default occurs or at maturity, in return for which the Originator is required to pay all outstanding amounts (through an Exercise Price) so that Trustee can pay the Investors.
Sale Undertaking (Wa'd)	Granted by Trustee in favour of Originator (as Obligor)	Allows the Originator to buy the Salam Assets back from the Trustee* in limited circumstances (e.g., the occurrence of a tax event), in return for which the Originator is required to pay all outstanding amounts (through an Exercise Price) so that Trustee can pay the Investors.

* The sale of the Salam Assets by the Trustee to the Originator can only occur after the Originator has delivered (either physically or constructively) the Salam Assets (or, in the case of periodic sales, a proportion thereof) to the Trustee.

Related Structures / Structural Developments

Although Islamic financial markets have seen rapid growth in recent times in the size and number of sukuk issuances, the use of sukuk al-salam by originators and Islamic financial institutions has been very limited. As a direct consequence of this, there has been a significant lack of development of the structure outlined above.

An alternative to the sukuk al-salam arrangement described above, and one that has been implemented in practice (for example, by the Central Bank of Bahrain) for short term investment purposes, is where the Originator does not buy back the Salam Assets under the Purchase Undertaking but is instead appointed by the Trustee as its agent to sell the Salam Assets at the time of delivery through its distribution channels to a third party in the open market for a price at least equal to the amounts due under the sukuk. This would, however, expose the Investors to risk that the Originator either: (i) may not be able to sell the Salam Assets to a third party; (ii) may be able to sell the Salam Assets but at a price lower than the amount due under the sukuk; and (iii) where a third party has already undertaken to purchase the Salam Assets, that third party fails to do so.

Chapter 2

Part 5: Sukuk al-Istisna

Introduction

Alternatively referred to as the "Islamic project bond", the structure of sukuk al-istisna has not been that widely used. Although, at first glance, the structure appears ideal for the financing of greenfield development, certain structural drawbacks have proven difficult to overcome and, as a result, sukuk al-istisna has not featured as an alternative source of Islamic funding on multi-sourced project financing in the manner once predicted.

Of particular significance is the prevailing view that sukuk al-istisna are not tradable during the construction period. In addition to this, the different approaches taken by Shari'a scholars to advance rentals and istisna termination payments have also led structurers to consider other more 'flexible' structures (such as sukuk al-musharaka).

Broadly speaking, istisna translates as being 'to order a manufacturer to manufacture a specific good for the purchaser'. Under an istisna, it is important that the price and specification of the good to be manufactured are agreed at the outset.

In the modern day context of Islamic finance, the istisna has developed into a particularly useful tool in the Islamic funding of the construction phase of a project – it is often regarded as being similar to a fixed-price 'turnkey' contract.
In order to enable investors to receive a return during the period where assets are being constructed under an istisna arrangement, some Shari'a scholars have permitted the use of a forward lease arrangement (known as ijara mawsufah fi al-dimmah) alongside such istisna arrangement. Accordingly, sukuk al-istisna often combines an istisna arrangement with a forward lease arrangement – whilst the istisna is the method through which the investors can advance funds to an originator, the ijara provides the most compatible payment method to those investors.

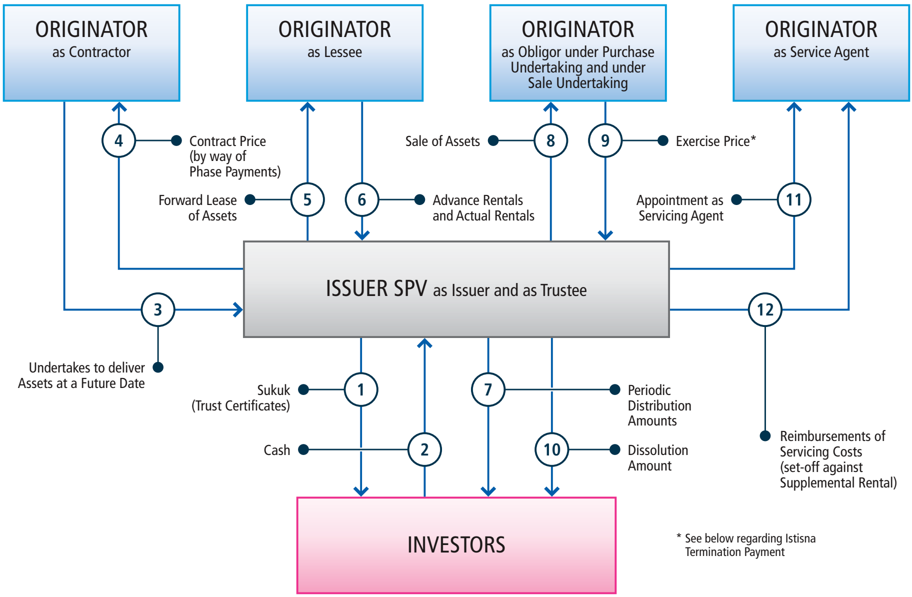
The use of staged payments (a common feature in istisna construction arrangements – see further below) may however result in an unutilised amount of sukuk proceeds being held in the structure for a prolonged period during construction (pending the achievement of the relevant milestones). Accordingly, it may be necessary to consider investing these amounts in Shari'a-compliant investments in order to mitigate negative carry (i.e. periodic distributions continue to be payable whilst cash remains unutilised – a position which is likely to be unacceptable to the originator). It should, however, be noted that this approach to investment of the unutilised sukuk proceeds has received some criticism.

As of the date of publication, there are no sukuk al-istisna issuances listed by originators on NASDAQ Dubai.

The Qatar Real Estate Investment Company (QREIC) sukuk offering in 2006, which has an istisna component to its structure, is listed on the Euro MTF market of the Luxembourg Stock Exchange. The 2008 issue of a second sukuk by National Central Cooling Company (Tabreed) also has an istisna and is listed on the London Stock Exchange.

Set out in the following page is a basic example of a sukuk al-istisna structure.

Figure 5: Structure of Sukuk al-Istisna



Overview of Structure

(Using the numbering from Figure 5 above)

1. Issuer SPV issues sukuk, which represent an undivided ownership interest in an underlying asset or transaction. They also represent a right against Issuer SPV to payment of the Periodic Distribution Amount and the Dissolution Amount.

2. The Investors subscribe for sukuk and pay the proceeds to Issuer SPV (the "Principal Amount"). Issuer SPV declares a trust over the proceeds (and any assets acquired using the proceeds - see paragraph 3 below) and thereby acts as Trustee on behalf of the Investors.

3. Originator enters into an istisna arrangement with Trustee, pursuant to which Originator agrees to manufacture or construct certain assets (the "Assets") and undertakes to deliver those Assets at a future date, and Trustee agrees to commission those Assets for delivery at such future date.

4. Trustee pays a price (typically by way of staged payments against certain milestones) to Originator as consideration for the Assets in an aggregate amount equal to the Principal Amount.

5. Trustee undertakes to lease the Assets to Originator under a forward lease arrangement (known as ijara mawsufah fi al-dimmah) for an overall term that reflects the maturity of the sukuk.

6. Originator (as Lessee) makes payments of:
   (i). Advance Rental prior to the delivery of the Assets; and

   (ii). Actual Rental following the delivery of the Assets,

   at regular intervals to Trustee (as Lessor) in amounts which are equal to the Periodic Distribution Amount payable under the sukuk at that time. These amounts may be calculated by reference to a fixed rate or variable rate (e.g. LIBOR or EIBOR) depending on the denomination of sukuk issued and subject to mutual agreement of the parties in advance.

7. Issuer SPV pays each Periodic Distribution Amount to the Investors using the Advance Rental or, as the case may be, the Actual Rental it has received from Originator.

8. Provided that delivery of the Assets has occurred, upon:
   (i). an event of default or at maturity (at the option of Trustee under the Purchase Undertaking); or

   (ii). the exercise of an optional call (if applicable to the sukuk) or the occurrence of a tax event (both at the option of Originator under the Sale Undertaking),

   Trustee will sell, and Originator will purchase, the Assets at the applicable Exercise Price, which will be equal to the Principal Amount plus any accrued but unpaid Periodic Distribution Amounts owing to the Investors. Any termination occurring prior to the delivery of the Assets will be dealt with under the istisna arrangement - with a refund and compensation amount (an "Istisna Termination Payment") being required in order to leave Issuer SPV with a claim against Originator for an amount sufficient to cover the Dissolution Amount (taking into account that the Issuer SPV will also be required to refund Advance Rentals to the Originator (as Lessee) under the forward lease arrangement – see further below).

9. Payment of Exercise Price by Originator (as Obligor) or, if termination occurs prior to delivery of the Assets, payment of the Istisna Termination Payment by Originator (as Contractor).

10. Issuer SPV pays the Dissolution Amount to the Investors using the Exercise Price (or, if termination occurs prior to delivery of the Assets, the Istisna Termination Payment) it has received from Originator.

11–12. Trustee and Originator will enter into a service agency agreement whereby Trustee will appoint Originator as its Servicing Agent, on and from delivery of the Assets, to carry out certain of its obligations under the forward lease arrangement, namely the obligation to undertake any major maintenance, insurance (or takaful) and payment of taxes in connection with the Assets. To the extent that Originator (as Servicing Agent) claims any costs and expenses for performing these obligations (the "Servicing Costs") the Actual Rental for the subsequent lease period under the forward lease arrangement will be increased by an equivalent amount (a "Supplemental Rental"). This Supplemental Rental due from Originator (as Lessee) will be set off against the obligation of Trustee to pay the Servicing Costs.

Key Features of the Underlying Structure

Set out below is a summary of the basic requirements that should be considered when using a combination of istisna and forward leasing as the underlying structure for the issuance of sukuk:

- The price and specifications for the good or asset need to be specified at the outset;
- It is quite common for the purchaser to split the purchase price (paid in advance) into staged payments that correspond to certain milestones that are agreed upfront with the contractor;
- Although it is not necessary to fix the time of delivery under the istisna, the purchaser may elect to fix a maximum time for delivery - this essentially means that, if the contractor delays delivery after the scheduled completion date, the purchaser will not be bound to accept the goods and to pay the price;
- Liquidated damages provisions may be included in order to incentivise the contractor to deliver on schedule (and to mitigate late delivery risk);
- Although not universally accepted, the majority of Shari'a scholars consider forward leasing permissible on the understanding that: advance rentals are taken into account (as rental which has been paid) and have to be refunded in full if the assets are never actually delivered for leasing. Such matters have to be carefully addressed in the documentation in order to ensure that the commercial deal is not disturbed: for example, by careful calculation of any termination payments that are triggered if a termination occurs pre-delivery (i.e. it becomes necessary to ensure that the amount payable by the contractor upon termination of the istisna arrangement is sufficient to cover the Dissolution Amount); and
- Following delivery of the asset(s), the basic requirements of an ijara discussed earlier in this Chapter 2 (Sukuk Structures) at Part 1: Sukuk al-Ijara in the section titled 'Key Features of the Underlying Structure' would otherwise apply.

The above requirements are based on the principles set out in AAOIFI Shari'a Standard No. 11 (Istisna and Parallel Istisna) and other established principles relating to istisna.

Required Documentation

In addition to the offering, trust and listing documentation (the requirements of which are discussed in more detail in Chapter 3 (Issuing Sukuk from the DIFC) and Chapter 4 (Listing Sukuk on NASDAQ Dubai)), the following documentation is typically required for a sukuk al-istisna transaction:

Table 5

Document	Parties	Summary / Purpose
Istisna Agreement	Originator (as Contractor) and Trustee (as Purchaser)	From Trustee›s (and the Investors›) perspective, this is the document that gives ownership of revenue generating assets (i.e. the Assets) at a future date. From Originator's perspective, this is the document under which it receives funding. Certain termination rights are granted to Trustee such that, prior to delivery of the Assets, Trustee is able to claim a refund and compensation amount (by way of an Istisna Termination Payment) sufficient to cover the Dissolution Amount.
Forward Lease (Ijara Mawsufah fi al-Dimmah) Agreement	Trustee (as Lessor) and Originator (as Lessee)	This contains an undertaking to lease such that, following delivery of the Assets, Trustee leases the Assets to Originator in a manner that: i. gives Originator possession and use of the Assets so that its principal business can continue without interruption; and ii. through Actual Rentals it generates a debt-based return for Trustee (and the Investors). Prior to delivery of the Assets, Advance Rentals are paid by Originator in order to generate a debt-based return for Trustee (and the Investors).
Service Agency Agreement	Trustee (as Lessor / Principal) and Originator (as Servicing Agent)	On and from delivery of the Assets, this allows Trustee to pass responsibility for major maintenance, insurance (or takaful) and payment of taxes (i.e. an owner's obligations) back to Originator. Any reimbursement amounts or service charges payable to Servicing Agent are set off against (i) a corresponding 'supplementary rental' under the Forward Lease or (ii) an additional amount which is added to the Exercise Price…

Document	Parties	Summary / Purpose
		(payable under the Purchase Undertaking or the Sale Undertaking, as applicable).
Purchase Undertaking (Wa'd)	Granted by Originator (as Obligor) in favour of Trustee	Allows Trustee to sell the Assets back to Originator if an event of default occurs or at maturity, in return for which Originator is required to pay all outstanding amounts (through an Exercise Price) so that Trustee can pay the Investors. Applies only on and from delivery of the Assets.
Sale Undertaking (Wa'd)	Granted by Trustee in favour of Originator (as Obligor)	Allows Originator to buy the Assets back from Trustee in limited circumstances (e.g. the occurrence of a tax event), in return for which Originator is required to pay all outstanding amounts (through an Exercise Price) so that Trustee can pay the Investors. Applies only on and from delivery of the Assets.

Structural Developments and Observations

The following structural refinements are possible in respect of the sukuk al-istisna structure described above:

- If legal and/or registered title to a particular asset exists and (due to, by way of example, the prohibitive cost implications or tax implications of registering such a transfer of title) it is not possible to transfer that legal / registered title, it may be possible, depending on the asset type and the view taken by the relevant Shari'a scholars, to rely upon the concept of beneficial ownership in structuring a sukuk al-istisna transaction. The istisna agreement (in the structure discussed above) would document the transfer to the trustee of the beneficial ownership interest in the underlying asset - and such beneficial ownership interest would be sufficient to enable the trustee's entry into the forward leasing arrangements contemplated in the example above; and
- Some Shari'a scholars regard the istisna arrangement as one that has to be entered into strictly between the purchaser and the contractor – and that the contractor has to be the person who will actually construct or manufacture the asset. Adopting this approach, the Trustee would be required to have a relationship directly with the ultimate contractor / manufacturer and not the Originator. In order to avoid the difficulties of such an analysis, it is sometimes necessary to re-characterise the istisna arrangement as a procurement arrangement, whereby the Originator is obliged to procure the construction / manufacture and delivery of the underlying asset(s). The Originator thereby retains the direct contractual relationship with the ultimate contractor / manufacturer.

Part 6: Sukuk al-Murabaha

Introduction

Although the sukuk al-murabaha structure is less commonly used in comparison to some of the other sukuk structures described in this Chapter 2 (Sukuk Structures), it could be considered as a possible alternative where it is not possible to identify a tangible asset for the purposes of the underlying investment.

In the Islamic finance industry, the term murabaha is broadly understood to refer to a contractual arrangement between a financier (the seller) and a customer (the purchaser) whereby the financier would sell specified assets or commodities to the customer for spot delivery in the expectation that the customer would be able to meet its deferred payment obligations under the murabaha agreement. The deferred price would typically include the cost price at which the financier had purchased the assets/commodities, plus a pre-agreed mark-up representing the profit generated from its involvement in the transaction. The payments of the deferred price from the customer may be structured as periodical payments on dates specified at the outset, thus creating an income stream for the financier for the term of the transaction.

The same characteristics of the murabaha structure can also be adapted for use as the underlying structure in a sukuk issuance. Sukuk proceeds from Investors may be applied by Issuer SPV to acquire commodities and on-sell such commodities to the Originator to generate revenue from the murabaha deferred price which would be distributed to the Investors throughout the term of the sukuk al-murabaha.

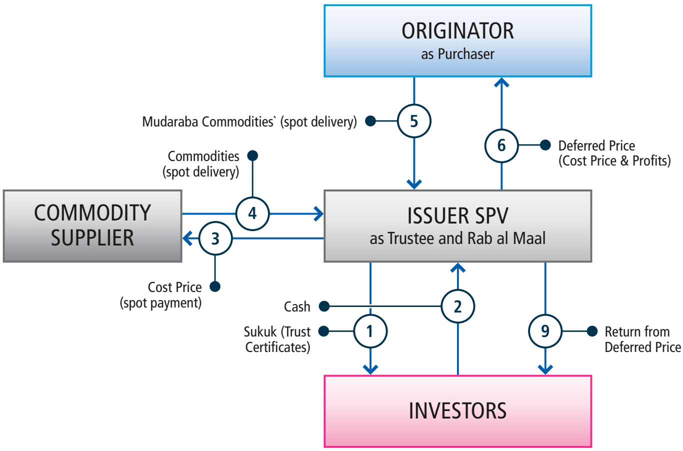
As the sukuk certificates in a sukuk al-murabaha essentially represent entitlements to shares in receivables from the purchaser of the underlying murababa, they are not negotiable instruments that can be traded on the secondary market because Shari'a does not permit trading in debt except at par value. This reduces the popularity of sukuk al-murabaha for potential investors and is reflected by the limited number of sukuk al-murabaha issuances in the sukuk market.

An example of a sukuk al-murabaha issuance is: Arcapita Bank, US$200million issued in October 2005.

Despite being debt instruments, sukuk al-murabaha certificates may still be negotiable if they form a small part of a larger portfolio comprising mostly of other negotiable instruments such as sukuk al-ijara, sukuk al-musharaka, and/or sukuk al-mudaraba.

Set out on the following page is an example of a typical sukuk al-murabaha structure.

Figure 6: Structure of Sukuk al-Murabaha



Overview of Structure

(Using the numbering from Figure 6 above)

1. Issuer SPV issues sukuk, which represent an undivided ownership interest in an underlying asset or transaction. They also represent a right against Issuer SPV to payment of the Deferred Price.

2. The Investors subscribe for sukuk and pay the proceeds to Issuer SPV (the "Principal Amount"). Issuer SPV declares a trust over the proceeds (and any commodities acquired using the proceeds – see paragraph 3 below) and thereby acts as Trustee on behalf of the Investors.

3. Originator (as Purchaser) enters into a murabaha agreement with Trustee (as Seller), pursuant to which Trustee agrees to sell, and Originator agrees to purchase, certain commodities (the "Commodities") from Trustee on spot delivery and deferred payment terms. The period for the payment of the deferred price will reflect the maturity of the sukuk. Trustee purchases the Commodities from a third party Commodity Supplier for a Cost Price representing the Principal Amount for spot payment.

4. Commodity Supplier makes spot delivery of the Commodities to Trustee in consideration for the Cost Price.

5. Trustee (as Seller) on-sells to Originator the Commodities upon delivery from Commodity Supplier in accordance with the terms of the murabaha agreement.

6. Originator (as Purchaser) makes payments of deferred price at regular intervals to Trustee (as Seller). The amount of each deferred price instalment is equal to the returns payable under the sukuk at that time.

7. Issuer SPV pays each deferred price instalment to the Investors using the proceeds it has received from Originator.

Key Features of the Underlying Structure

Set out below is a summary of the basic requirements which should be considered when using murabaha as the underlying structure for the issuance of sukuk:

- The consideration (deferred price) must be at an agreed rate and for an agreed period;

- In order to ensure that Issuer SPV obtains marketable title to the Commodities from Commodity Supplier to facilitate their on-sale to Originator, Issuer SPV may require certain representations and warranties from the Commodity Suppler that the Commodities will be purchased free of any encumbrances or liens;

- During the period of ownership of the Commodities by Issuer SPV, there is a risk of price fluctuation in the market value of the Commodities which can be mitigated by minimising the duration of Issuer SPV's ownership and specifying the deferred price payable by Originator (as Purchaser;

- If Originator requests physical delivery (as opposed to constructive delivery), there may be a risk that the Commodities are damaged whilst in transit which may be mitigated by undertakings from Originator in the murabaha agreement to accept the Commodities on an "as is" basis;

- To streamline the administrative processes involved in the purchase of the Commodities from the Commodity Supplier and its immediate on-sale to the Purchaser, the Trustee may appoint the Originator as its buying agent under a buying agency agreement to buy the commodities from the Commodity Supplier in its capacity as agent. Following the purchase of Commodities from the Commodity Supplier, the Trustee would (as principal) sell the same Commodities to the Originator (as Purchaser); and

- Depending on the type of Commodities involved, and the jurisdiction of the parties, tax liabilities in respect of the acquisition and sale of the Commodities should be considered in order to maximise the preservation of the Principal Amount in the Cost Price.

Required Documentation

In addition to the offering, trust and listing documentation (the requirements of which are discussed in more detail in Chapter 3 (Issuing Sukuk from the DIFC) and Chapter 4 (Listing Sukuk on NASDAQ Dubai)), the following documentation is typically required for a sukuk al-murabaha transaction:

Table 6

Document	Parties	Summary / Purpose
Murabaha Agreement	Originator (as Purchaser) and Trustee (as Seller)	Trustee (and the Investor) sells Commodities to Originator on spot delivery and deferred payment terms. Documents the terms of the murabaha sale transaction as well as terms of payment of deferred price.
Sale and Purchase Agreement	Trustee (as Buyer) and Commodity Supplier (as Supplier)	Commodity Supplier sells Commodities to Trustee on spot delivery and spot payment terms.

Related Structures/Structural Developments

Shari'a prohibits the trading of debt receivables, particularly when doing so at a discount may give rise to interest (riba). As discussed earlier, this limits the negotiability of sukuk certificates issued under the sukuk al-murabaha structure as such certificates essentially represent entitlements to shares of debt receivables from the purchaser of the underlying murabaha, and this structure has thus been less commonly used in recent times. However, the following should also be noted:

- Sukuk al-murabaha certificates would be negotiable if they were issued prior to the sale of the murabaha commodities from the Originator to the underlying purchaser. This is because the Shari'a analysis turns on whether there is some ongoing ownership stake between the Investor and the sukuk asset following a transfer of the sukuk certificate (which is permitted) or whether the transfer shifts ownership and creates a debt obligation on a third party (not permitted). As such, sukuk certificates issued prior to a murabaha commodity sale would represent ownership in those commodities rather than the right to the receivables generated by their sale;
- The transfer of sukuk al-murabaha certificates is permitted even if they are issued after the sale of commodities under the underlying murabaha, so long as they are traded at face value (rather than sold at a discount or a profit); and

- Sukuk certificates derived from an underlying murabaha structure may still be negotiable if the murabaha receivables form a small proportion (exact percentages may vary depending on the transaction and the analysis of each Shari'a scholar) of a larger portfolio of sukuk assets comprising mostly other negotiable instruments such as sukuk al-ijara, sukuk al-musharaka, and/or sukuk al-mudaraba.

  Despite the global downturn in sukuk issuance in 2008, issuances based on the sukuk al-murabaha structure increased by nearly 60%[4]. Whilst sukuk al-murabaha issuances still only account for a small fraction of the total value of the sukuk market, the increased number of issuances suggest that the structure is still favoured for smaller deals, where the Investors are more likely to be buy-to-hold investors hence more immune to uncertainties over negotiability.

4 "Global Sukuk Issuance: 2008 slowdown mainly due to Credit Crisis, but some impact from Shari'a Compliance Issues" (January 2009), Moody's Investor Service.

Part 7: Sukuk al-Istithmar

Introduction

As noted earlier in this Chapter 2 (Sukuk Structures), the first step in structuring a sukuk is often to analyse what exactly the business of an originator entails and what assets (if any) are available to support the issuance of sukuk. If it is not possible to identify a tangible asset and the business of such originator is largely 'intangible', then structuring a sukuk issuance can still be achieved (although not universally accepted).

Perhaps the best examples of this involve Islamic financial institutions and their rights to receivables under a variety of different Islamic financing techniques (evidenced through Islamic contracts with these institutions' customers / clients). It is possible for the rights under these Islamic contracts to be packaged together and 'sold' in order to form the underlying basis for issuing sukuk. However, care needs to be taken so as to ensure that this is not construed as trading in debt.

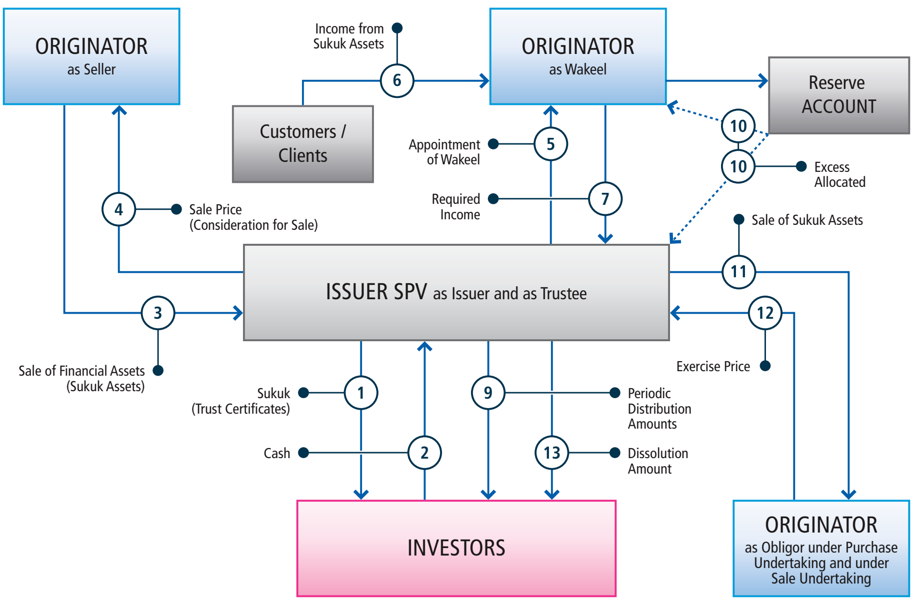
The term "istithmar" is broadly understood to mean an "investment". Under a sukuk al-istithmar structure it is possible for ijara contracts (and the relevant underlying assets), murabaha receivables, and/or istisna receivables (each generated by the originator), as well as shares and/or sukuk certificates to be packaged together and sold as an investment. The income generated by such investment can then be used to make payments to the investors under the sukuk.

As of the date of publication, there are no sukuk al-istithmar issuances listed by originators on NASDAQ Dubai.

Examples of sukuk al-istithmar issuances advised on by Clifford Chance LLP and listed elsewhere include Islamic Development Bank's 2009 issuance (listed on the London Stock Exchange).

Set out in the following page is an example of a sukuk al-istithmar structure, sometimes referred to as investment agency sukuk:

Figure 7: Structure of Sukuk al-Istithmar



Overview of Structure

(Using the numbering from Figure 7 above)

1. Issuer SPV issues sukuk, which represent an undivided ownership interest in an underlying asset or transaction. They also represent a right against Issuer SPV to payment of the Periodic Distribution Amount and the Dissolution Amount.

2. The Investors subscribe for sukuk and pay the proceeds to Issuer SPV (the "Principal Amount"). Issuer SPV declares a trust over the proceeds (and any assets acquired using the proceeds – see paragraph 3 below) and thereby acts as Trustee on behalf of the Investors.

3. Originator enters into a sale and purchase arrangement with Trustee, pursuant to which Originator agrees to sell, and Trustee agrees to purchase, a portfolio of certain financial assets (the "Sukuk Assets") from Originator.

4. Trustee pays the purchase price to Originator as consideration for its purchase of the Sukuk Assets in an amount equal to the Principal Amount.

5. Trustee appoints Originator as its wakeel (or agent) with respect to the Sukuk Assets for a term that reflects the maturity of the sukuk. Originator is responsible for servicing the Sukuk Assets and, in particular, collection of the income (comprising principal and profit) therefrom.

6. Originator collects income in respect of the Sukuk Assets from the relevant customers / clients and will deposit these amounts into a collection account (the "Collection Account").

7. At regular intervals, corresponding to Periodic Distribution Dates, Originator will be required to make income payments to Trustee in respect of the Sukuk Assets. This will be achieved through a target amount (the "Required Income") which is agreed for each collection period. The amount of Required Income during a collection period will be equal to the Periodic Distribution Amount payable under the sukuk at that time. This amount may be calculated by reference to a fixed rate or variable rate (e.g. LIBOR or EIBOR) depending on the denomination of sukuk issued and subject to mutual agreement of the parties in advance.

8. During a particular collection period, if the income amount collected in respect of the Sukuk Assets (as reflected in the Collection Account) is in excess of the Required Income such excess can either be:
   (i). credited to a reserve account (the "Reserve Account") with Originator; or

   (ii). in a case where a financial asset has matured (and principal therefrom has been repaid by the customer / client), and in order to avoid excess cash in the structure, used to purchase additional financial assets under the purchase arrangement referred to in paragraph 3 above (and which will then become Sukuk Assets).

   The balance in the Reserve Account (if any) can also be used to cover a shortfall in collections to meet the Required Income in any given collection period. In the event that there is a shortfall in both collections and the Reserve Account, it may be permissible for Originator to make an on-account payment or to provide Shari'a-compliant liquidity funding to bridge any gap in funding.

9. Issuer SPV pays each Periodic Distribution Amount to the Investors using the Required Income it has received from Originator.

10. Upon redemption of the sukuk (see paragraph 11 below), the balance of the Reserve Account (if any) will be paid (being the "Distributed Reserve Amount") to Trustee in order to enable the payment of the Dissolution Amount to the Investors. The excess (if any) will be retained by Originator as incentive fees.

11. Upon:
    (i). an event of default or at maturity (at the option of Trustee under the Purchase Undertaking); or

    (ii). the exercise of an optional call (if applicable to the sukuk) or the occurrence of a tax event (both at the option of Originator under the Sale Undertaking),

Trustee will sell, and Originator will purchase, the Sukuk Assets at the applicable Exercise Price, which will be equal to the Principal Amount plus any accrued but unpaid Periodic Distribution Amounts owing to the Investors less the Distributed Reserve Amount (if any)

12. Payment of Exercise Price by Originator (as Obligor).

13. Issuer SPV pays the Dissolution Amount to the Investors using the Exercise Price and the Distributed Reserve Amount (if any) it has received from Originator.

Key Features of the Underlying Structure

Set out below is a summary of the basic requirements that should be considered when using sukuk al-istithmar:

- It is likely that the customers / clients to whom the financial assets (comprised in the sukuk assets) relate will need to be informed about (and, in some instances, requested to consent to) the sale of those financial assets to the Trustee and the role of the Originator in acting on the trustee's behalf;
- In order to ensure the continuing acceptance and tradability of the sukuk, it will be necessary to introduce safeguards into the documentation to ensure that the net asset value of ijara contracts (together with underlying assets), shares and asset-based sukuk certificates (i.e. non-sukuk al-murabaha) comprised in the sukuk assets as at any given date is not less than 30%[5] of the net asset value of the sukuk assets (taken as a whole) as at the closing date;
- The role of a custodian may be required in order to ensure that the sukuk assets are sufficiently segregated from the other financial assets of the Originator;
- Principal amounts from the underlying financial assets should never be used to service coupon payments under the sukuk; and
- Although the wakala arrangement will require an upfront fee to be paid to the Originator (as wakeel), this can be combined with incentive fees payable at maturity based on the overall performance of the sukuk assets (but care should be taken to ensure that this does not amount to profit-sharing).

The above requirements are based on the principles set out in AAOIFI Shari'a Standards No. 17 (Investment Sukuk), No. 21 Financial Paper (Shares and Bonds) and No. 23 (Agency) and other established principles relating to the concept of istithmar.

5 This is the minimum percentage of tangible assets as prescribed by AAOIFI. However, note that a higher threshold (in some cases, up to 51%) may be required by certain Shari'a scholars.

Required Documentation

In addition to the offering, trust and listing documentation (the requirements of which are discussed in more detail in Chapter 3 (Issuing Sukuk from the DIFC) and Chapter 4 (Listing Sukuk on NASDAQ Dubai), the following documentation is typically required for a sukuk al-istithmar transaction:

Table 7

Document	Parties	Summary / Purpose
Sale and Purchase Agreement	Originator (as Seller) and Trustee (as Purchaser)	From Trustee's (and the Investors›) perspective, this is the document that gives ownership of revenue-generating financial assets (i.e. the Sukuk Assets). From Originator's perspective, this is the document under which it receives funding.
Wakala Agreement	Trustee (as Principal) and Originator (as Wakeel)	Trustee appoints Originator as Wakeel (or agent) in respect of the servicing of the Sukuk Assets, such that: Originator retains control of the Sukuk Assets so that its principal business can continue without interruption; and through collection of income and the target level of Required Income, it generates a return for Trustee (and the Investors).
Purchase Undertaking (Wa'd)	Granted by Originator (as Obligor) in favour of Trustee	Allows Trustee to sell the Sukuk Assets back to Originator if an event of default occurs or at maturity, in return for which Originator is required to pay all outstanding amounts (through an Exercise Price) so that Trustee can pay the Investors.
Sale Undertaking (Wa'd)	Granted by Trustee in favour of Originator (as Obligor)	Allows Originator to buy the Sukuk Assets back from Trustee in limited circumstances (e.g., the occurrence of a tax event), in return for which Originator is required to pay all outstanding amounts (through an Exercise Price) so that Trustee can pay the Investors.

Structural Developments and Observations

SDespite similarities in certain structural features, sukuk al-istithmar should be distinguished from sukuk al-mudaraba and sukuk al-wakala.

The following aspects of a sukuk al-istithmar issuance warrant further consideration:

- There are differing views as to how a shortfall during a collection period should be remedied – some Shari'a scholars would prefer to avoid using the purchase undertaking in this scenario and would instead look to the Originator to make good any shortfall through either on-account payments or provision of Shari'a-compliant liquidity funding. These arrangements are however not without their own difficulties;

- There are also differing opinions between the Shari'a scholars as to what is required (in terms of minimum thresholds and asset types) in order to maintain the tradability of the sukuk; and

- It may be necessary for certain roles of the Originator to be performed by another entity altogether and/or for a sub-agency or delegation arrangement to be put in place in order to overcome any residual concerns over the entity that will ultimately provide the purchase undertaking.

Part 8: Sukuk al-Wakala

Introduction

A more recent innovation in sukuk structures is the sukuk al-wakala. This structure stems from the concept of a wakala which, literally translated, means an arrangement whereby one party entrusts another party to act on its behalf. A wakala is thereby akin to an agency arrangement. A principal (the investor) appoints an agent (wakeel) to invest funds provided by the principal into a pool of investments or assets and the wakeel lends it expertise and manages those investments on behalf of the principal for a particular duration, in order to generate an agreed upon profit return. The principal and wakeel enter into a wakala agreement, which will govern the appointment, scope of services and fees payable to the wakeel, if any. The relationship between the principal and the wakeel must comply with certain basic conditions, which are described below in "Key Features of Sukuk al-Wakala".

The wakala structure is particularly useful where the underlying assets available to the originator, and which can be used to support the issuance of the sukuk, comprise a pool or portfolio of assets or investments as opposed to a particular tangible asset or assets. The wakeel thereby uses its expertise to select and manage investments on behalf of the investor to ensure that the portfolio will generate the expected profit rate agreed by the principal. While the wakala structure has some similarities with the mudaraba structure, the main difference is that unlike a mudaraba, in which profit is divided between the parties according to certain ratios, an investor via a wakala structure will only receive the profit return agreed between the parties at the outset. Any profit in excess of the agreed upon profit return will be kept by the wakeel as a performance or an incentive fee.

Some of the advantages of adopting the wakala structure are as follows:

(a) the portfolio of assets may comprise a broad range of Shari'a compliant assets that will be selected by the wakeel for a period of time corresponding to the duration of the sukuk. The criteria for the assets that may be included in the portfolio must be set or approved by the relevant Shari'a board that issues the fatwa. However, the range of assets may be fairly broad and could include equities (which are issued by companies complying with certain Shari'a guidelines or listed on Shari'a approved indices), other Shari'a compliant assets (such as murabaha, istisna or even other sukuk – see below) or even other types of derivative products, provided they meet Shari'a guidelines.

(b) it allows the originator (which may also be the wakeel) to build its balance sheet by acquiring the investments comprised in the portfolio and to utilise those investments as underlying assets for a sukuk issuance.

(c) it enables the originator to utilise certain assets that cannot be traded on the secondary market such as murabaha and istisna contracts . These products are debt arrangements and are financial assets and, as such, they are unsuitable as underlying assets for a sukuk issuance for trading purposes. However, they could form part of a portfolio of assets, provided that at least 30%[6] of the portfolio comprises tangible assets (such as ijara or equities or

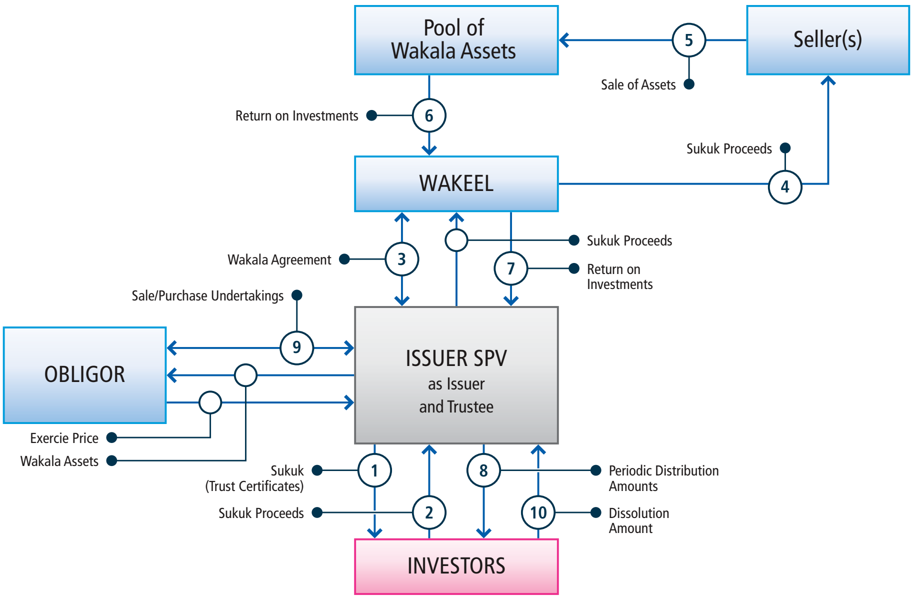
[6] This is the minimum percentage of tangible assets as prescribed by AAOIFI. However, note that a higher threshold (in some cases, up to 51%) may be required by certain Shari'a scholars.

other asset-based sukuk). This enables the originator to mix and match different types of assets and effectively utilise those assets which, by themselves, may not comply with the tangibility criteria. Therefore, the wakala structure may be particularly useful for Islamic banks and financial institutions, which tend to have a large number of commodity murabaha and istisna contracts on their balance sheets.

Due to the structural issues relating to the wakala structure (which are highlighted below), it has not been a popular structure for sukuk issuances. As a result, there are very few recent examples of sukuk al-wakala in the market.

Set out below is an example of a sukuk al-wakala structure:

Figure 8: Structure of Sukuk al-Wakala



Overview of Structure

(Using the numbering from Figure 8 above)

1. Issuer SPV issues the sukuk, which represent an undivided ownership interest in, inter alia, the wakala assets. They also represent a right of the investors against the Issuer SPV to payments of the Periodic Distribution Amounts and Dissolution Amounts.

2. The Investors subscribe for the sukuk in return for a fixed principal amount (the sukuk proceeds) payable to the Issuer SPV.

3. The Issuer SPV, in its capacity as principal, enters into a wakala agreement with the wakeel pursuant to which the wakeel agrees to invest the sukuk proceeds, on behalf of the Issuer SPV, in a pool or portfolio of investments (the wakala assets), selected by the wakeel, in accordance with specified criteria.

4. The sukuk proceeds will be used by the wakeel to purchase the selected wakala assets from one or more sellers.

5. The wakala assets will be held and managed by the wakeel, on behalf of the Issuer SPV, for the duration of the sukuk in order to generate an expected profit to be agreed upon by the principal. The wakala assets will constitute part of the trust assets held by the Issuer SPV (in its capacity as trustee) on behalf of the investors.

6. The wakala assets will generate a profit return, which will be held by the wakeel on behalf of the Issuer SPV.

7. The profit return will be used to fund the Periodic Distribution Amounts payable by the Issuer SPV to the Investors. Any profit in excess of the Periodic Distribution Amounts will be paid to the wakeel as an incentive fee. It is possible that the wakala assets may generate a return that is less than the Periodic Distribution Amounts. One possible mechanism used in the past, to ensure that there are sufficient funds to make up any shortfall between the income generated by the wakala assets and the Periodic Distribution Amounts due to Investors, is for the Obligor to agree (under the purchase undertaking) to purchase a certain portion of the wakala assets at regular intervals for an Exercise Price equal to the Periodic Distribution Amounts. However, following the AAOIFI Statement, the general view amongst Shari'a scholars is that it is not permissible for an Obligor to agree to purchase wakala assets for fixed or variable amounts (calculated by reference to a formula), as this would be akin to a guarantee of profit. This mechanism would only be acceptable under AAOIFI standards if the Seller and the Obligor were different entities (see "Key Features of the Underlying Structure" below).

8. The Periodic Distribution Amounts will be paid to the investors on the relevant periodic distribution dates. The Periodic Distribution Amounts will either be a fixed or variable amount calculated in accordance with a fixed formula (e.g., based upon LIBOR).

9. Upon:
   (i). the maturity date or upon the occurrence of an event of default, the Issuer SPV, in its capacity as trustee will exercise its option under the Purchase Undertaking to require the Obligor to purchase the wakala assets at an Exercise Price that is equal to the Dissolution Amount payable to investors together with any accrued but unpaid Periodic Distribution Amounts.

   (ii). the exercise of an optional call (if applicable) or the occurrence of a tax event, the Obligor will exercise its option under the Sale Undertaking to buy the wakala assets from the Issuer SPV, in its capacity as Trustee, at an Exercise Price that is equal to the Dissolution Amount payable to investors together with any accrued but unpaid Periodic Distribution Amounts.

10. Upon the occurrence of one of the events described in (9) above, the Issuer SPV, in its capacity as Trustee, will pay the Dissolution Amount to investors using the Exercise Price received from investors and redeem the sukuk, upon which the trust will be dissolved.

Key Features of the Underlying Structure

Set out below is a summary of the basic requirements that should be considered when using wakala as the underlying structure of the issuance of sukuk:

- The scope of the wakala arrangement must be within the boundaries of Shari'a i.e. the principal cannot require the wakeel to perform tasks that would not otherwise be Shari'a compliant.

- The subject matter of the wakala arrangement must be clear and unambiguous and must be set out in the wakala agreement i.e. the duration of the wakala, the type or criteria of assets that the wakeel can select, the fees payable to the wakeel for its services and the conditions for termination of the wakala agreement. Note that the wakeel must be paid a fee, even if nominal, in order for the wakala to be valid.

- The principal (the Issuer SPV) can only receive the expected profit, i.e., the amount used to fund the Periodic Distribution Amounts. Any excess will be held by the wakeel for its benefit.

- The wakala assets must comply with eligibility criteria. First, at least 30%[7] of the portfolio of assets should comprise tangible assets (such as ijara or equities or other asset-based sukuk). The Originator must therefore assess whether it has a sufficient quantity of the relevant assets to satisfy this ratio. In addition, a Shari'a board would typically impose further

[7] This is the minimum percentage of tangible assets as prescribed by AAOIFI. However, note that a higher threshold (in some cases, up to 51%) may be required by certain Shari'a scholars.

criteria, which may include (but not be limited to) the following:

(i). If the pool comprises equities, the wakeel may only purchase equities of companies where the primary business activity of the company is compliant with Shari'a – for example, the wakeel may not purchase equities of companies whose primary business activity is connected with alcohol, pork-related products, gambling or other haram activities (note that some Shari'a boards may permit the purchase of equities in companies involved in such activities provided that the revenue generated from such activities only forms a very small percentage (no more than 5%) of the aggregate revenue of the company).

(ii). The Shari'a board may impose certain financial ratios in relation to the acquisition of equities of listed and unlisted companies – this would relate to the ratio of conventional debt to equity on the company's balance sheet. Alternatively, the wakeel may purchase equities listed on an index that has been approved as Shari'a compliant.

(iii). If the pool comprises sukuk, the sukuk must have been approved by the relevant Shari'a board and must be fully backed by tangible assets.

(Note that there may be variations in the criteria imposed by different Shari'a boards. In addition, the above list of criteria is not exhaustive.)

- If any of the assets cease to be Shari'a compliant at any time during the duration of the sukuk, they must be removed from the pool of assets and be replaced with Shari'a-compliant assets. There must therefore be a mechanism for substituting assets. This may be achieved through the purchase undertaking or a separate substitution undertaking whereby the Obligor may be required to purchase the non-compliant asset from the pool in consideration for a new Shari'a-compliant asset.

- As mentioned above, the structure may contemplate that the Obligor shall fund payments of Periodic Distribution Amounts by purchasing certain proportions of the wakala assets for a fixed price under the purchase undertaking. However, the AAOIFI Statement has restricted the use of this mechanism to fund periodic distribution amounts except where the Obligor and the Seller are different entities and are independent of one another. Assuming that the relevant investments are held by the Obligor, those investments should first be sold to the Seller, who will in turn sell the assets on to the wakeel. However, the parties may only want an entity that is affiliated to the Obligor to act as the Seller. This may be acceptable to the Shari'a board provided that the Seller is not within the Obligor's group.

Required Documentation

Table 8

Document	Parties	Summary / Purpose
Wakala Agreement	Trustee (as principal) and wakeel	This document sets out the terms of the wakala, the fees payable to the wakeel, the duration of the wakala and the conditions for termination. It also sets out the eligibility criteria for the assets to be selected by the wakeel.
Asset Buying Agreement	Seller and wakeel	On behalf of Trustee, the wakeel will use the sukuk proceeds to purchase assets from the Seller that comply with the eligibility criteria.
Purchase Undertaking (Wa'd)	Granted by Originator (as Obligor) in favour of Trustee	Allows Trustee to sell the wakala assets back to Originator if an event of default occurs or at maturity, in return for which Originator is required to pay (through an Exercise Price) all outstanding amounts so the Trustee can pay the Investors.
Sale Undertaking (Wa'd)	Granted by Trustee in favour of Originator (as Obligor)	Allows Originator to buy the wakala assets back from Trustee in limited circumstances (e.g., the occurrence of a tax event), in return for which the Originator is required to pay all outstanding amounts (through an Exercise Price) so that Trustee can pay the Investors.
Substitution Undertaking (Wa'd) - OPTIONAL	Granted by Originator in favour of Trustee	Trustee may exercise its option to require the Originator to purchase any of the wakala assets that cease to be Shari'a compliant in return for new Shari'a compliant assets or cash, which will then be used to purchase new Shari'a-compliant assets.[8]

Related Structures/Structural Developments

- As mentioned above, the Periodic Distribution Amounts may be funded by the Obligor purchasing a portion of the wakala assets under the purchase undertaking (for an Exercise Price equal to the Periodic Distribution Amounts), provided that the Obligor and Seller are different entities. By utilising this mechanism, the payment

[8] Alternatively, this mechanism may be achieved via the purchase undertaking.

on the sukuk may be de-linked to the actual performance of the asset. This would also avoid certain other risks such as currency risks or the risk that the timing of payments on the investments will not match the periodic distribution dates, for which risk management mechanisms (similar to swaps) would need to be built into the structure. Instead these risks will be borne by the Obligor, which will be required to fund the Periodic Distribution Amounts (regardless of any shortfall in the income generated by the wakala assets or any currency or timing mismatches).

- Once an asset is purchased by the wakeel and included in the pool of wakala assets, it cannot be utilised by the originator, i.e., it cannot be sold or traded but must be held in the pool, until it is purchased by the Originator, through the purchase or sale undertakings. This may be undesirable from a commercial perspective, as the assets will be "locked up" for a period of time. In order to allow for some flexibility, a salam contract can be incorporated into the structure, whereby instead of the seller delivering all the Shari'a-compliant assets to the wakeel immediately upon purchase, some of the Shari'a-compliant assets can be delivered at certain specified dates in the future. Even though the purchase price is received up front, only a certain portion (which should be at least one-third of the total pool of assets) will be delivered immediately, thereby allowing the Originator to utilise its other assets, provided that it undertakes to deliver the required portion of Shari'a-compliant assets on the specified dates.

Part 9: Others

AAOIFI Shari'a Standard No.17 (Investment Sukuk), broadly define sukuk as certificates of equal value representing undivided shares in the ownership of tangible assets, usufructs and services, or in the ownership of the assets of particular projects or special investment activities. Sukuk can therefore be interposed on any underlying Shari'a-compliant structure. The previous parts of this Chapter 2 (Sukuk Structures) focused on those structures that are frequently implemented in the Islamic finance market. The AAOIFI Shari'a Standard, however, list other types of sukuk in addition to those already discussed. A summary of each these structures is set out below.

1. Sukuk al-Manfa'a
   The sukuk al-manfa'a structure envisages the grant to the Trustee of a long-term right to use an asset. This grant can take a number of forms depending on the nature of the asset involved but can include, for example, a headlease to the Trustee or an assignment or sale of certain rights in an asset to the Trustee. The Trustee, as owner of those rights to use, can apply those rights to use in order to generate returns for the Investors. The method in which the rights to use are applied can vary depending on the nature of the asset involved and the rights to use granted to the Trustee, but can include, for example, a sublease of the rights to use back to the Originator or appointing a distributor for the purposes of distributing the rights to generate returns for the Investors. Alternatively, the rights granted to the Trustee may already be generating returns and, as owner of those rights, the Trustee is entitled to receive those returns on behalf of the Investors.

2. Sukuk al-Muzara'a
   A muzara'a contract is used in relation to sharecropping. Under a sukuk al-muzara'a arrangement the Originator would typically be an owner of land or of the usufruct of that land and the subscribers would typically be farmers (or other cultivators) who assume the obligation of cultivating the land on the basis of a muzara'a contract. The farmers would cultivate the land and the proceeds of the issuance would represent the costs of the cultivation. Alternatively, the Originator can be the farmer that requires land and therefore issues sukuk al-muzara'a certificates to Investors. The proceeds of the issuance are then used to acquire the land for the purposes of cultivating it. In both situations, the holders of the sukuk are entitled to a share of the crop produced as a result of the cultivation. Where the Investors are the farmers, the sukuk can only be traded after the crop has been produced. However, where the Investors are the owners of the land, the sukuk can be traded once the sukuk have been issued and the activity on the land commences.

3. Sukuk al-Musaqa
   A musaqa contract is similar to a muzara'a contract except that it is used in relation to irrigating fruit-bearing trees and spending and caring for them. Under a sukuk al-musaqa arrangement the Originator would typically be an owner of land that consists of trees or of the usufruct of that land and the subscribers would typically be workers (i.e., irrigators) who assume the obligation of irrigating the land pursuant to a musaqa contract.

The irrigators would irrigate the trees and spend and care for them and the proceeds of the issuance would represent the costs of the irrigation and upkeep. Alternatively, the Originator can be the irrigator and the subscribers to the sukuk can be the owners of the land. The proceeds of the issuance are then used to finance the irrigation of the land. In both situations, the holders of the sukuk are entitled to a share of the produce of the trees. Where the Investors are the irrigators, the sukuk can only be traded after the produce of the trees has matured. However, where the Investors are the owners of the land, the sukuk can be traded once the sukuk have been issued and the activity on the land commences.

4. Sukuk al-Mugharasa
A mugharasa contract is used for planting trees and undertaking the work and expenses required by such plantation. Under a sukuk al-mugharasa arrangement the Originator would typically be an owner of land suitable for planting trees and the subscribers would typically be workers (i.e. planters) who assume the obligation of planting trees on the basis of a mugharasa contract. The planters would plant and maintain the trees and the proceeds of the issuance would represent the costs of maintaining the plantation. Alternatively, the Originator can be the planter and the subscribers to the sukuk can be the owners of the land. The proceeds of the issuance are then used to finance the plantation on the land. In both situations, the holders of the sukuk are entitled to a share in both the trees and the land. Sukuk al-mugharasa certificates can be traded after closing of subscription and once activity on the land commences (irrespective of whether the holders of the sukuk are planters or owners of the land).

Chapter 3
Issuing Sukuk from the DIFC

Issuing Sukuk from the DIFC

Introduction to the DIFC[9]

The Dubai International Financial Centre is the pre-eminent international financial centre in the GCC. It serves the vast region between Western Europe and East Asia, tapping into a region of 2.1 billion people and a combined economy worth US$1.8 trillion in terms of GDP that is growing at an annual rate in excess of 5%. With its mission to be a catalyst for regional growth, development and diversification, the DIFC is part of the larger vision of His Highness Sheikh Mohammed bin Rashid Al Maktoum, Vice President and Prime Minister of the UAE and Ruler of Dubai, together with the Government of Dubai, to create an environment for progress and economic development in the UAE and the wider region.

The DIFC was designed to:

- Attract liquidity into investment opportunities within the region and contribute to its economic growth;
- Facilitate planned privatisations and enable initial public offerings by privately owned companies, giving impetus to the programme of deregulation and market liberalisation throughout the region;
- Create added insurance and reinsurance capacity – 65% of annual premiums are reinsured outside the region; and
- Develop a global centre for Islamic Finance – an over US$260 billion international market serving large Islamic communities stretching from Malaysia and Indonesia to the United States.

Unlike 'offshore' centres, such as Jersey, Bermuda or the Cayman Islands, the DIFC is a fully fledged 'onshore' international finance centre, aspiring to develop the same stature as leading global centres such as Hong Kong, London and New York.

The DIFC is set up as a separate jurisdiction within the UAE, with laws and financial regulations based on common law, and with the highest international standards in supervision and enforcement. The centre is managed by the Dubai International Financial Centre Authority, and its important bodies also include the Dubai Financial Services Authority ("DFSA"), the independent regulator, the DIFC Courts, the DIFC-LCIA Arbitration Centre, and the stock exchange, NASDAQ Dubai (formerly known as the Dubai International Financial Exchange or DIFX), that opened in September 2005.

Since it opened in September 2004, the DIFC has attracted leading players in financial services and related service sectors from around the globe as well as from the Middle East. As of September 2009, close to 900 companies have been registered to operate from the DIFC.

[9] Source: www.difc.ae.

Sectors of Activity in the DIFC

The DIFC focuses on several sectors of financial activity: Banking and Brokerage (investment, corporate and private banking); Capital Markets (equity, debt instruments, derivatives and commodity trading); Wealth Management (asset management, funds and family offices); Insurance, Reinsurance and Captives; Islamic Finance and Ancillary Services (comprising all service sectors of importance in the financial services industry, such as legal, accounting, rating and market information, compliance, recruitment and management consulting services).

Firms operating in the DIFC are eligible for benefits such as a zero tax rate on profits, 100% foreign ownership, a US dollar-denominated environment, no restrictions on foreign exchange or repatriation of capital, a wide network of double taxation treaties available to UAE incorporated entities, operational support, ultra modern office accommodation, state-of-the-art technology, sophisticated infrastructure, data protection/security, operation support and business continuity facilities of uncompromisingly high standards. Financial services in the DIFC are regulated to international standards by the Dubai Financial Services Authority ("DFSA"). This ensures a transparent operating environment with best-practice rules and regulations and strict supervision and enforcement of anti-money laundering laws.

Issuance of Sukuk

As noted previously, from a legal and regulatory perspective, as well as otherwise, the DIFC seeks to facilitate and encourage the issuance of sukuk. In the majority of sukuk transactions, the issuer of the sukuk certificates is also the trustee of the relevant trust assets which are held for the benefit of the holders of the sukuk certificates. To date, the issuer/trustee has generally been a special purpose vehicle established in a jurisdiction such as the Channel Islands or the Cayman Islands.

With the introduction of the Dubai International Financial Centre Authority ("DIFCA") Special Purpose Company Regulations (the "SPCoR"), which allow for the establishment of special purpose companies ("SPCs") in the DIFC, the DIFC is now well positioned to provide an alternative to the Channel Islands or the Cayman Islands and to allow the potential future issuance of sukuk from the DIFC.

Special Purpose Companies in the DIFC

Under the new regulations, an SPC is a company limited by shares that is established under standard articles of association published by the DIFCA. Each SPC will be registered in the General Register of Companies and Recognised Companies, but also in a new separate register maintained by the DIFCA called the Special Purpose Companies Register. An SPC established in the DIFC is intended to have similar characteristics to special purpose vehicles and qualifying special purpose entities, which are often established in other jurisdictions for the purposes of financial transactions. Use of an SPC is not limited to Islamic finance, and indeed there could be a diverse number of conventional finance transactions for which an SPC could be used.

SPCs are limited to certain restricted activities (“Exempt Activities”), including those activities typically undertaken by special purpose vehicles in financial transactions. So long as the activities undertaken by an SPC fall within the definition of Exempt Activities and do not constitute financial services regulated by the DFSA such as accepting deposits, providing credit, providing money services, managing assets, effecting contracts of insurance, providing trust services, acting as a trustee for a fund and providing fund administration, there are no restrictions on the activities of the SPC. The DFSA is involved in the application process for the establishment of SPCs in order to ensure that the proposed activities of the SPC will not require the authorisation of the DFSA.

Exempt Activities that an SPC can undertake include, inter alia, any of the following activities, whether conducted in a conventional or Shari’a-compliant manner:an alternative to the Channel Islands or the Cayman Islands and to allow the potential future issuance of sukuk from the DIFC.

- The acquisition (by way of leasing, title transfer, risk transfer or otherwise), the holding and the disposal of any asset (tangible or intangible, including but not limited to receivables and shares);
- The obtaining of any type of financing (banking or capital markets), the granting of any type of security interest over its assets, the providing of any indemnity or similar support for the benefit of its shareholder(s) or any of its subsidiaries, or the entering into of any type of hedging arrangements;
- The financing of the entity for whose transaction the SPC has been established or another SPC;
- The acting as trustee or agent;
- Any other activity approved in writing by the Registrar of Companies in the DIFC; or
- Any ancillary activities that are related to the activities set out above.FSA.

Like similar special purpose vehicles and qualifying special purpose entities established in other jurisdictions, SPCs are often intended to be “insolvency remote” meaning that the circumstances that could lead to a declaration of their insolvency are minimised to the greatest extent possible. Therefore, an SPC would not be expected to have any employees of its own, instead the SPC must appoint a corporate services provider in order to provide it with corporate management services. The corporate management services typically provided by a corporate services provider to an SPC would include the provision of corporate officers such as directors and a secretary, the provision of a registered office and the provision of other day-to-day administration and accounting services. The corporate services provider of an SPC must be registered in the DIFC or licensed in any jurisdiction recognised or approved by the Registrar of Companies in the DIFC to undertake corporate services business.

The number of shareholders of an SPC is restricted to three persons/entities, who can be either:

- participants in the financing transaction for which the SPC has been established;
- another SPC; or
- a nominee holding the shares in the SPC on trust for discretionary purposes (which would make the SPC an "orphan" SPC).

An "orphan" SPC may be used in transactions to ensure that the SPC would be viewed as an independent company that is unconnected to any other party in the transaction as the alternate shareholders/owners of the company would not be identifiable.

Benefits of using an SPC in Capital Markets and Structured Finance Transactions

Sukuk and other structured finance transactions have often utilised companies established in offshore jurisdictions. This has been partly for tax purposes, but also due to uncertainties in the legal framework and enforcement process in the courts in relation to structured finance in many GCC countries.

The introduction of the SPCoR allowing the incorporation of SPCs in the DIFC, together with the DIFC's common law court system that is able to draw on the jurisprudence of more established financial centres, is intended to encourage the sukuk and structured finance market within the DIFC.

The use of an SPC in a financing transaction provides sufficient nexus to the DIFC to allow the use of DIFC law as the governing law of the transaction and also allows the DIFC courts jurisdiction in relation to the transaction.

DIFC law draws on many of the positive aspects of various established foreign legal systems, including English common law, in order to provide a sophisticated and developed legal framework to facilitate commercial transactions. DIFC law is therefore suitable as the governing law of complex financing transactions, such as sukuk transactions, as there is greater certainty surrounding the interpretation and application of the law to such transactions, particularly in the areas of insolvency and enforcement.

Moreover, the DIFC courts represent an independent legal system established to deal with the sophisticated commercial transactions conducted within the DIFC. The DIFC court system is an English-language based, common law court system with an international bench of judges who are well versed and experienced in dealing with commercial disputes. By granting the DIFC courts jurisdiction over a transaction, some of the uncertainties pertaining to certain regional courts can be eliminated. Furthermore, to the extent that enforcement proceedings will be required in a Dubai court outside of the DIFC, such courts would recognise the judgement of the DIFC court, which may not necessarily be the case with a foreign judgement that has been obtained in relation to a transaction.

Advantages of utilising an SPC as Opposed to an Ordinary DIFC Company

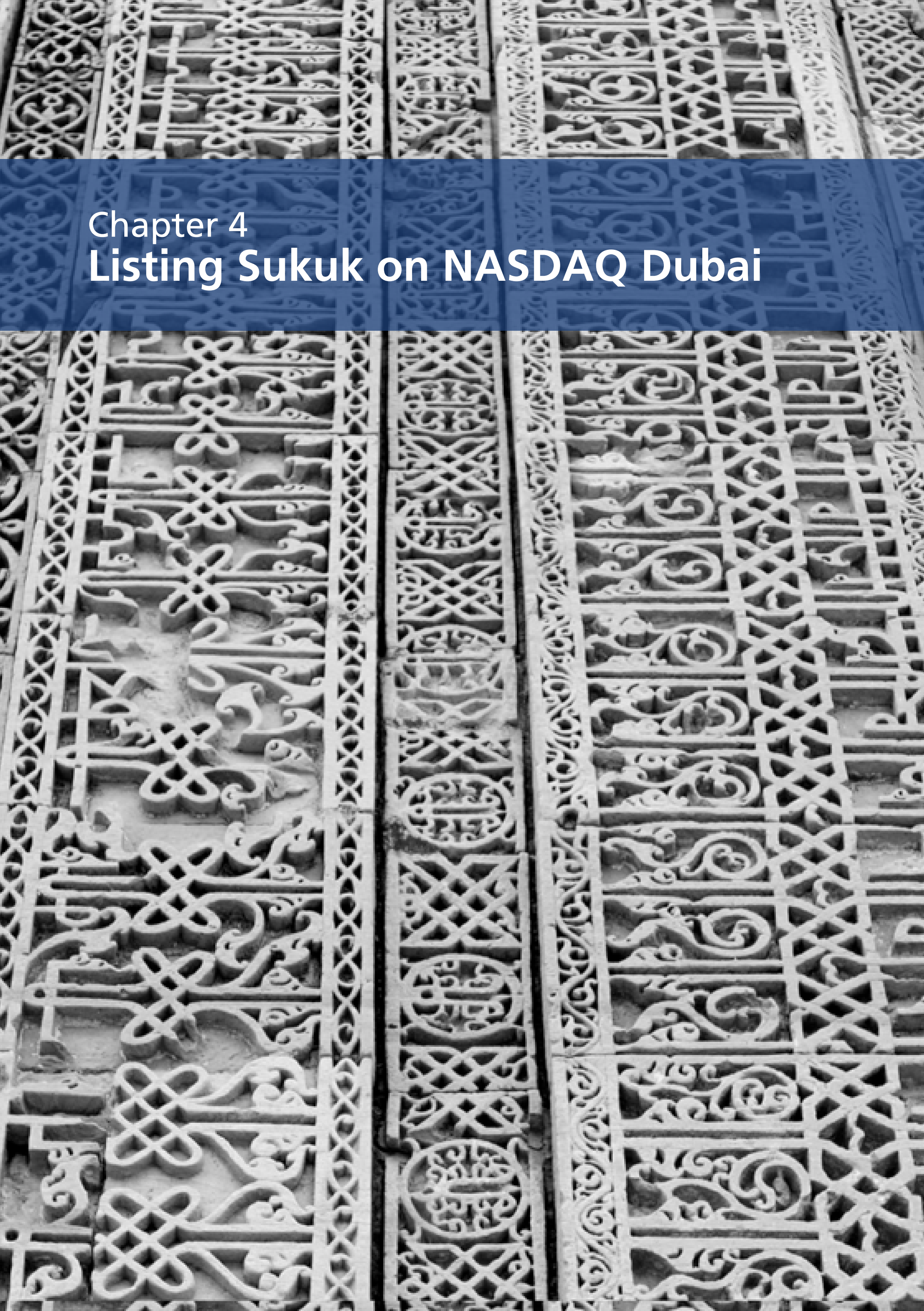
The advantages mentioned above in relation to the use of DIFC law and the jurisdiction of the DIFC courts may also be available to the extent that an ordinary DIFC company can be utilised in a transaction. However, the use of an ordinary DIFC company will often not be suitable. The SPCoR have therefore sought to amend the Companies Law of the DIFC by modifying or disapplying certain of the provisions in order to encourage the establishment and use of SPCs to allow the benefits of the DIFC to be utilised in financing transactions.

Through the amendment of the Companies Law, the benefits of utilising an SPC over an ordinary company in the DIFC includes the following:

- Lower minimum share capital requirements (currently only US$100);
- Principal business need not actually be in the DIFC;
- No requirement for annual shareholder meetings;
- No requirement to maintain, audit or file accounts unless the SPC has obtained a listing on any stock exchange of securities issued by it; and
- Exemptions from certain provisions of the Insolvency Law (for example, certain claw back rights of the administrator do not apply to SPCs).

Conclusion

The SPCoR allowing the incorporation of SPCs in the DIFC represents a clear signal on the part of the DIFCA that it supports the arranging of complex financial transactions within the DIFC. In recent years, the majority of sukuk transactions in the Middle East have utilised as their issuers/trustees special purpose vehicles incorporated in jurisdictions such as The Channel Islands and the Cayman Islands. Part of the reason for this relates to the uncertainties regarding both local law and the processes of the local courts. The DIFC represents a jurisdiction in which participants can avoid such uncertainties through the use of both the DIFC law and the DIFC courts, both of which represent a sophisticated legal regime designed to encourage complex financial transactions. However, the use of a DIFC company has not always been suitable in such transactions. With the ability to establish SPCs in the DIFC through the SPCoR, market participants now have the opportunity to utilise such vehicles in order to act as both the issuer and trustee in sukuk transactions within the DIFC. When coupled with the opportunity to list on the NASDAQ Dubai within the DIFC and the comprehensive and unique regulatory regime that the listing authority and the DFSA represent for sukuk transactions, the SPCoR represent an exciting prospect for the future of not only sukuk but also other structured finance transactions for the DIFC and the region as a whole.



Chapter 4
Listing Sukuk on NASDAQ Dubai

Listing Sukuk on NASDAQ Dubai

Introduction to the DIFC

NASDAQ Dubai (formerly the Dubai International Financial Exchange (DIFX)) is the international stock exchange serving the Middle East. Its standards are comparable to those of leading international exchanges in New York, London and Hong Kong. By listing securities on NASDAQ Dubai, regional issuers and international issuers are better able to access investment in the region. NASDAQ Dubai currently lists equities, sukuk and conventional bonds, structured products and funds. It has an independent listing authority that acts as the front-end regulator for all product listings. Borse Dubai is the majority shareholder in NASDAQ Dubai, holding two thirds of the shares, with the remaining one-third being held by NASDAQ OMX.

Listing of Sukuk

Most sukuk which have been issued to date (both regionally and internationally) tend to be privately placed, i.e., the trust certificates are issued to sophisticated or institutional investors (known in capital markets terms, as "wholesale or qualified investors"), who will invest in trust certificates in large denominations, rather than to the general public (or "retail investors") who tend to subscribe for securities in smaller denominations. Nevertheless, a large proportion of privately placed sukuk are listed on a stock exchange and are thereby viewed as "public issuances".

However, as with conventional debt securities, sukuk are not traded on a stock exchange (unlike equity securities) but are traded by investors over the counter in the secondary market, although there have been some considerations as to whether this practice will change. Even though the stock exchange does not function as a trading platform for sukuk, many issuers would still endeavour to list sukuk for the following reasons:

- Regulatory oversight – the fact that the offering document must be reviewed and approved by the relevant stock exchange assures investors that the issuer, the offer and the disclosure contained in the offering document complies with certain minimum standards, and thereby makes the offer more attractive to investors;

- Investor requirements – certain investors may only be permitted to invest in listed sukuk (for example, in order to benefit from favourable tax treatment); and

- Public profile – the listing enhances the public profile of the issuer/obligor and thereby attracts more interest from investors in the secondary market.

NASDAQ Dubai as Listing Platform for Sukuk

Traditionally, the regulated stock exchanges in Europe (primarily the London Stock Exchange and the Luxembourg Stock Exchange) have been the listing platforms of choice for most issuers of debt securities, and, consequently, these exchanges have also dominated the sukuk market. However, since the establishment of NASDAQ Dubai in September 2005, several key issuers in the UAE and regionally have looked to NASDAQ Dubai to list both conventional debt securities and sukuk. As of November 2009, the total nominal value of sukuk listed on NASDAQ Dubai was approximately US$15.7 billion. Some notable sukuk listings include:

- US$1,500,000,000 trust certificates (sukuk al-mudaraba), due 2017 issued by DP World Funding Limited;
- US$200,000,000 convertible trust certificates (sukuk al-mudaraba) due 2012 issued by IIG Funding Limited; and
- AED7,500,000,000 trust certificates (sukuk al-musharaka) due 2012 issued by Jafz Sukuk Limited.

In order to operate as an international exchange, NASDAQ Dubai has sought to strike a balance between, on the one hand, attracting issuers (whether corporate issuers, financial institutions or sovereign entities) to choose NASDAQ Dubai as the listing platform for their sukuk and, on the other hand, protecting the interests of investors by ensuring that certain minimum conditions and high disclosure standards are met in order for the sukuk to be eligible for listing.

Regulation of Sukuk listing

The listing of securities (including sukuk) is regulated by both NASDAQ Dubai as well as the DFSA. As the overall regulator of the DIFC, the DFSA regulates NASDAQ Dubai itself and governs the offering of securities within the DIFC. NASDAQ Dubai functions as the listing authority and the stock exchange for securities; it handles listing applications and grants the listing of securities to the Official List of Securities maintained by NASDAQ Dubai (the "Official List"). NASDAQ Dubai has the primary role of reviewing and approving the offering document and the listing application. However, the DFSA has the power to object to an admission of securities to the Official List if it is in the interests of the DIFC to do so or under specific circumstances as prescribed by law. If the DFSA objects to the listing, NASDAQ Dubai will be prohibited from admitting the securities to the Official List, subject to an appeals process.

The Listing Rules of NASDAQ Dubai (the "Listing Rules")[10] govern the admission criteria for the issuer and its sukuk, as well as the actual listing process. It also contains the continuing obligations that apply once the sukuk is listed. The Offered Securities Rules of the DFSA (the "OSRs") contain rules concerning the manner in which sukuk may be offered to investors,

[10] Please refer to the Listing Rules of the Dubai International Financial Exchange Version 1.0 (25th September, 2005). Note that these rules are currently undergoing review and may be amended by the end of 2009.

the disclosure requirements for the offering document and also imposes certain additional continuing obligations on listed issuers. The OSRs apply to all sukuk offered in the DIFC, whether or not they are listed on NASDAQ Dubai.

An issuer seeking to list its sukuk on NASDAQ Dubai must therefore be aware of both the Listing Rules and the OSRs.

Key Elements of the Listing Rules and the OSRs

Restricted securities and exempt offers

The Listing Rules impose fewer requirements if an issuer is seeking to list "Restricted Securities"[11], which are securities issued to "Professional Clients"[12]. A "Professional Client" is equivalent to a wholesale or qualified investor, who is deemed to have a sufficient understanding of the risks involved in investing in securities as compared to a retail investor. Issuers of restricted securities will be exempt from some of the eligibility criteria and will be subject to fewer disclosure requirements. As mentioned above, most sukuk are privately placed with wholesale or qualified investors and will therefore benefit from the restricted securities exemptions.

An issuer should also be aware of the additional requirements imposed in the OSRs if it is offering securities "within the DIFC"[13]. An offer of securities is deemed to be made within the DIFC if either (i) the issuer is located in the DIFC or (ii) the offer is being directed to entities located and/or licensed within the DIFC. The OSRs impose an extensive set of disclosure requirements in relation to an offer of securities within the DIFC unless the offer qualifies as an "Exempt Offer"[14]. An "Exempt Offer" includes an offer of securities to Professional Clients and is thereby equivalent to an offer of Restricted Securities. Most offers of sukuk within the DIFC will be Exempt Offers and therefore be exempt from the disclosure requirements in the OSRs (although it will be necessary to include an "Exempt Offer Statement" in the offering document, which sets out the restrictions applicable to the offer).

Issuer and obligor

Under the Listing Rules, the issuer of securities must comply with certain eligibility criteria[15]; for example it must have net assets of at least US$10 million. However, in most cases, the issuer of sukuk will be a special purpose vehicle with no assets of its own and no financial track record and it will not be able to satisfy most of the eligibility criteria. Moreover, in a typical sukuk issuance, it is the obligor which would ultimately be responsible for fulfilling the issuer's payment obligations to investors. The issuer can apply for a waiver from NASDAQ Dubai to "look

---

11 Definition 1.1.31 of the Listing Rules and Listing Rule 7.
12 DFSA Rulebook, Glossary Module.
13 OSR 2.2 and Guidance thereto.
14 OSR 2.4.
15 Listing Rules, Part 2 (Eligibility), Part 1 of Appendix E and Part 2 of Appendix E.

through" the issuer so that the obligor will be required to satisfy the eligibility criteria. For the purposes of this chapter, where the issuer contemplated is a special purpose vehicle, references to the "issuer" should be construed as references to the "obligor".

Reporting Entity

Once an issuer lists securities on the Official List, it is deemed to be a "Reporting Entity"[16] by the DFSA and will be subject to the continuing obligations set out in the OSRs, as described further below. These continuing obligations apply whether or not the issuer makes an offer of securities within the DIFC.

In sukuk structures where the issuer is not an SPV, the issuer itself will be deemed to be the Reporting Entity as investors will be concerned about the issuer's ongoing financial condition. Where sukuk is issued by an SPV, investors will be concerned with the ongoing financial condition of the obligor rather than the issuer, as the ability of the issuer to meet its payments obligations to investors ultimately rests upon the credit of the obligor. The issuer can therefore apply to the DFSA for a waiver to treat the obligor, rather than the issuer, as the Reporting Entity. Once the obligor is named as the Reporting Entity, it will be required to submit the names of two of its officers to act as the ongoing contacts with the DFSA; these officers will be answerable to the DFSA with respect to the Reporting Entity's compliance with its continuing obligations.

Even though the "Reporting Entity" is responsible for compliance with the OSRs, it will also be responsible for complying with the continuing obligations under the Listing Rules, which largely mirror the continuing obligations in the OSRs.

Primary vs Secondary Listing

Once an issuer lists securities on the Official NASDAQ Dubai can admit sukuk to listing on either a primary or a secondary basis. An issuer may apply for a primary listing whereby NASDAQ Dubai will be the main (but not necessarily the only)[17] listing platform for sukuk and, subject to any applicable exemptions, will be required to satisfy the full range of eligibility criteria and disclosure requirements under the Listing Rules.

On the other hand, an issuer that has or will obtain a primary listing of its sukuk on another recognised stock exchange[18], may apply for a secondary listing of the same class of sukuk on NASDAQ Dubai. While the issuer must still satisfy the same eligibility criteria as would be required of it for a primary listing, it will not need to comply with the full set of disclosure requirements under the Listing Rules[19]. Note however that the same set of continuing obligations under the Listing Rules and the OSRs will apply whether the sukuk is listed on a primary or secondary basis.

---

[16] OSR, Chapter 8.

[17] An issuer may choose more than one exchange as its primary exchange.

[18] Appendix B of the Listing Rules states that only an exchange that is a member of an affiliate of the World Federation of Exchanges (which includes the London Stock Exchange and the Luxembourg Stock Exchange, amongst others) will be considered a recognised exchange.

[19] Listing Rule 6.

Criteria for Admission to Listing

The Listing Rules set out the eligibility criteria that an issuer must satisfy in order to be considered for listing. While most of the criteria apply to debt securities in general, the Listing Rules also set out additional criteria that apply to sukuk or other Shari'a-compliant securities.

The criteria relating to the issuer (or obligor, as the case may be) include the following[20]:

(i). NASDAQ Dubai must be satisfied that both the issuer and its business are suitable for listing;

(ii). The issuer must have net assets of at least US$10 million;

(iii). The issuer must have published audited accounts which cover at least three years (note: in the case of an offering of restricted securities or in respect of secondary listing, only two years of accounts are required);

(iv). The issuer must appoint a Shari'a board that meets the DFSA's requirements and ensure that the Shari'a board advises, in respect of Shari'a compliance, on all aspects of the offering; and

(v). The members of the Shari'a board must have, in the opinion of NASDAQ Dubai, adequate qualifications, experience and expertise in Islamic jurisprudence and Islamic finance.

The Listing Rules do not require the relevant issuer or obligor to appoint its own Shari'a board but specifically provides that the Shari'a board may be appointed by one of the arranging banks or lead managers of the sukuk.[21]

Overview of the Listing Process

In considering a listing application, NASDAQ Dubai will assess whether the issuer meets the eligibility criteria for listing and will also review the offering document to ensure it complies with the relevant disclosure standards. In addition, the issuer will be required to submit ancillary documents as part of the application process, including, but not limited to, a listing application form, letter(s) requesting a waiver from certain rules (if applicable), company board resolutions, profiles of the members of the Shari'a board and the fatwa issued by the Shari'a board, and all other material documents relating to the transaction.

For a debut issuer, the listing application process takes approximately four to six weeks from the date on which the offering document is submitted for review. At the end of the listing application process, the DFSA will review NASDAQ Dubai's approval, which typically takes an additional five business days. Once

[20] OPlease note that this is not an exhaustive list; please refer to Listing Rules, Part 2 (Eligibility), Appendix E (Parts 1 and 2) for the full set of eligibility criteria.

[21] Listing Rules, Appendix E, Part 1, Rule 17.

the DFSA is satisfied with the application, it will grant a "no-objection" letter, following which the sukuk will be admitted to NASDAQ Dubai's Official List of Securities.

Continuing Obligations and Financial Reporting

Once a sukuk is listed on NASDAQ Dubai, the relevant Reporting Entity will be obliged to comply with the continuing obligations under the Listing Rules[22] and the OSRs[23] until the sukuk matures or is redeemed. The purpose of the continuing obligations is to "give investors dealing in securities proper information for the determining the current value of the securities and confidence that the NASDAQ Dubai market is well-regulated"[24]. The continuing obligations are broadly divided into two categories; obligations that apply on an ongoing basis at all times and obligations that must be satisfied on a periodic basis. The continuing obligations imposed by the OSRs and the Listing Rules in respect of sukuk are substantially similar to the continuing obligations imposed in respect of corporate bonds, with some additions and variations.

The first category of obligations primarily relate to the disclosure of price sensitive information to the market[25]. Price sensitive information is information that is liable to lead to a substantial movement in price of securities or to affect significantly the ability of the issuer to meet its commitments. Certain types of price sensitive information are specifically listed in Appendix F (Part 1) of the Listing Rules but this is not an exhaustive list. The Reporting Entity is required to consider whether any material development is likely to constitute price sensitive information. Any price sensitive information must be disclosed to the market in a timely manner via NASDAQ Dubai's Company Announcement Platform (CAP)[26].

The second category of obligations require the Reporting Entity to file specific types of information periodically and these obligations apply regardless of the occurrence of any material events or otherwise. For example, the Reporting Entity is required to disseminate its annual report and year end audited accounts[27] via the CAP system within four months of the end of the relevant financial period.

While these continuing obligations apply to all reporting entities, certain additional obligations apply to Reporting Entities in respect of listed sukuk or other Shari'a-compliant securities. For example, a Reporting Entity is required to disclose, by way of an announcement to NASDAQ Dubai, any changes to the composition and membership of the relevant Shari'a board that issued the fatwa[28]. However, in a majority of sukuk issuances, the fatwa will have been issued by the Shari'a board of one of the arranging banks as the Reporting Entity may not have its own Shari'a board. It will therefore not

[22] Listing Rule 28 and Appendix F, Part 1 and 2.
[23] OSR chapter 8.
[24] Listing Rule 27.
[25] Listing Rule 28 and Appendix F, Part 1.
[26] Listing Rule 28.2.
[27] OSR Appendix 2.1.1, Rule 13.
[28] OSR Appendix 2.1.1, Rule 5.

be possible for the Reporting Entity to monitor changes to the composition of the Shari'a board on an ongoing basis. In such cases, the Reporting Entity may apply to the DFSA for an exemption from this rule. The Listing Rules also contain a technical requirement for a Reporting Entity to provide an annual certificate from the relevant Shari'a board certifying that the sukuk continues to meet Shari'a standards.[29] However, due to the concerns raised by issuers about the feasibility of complying with this rule, NASDAQ Dubai has not insisted on compliance with this requirement.

Sovereign Issuers

Where the issuer is a sovereign, government or supra-national organisation, it is not deemed to be a Reporting Entity and is exempt from some or all of the continuous disclosure requirements under the OSRs[30]. For example, a sovereign entity will not be required to file annual reports on a yearly basis. It will, however, still be subject to the general requirement under the Listing Rules to disclose price sensitive information to the market through NASDAQ Dubai as this obligation is pervasive and essential to maintaining market stability regardless of the identity of the issuer or obligor.

Sukuk Programmes

It has become increasingly common for issuers to establish sukuk programmes, under which sukuk are issued in multiple tranches through the course of a year, rather than as standalone sukuk issuances. This is often more cost effective and time efficient for an issuer that anticipates issuing separate tranches of sukuk from time to time as it will rely on one umbrella set of agreements and one offering document.

NASDAQ Dubai applies Listing Rule 12, which covers debt issuance programmes, to sukuk programmes as well. The issuer can apply for a maximum amount of sukuk to be issued under the programme. If NASDAQ Dubai approves the application, it will grant a pre-approval of the listing of all sukuk issued under the programme within a period of 12 months after the approval is received (although note that the DFSA's approval is required for the listing of each tranche of sukuk issued under the programme). In respect of each individual tranche of sukuk, the issuer must file a set of final terms (including the specific terms and pricing of that tranche of sukuk) at least a day prior to the listing date of the sukuk and seek the DFSA's approval for the listing. An example of a listed sukuk programme is the RAK Capital US$2,000,000,000 certificates issuance programme established in May 2008, which was the first sovereign sukuk programme to be listed on NASDAQ Dubai.

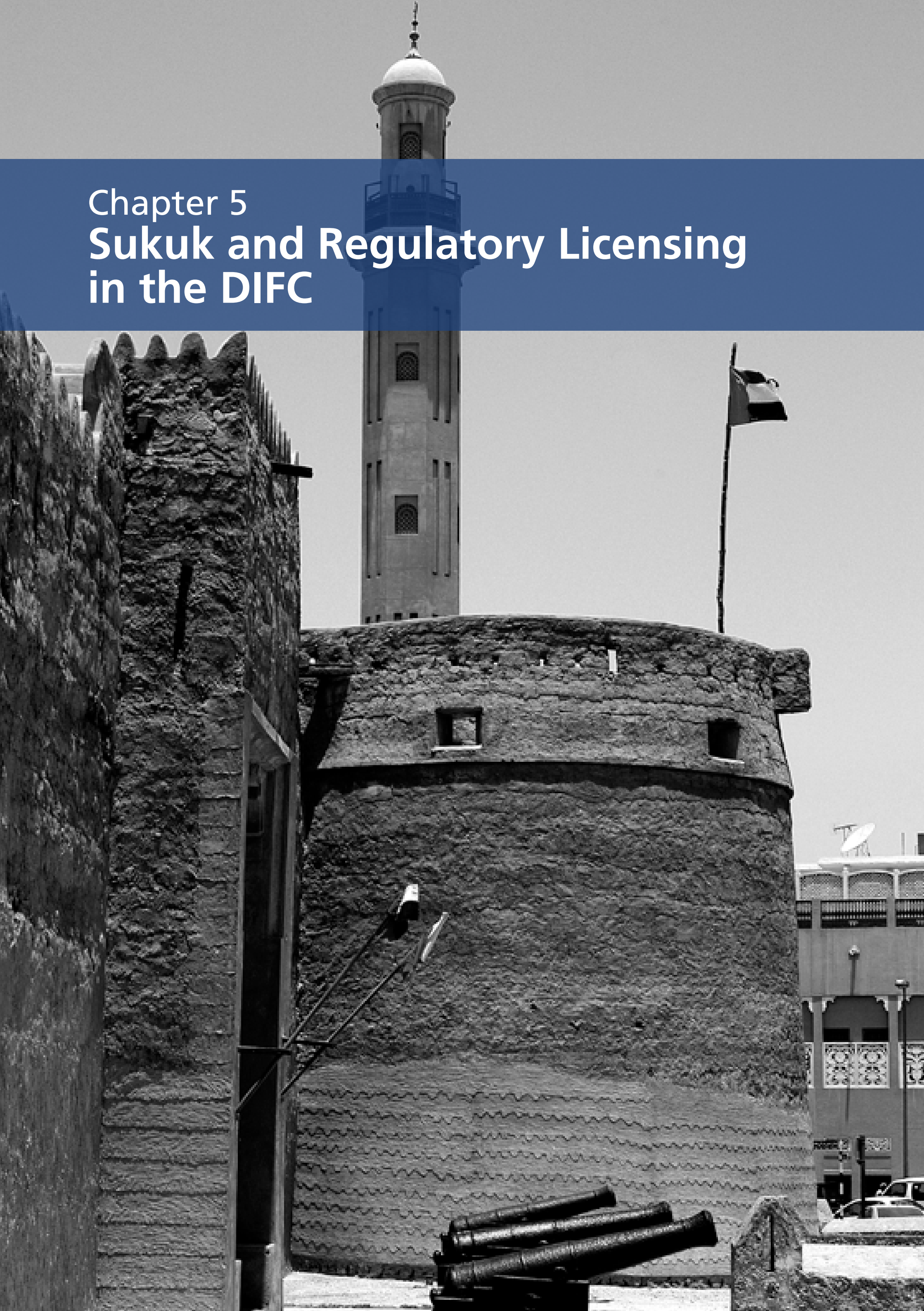
---

[29] Listing Rules, Appendix F, Part 2, para 15.
[30] OSR 8.1.1 and Guidance thereto.

New developments

NASDAQ Dubai has recently introduced custody services for issuers of sukuk through its Central Securities Depository (CSD). It is mandatory for issuers to use the custody services provided by the CSD in respect of all primary listings on NASDAQ Dubai. NASDAQ Dubai is committed to developing additional services to further enhance the issuance of sukuk by local and regional issuers.

Chapter 5
Sukuk and Regulatory Licensing in the DIFC



Sukuk and Regulatory Licensing in the DIFC

The DIFC's financial services and markets regulator, the Dubai Financial Services Authority ("DFSA") regulates those who offer financial services products and services in or from the DIFC. Where an institution offers a financial service as defined in the GEN Module of the DFSA Rulebook it will be required to have a DFSA licence. It will have to comply with the provisions of the DFSA Rulebook governing, for example: the manner in which the institution conducts its business, including how it treats its customers; and the safeguards, including the regulatory capital resources, that the institution has to put in place to manage the risks associated with its business.

In the context of sukuk, this has implications for the following:

- The exchanges that wish to list sukuk;
- The issuers and the obligors of sukuk; and
- The firms that wish to market sukuk or advise issuers and obligors.

The position of exchanges and the rules governing offers of securities, in respect of which the DFSA also has jurisdiction, are dealt with in Chapter 4, above in the context of the Listing of sukuk.

In general, neither issuers nor obligors would be required to be licensed by the DFSA. Firms marketing sukuk in or from the DIFC will, in general, be required to be licensed, as may some advisors. Some firms in these categories may need an endorsement to their licences to allow them to carry on Islamic financial business. Some particular legal points which arise in these contexts are discussed below.

1. The Regulation of Issuers of Sukuk and Obligors

The issuers of conventional securities, and the obligors where an SPV is used, are not generally to be considered, by virtue of that issuance, to be conducting financial services. In the case of the DIFC, they are protected by the fact that an activity has to be carried on "by way of business" to constitute a financial service (DFSA Rule GEN 2.2.1(b)). An issuer or obligor will not normally meet that test.

However, in some other jurisdictions, notably the UK, some sukuk have in the past been deemed to be collective investment funds, attracting the regulatory obligations associated with such funds. Could this happen in the DIFC?

Article 15 of the DIFC Collective Investments Law (CIL) defines a Fund as any arrangement with respect to property of any description, including money, where:

- The purpose or the effect of the arrangements are to enable persons taking part in the arrangements (whether by becoming owners of the property or any part of it or otherwise) to participate in or receive profits or income arising from the acquisition, holding, management or disposal of the property or sums paid out of such profits or income;
- The arrangements must be such that

the persons who are to participate (the "Unitholders") in the arrangements do not have day-to-day control over the management of the property whether or not they have the right to be consulted or to give directions; and

- The arrangements have either or both of the following characteristics: (a) the contributions of the Unitholders and the profits or income out of which payments are to be made to them are pooled; or (b) the property is managed as a whole by or on behalf of the operator of the Fund.

However, Article 16 of the CIL deals with arrangements not constituting a Fund and states that the Authority may make rules excluding certain arrangements or types of arrangements from constituting a Fund. These rules are contained in Section 2.3 of the DFSA Collective Investment Rules ("CIR"). They exclude most debentures, and the DFSA has ruled in the past that certain sukuk should for this purpose be treated as debentures. In November 2008 the DFSA amended the CIR to put the point beyond doubt for at least some sukuk.

CIR, Rule 2.3.9 (the "Sukuk Exclusion") states that: "Arrangements do not, for the purposes of Article 15 of the Law, amount to a collective investment fund if the arrangements are arrangements under which the rights or interests of the participants are evidenced by sukuk certificates where the holders of the certificates are entitled to rely on the credit worthiness of: (a) the issuer of the sukuk certificates; or (b) any other persons who has assumed obligations under the sukuk certificates, for obtaining their rights and benefits arising under the certificates."

The Sukuk Exclusion seeks to capture those Shari'a-compliant instruments that are structured to have the economic effect of a bond or similar debt instrument. It would not apply to all sukuk. For example, it would not apply to a Shari'a-compliant exchange traded fund (ETF) where an investor participated directly in the rise and fall of the value of the units in the ETF, thereby taking risk on the assets to which the value of the ETF was linked, receiving an amount representing that value when the investor redeemed the units as opposed to a value equal to his initial investment.

The exclusion is, therefore, designed to ensure that the issuers of sukuk will receive the same regulatory treatment as issuers of conventional bonds and not simply to provide a way out of the CIL and CIR regimes for the issuer of any Shari'a-compliant instrument. (See DFSA Consultation Paper No. 57 Miscellaneous Amendments to the Rulebook, Item 5.)

The DFSA has wide powers to waive or modify its Rules in specific cases and where sukuk are structured to have the same economic effect as a conventional instrument, it can be expected to look favourably on requests to use these powers to ensure that the regulatory treatment is similar to the treatment of that instrument.

2. The Regulation of Those Who Market Sukuk and Advise Issuers and Obligors

(a) **Marketing sukuk or sukuk based products**

The DFSA requires anyone who carries on the financial services of (a) arranging credit or deals in investments and (b) advising on financial products or credit to be licensed. With respect to the regulatory classification of the investments or financial products to which these activities would relate, most sukuk would be debentures. The definitions of the arranging and advising activities, contained in GEN Rule 2.9 and GEN Rule 2.11, respectively, are broad and would capture any entity that sought to market securities in or from the DIFC, thereby requiring that entity to be DFSA authorised.

In the absence of a specific securities advertisements regime, such as that in the Kingdom of Saudi Arabia, or financial promotion regime, such as that in the United Kingdom, it is the requirements surrounding the activities of arranging and advising which provide the regulatory regime for marketing. Importantly, unlike Saudi Arabia or the United Kingdom, the DFSA rules do not contain any general exemptions from the requirement to be licensed to market investments or products based on, for example, the recipient being a DFSA authorised firm.

(b) **Advisory firms**

Certain advisory firms may require to be licensed. One of the tests will be whether they are carrying on financial services within the DIFC. Lawyers and accountants will not require to be licensed, though if they have a place of business within the DIFC they may have to be registered as Ancillary Service Providers. Shari'a advisors will not generally be required to be licensed.

For corporate financial advisors, the key test will be whether they are carrying on the Financial Service of Advising on financial products or credit, the definition of which is in GEN Rule 2.11.1 of the DFSA Rulebook. In general, corporate financial advisers are likely to fall within this definition, if they carry on the activity within the DIFC, subject to the "by way of business" test already referred to. Thus a firm that gave advice to a DIFC entity, but only from its premises in London, would not be caught. Nor would a firm that made a one-off visit to the DIFC to give advice.

(c) **The need for an "Islamic Financial Business Endorsement"**

The Law Regulating Islamic Financial Business, DIFC Law No. 13 of 2004 (the "IFBL") prohibits any DFSA authorised firm from "holding itself out as conducting Islamic Financial Business unless it has an endorsed licence authorising it to conduct Islamic Financial Business as an Islamic Financial Institution i.e. carry on its entire business in accordance with the Shari'a or by operating an Islamic Window i.e. carrying on part of its business in accordance with the Shari'a" (the "Islamic Endorsement Requirement"). The IFBL defines Islamic Financial Business as "carrying on one or more financial services in accordance with Shari'a."

The Islamic Endorsement Requirement is a supplementary general licensing requirement: in order for a firm to hold itself out as carrying on one or more financial services in accordance with the Shari'a, a DFSA licence is not, of itself, sufficient.

With the exception, in practice, of financial services activity of "managing a profit-sharing investment account" (see GEN, Rule 2.21.), the Islamic Endorsement Requirement does not focus on particular financial services. Unlike some other regimes, the DFSA regime does not identify, for example, a specific activity of arranging deals in Shari'a compliant investments. A DFSA authorised firm wanting to market or advise on sukuk will, therefore, need to ask whether by doing so the firm would be holding itself out as conducting Islamic Financial Business. Clearly this is an issue only for firms that require DFSA authorisation, by virtue of carrying on financial services in the DIFC.

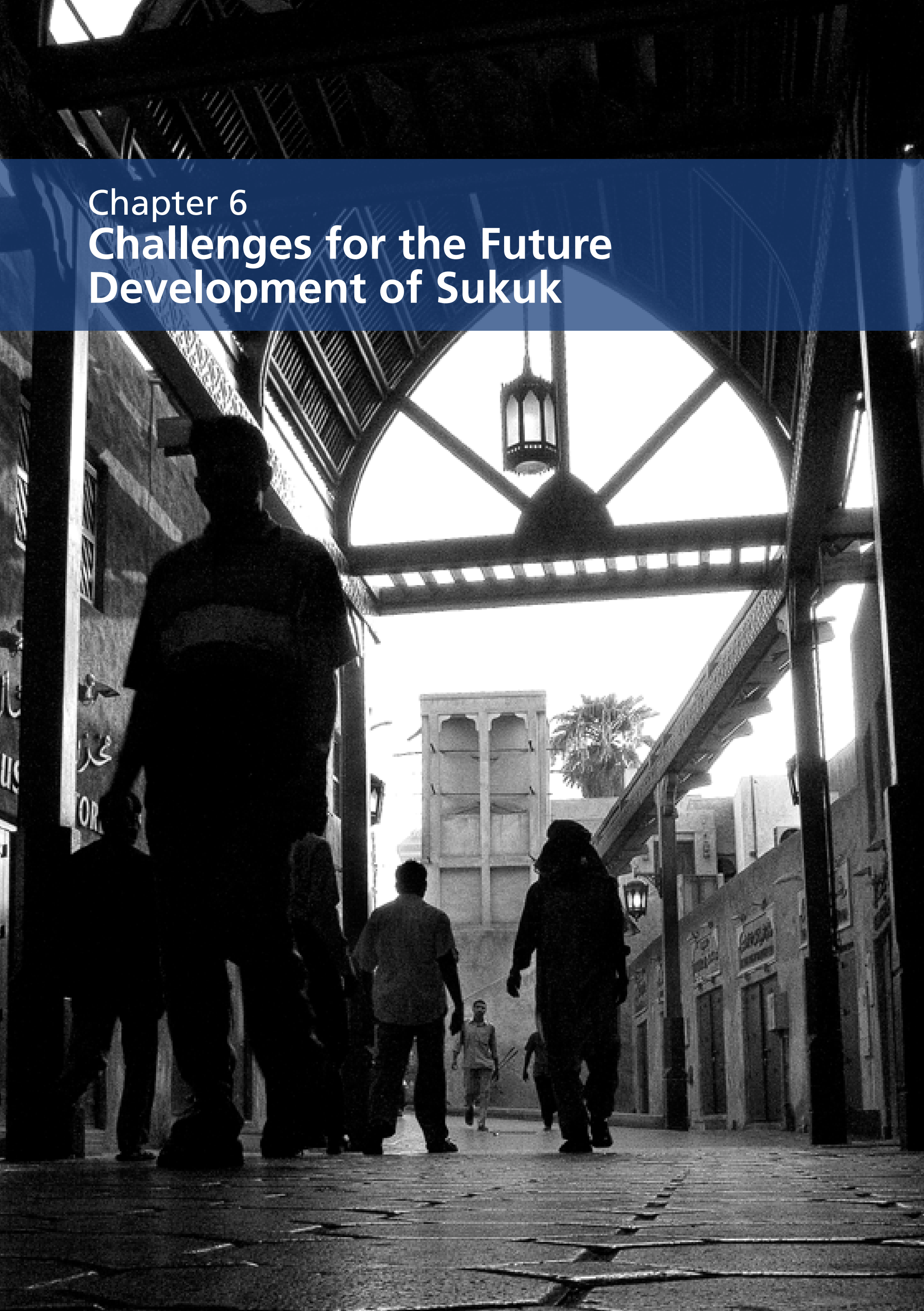
For an authorised firm marketing sukuk, to the extent that the firm has no Shari'a board or its Shari'a board has played no part in issuing a Fatwa on the sukuk and the firm states this clearly in any promotional materials (Rule 2.1.2 of the Islamic Financial Business Module of the DFSA Rulebook requires a firm to identify in marketing material which Shari'a board has reviewed the product to which the material relates), it should not be holding itself out as conducting Islamic Financial Business. To the extent that any marketing material relating to the sukuk states that the firm's Shari'a board has issued the Fatwa on the sukuk, the firm will be holding itself as conducting Islamic Financial Business and it will need to comply with the Islamic Endorsement Requirement.

For an advisory firm, it is unlikely that the mere act of giving advice on the structuring of a sukuk transaction, even advice on structuring a particular instrument to make it Shari'a compliant, would in itself trigger the Islamic Endorsement Requirement.

Either type of firm would, however, require an Islamic Endorsement if it held itself out to clients or potential clients as conducting its financial services business in accordance with Shari'a – for example if it claimed to offer only products that were Shari'a compliant.

Chapter 6

Challenges for the Future Development of Sukuk



Challenges for the Future Development of Sukuk

1. Introduction

Since its debut on the international financial market, the sukuk market has grown and developed significantly year on year. From a market worth less than US$500 million in 2001 to one worth over US$60 billion in 2007, the sukuk market experienced phenomenal growth between 2001 and 2007. In a report published in 2008[31], Standard & Poor's commented that, provided credit market conditions return to normal, it expected this growth to continue and predicted that over the next few years the total value of sukuk issuances outstanding would exceed US$100 billion.

Despite its recent growth, in 2008 the number of sukuk issued globally declined for the first time by over 50 per cent, compared with 2007. In the first seven months of 2009 new issuances amounted to US$9.3 billion compared with US$11.1 billion during the same period in 2008[32]. This slowdown in sukuk has been attributed to a number of different factors by different experts and commentators in the market, including:

– the global credit crunch and resulting market conditions;

– the lack of standardisation in the market and the AAOIFI Statement made in February 2008; and

– recent high-profile sukuk defaults by originators.

Each of the above poses challenges for the sukuk market as a whole and has the potential to impede the growth, and restrict the future development, of the sukuk market going forward. This chapter analyses these obstacles in some detail and takes a look at the recent consequential developments that have resulted and those that need to take place in order to overcome the concerns that these obstacles create.

2. Global Credit Crunch and Market Conditions

Standard & Poor's commented in a recent report[33], that, in their view, the two principal reasons for the recent slowdown in the sukuk market were the deteriorated global market conditions (which were further exacerbated by the Lehman Brothers collapse) and the consequential drying up of liquidity, particularly in the GCC (a key hub for sukuk issuances globally). Although at the time of the global credit crisis there was much speculation as to whether the Islamic financing system was immune from the crisis, the reality on the ground proved that any movements in the conventional markets would have an impact on the Islamic financial markets (albeit perhaps to a lesser extent). A slowdown in the sukuk market was therefore inevitable and unavoidable.

[31] Source: Standard & Poor's - "The Sukuk Market Continues To Soar And Diversify, Held Aloft By Huge Financing Needs".
[32] Source: Standard & Poor's.
[33] Source: Standard & Poor's.

That said, however, the impact of the global credit crisis has resonated throughout all aspects of international and domestic financial markets and is not unique to sukuk. It is expected that once the global markets normalise, the sukuk market too will normalise and will continue to grow, although perhaps not at the phenomenal pace that was once witnessed in the past

3. Standardisation and the AAOIFI Statement

Experts in the Islamic finance industry have, for a number of years, commented that the lack of standardisation in the industry and differences of opinion among various Shari'a scholars is a key issue that needs to be addressed, and this is no different in the sukuk market itself. Due to the lack of standardisation, differences in opinions can and do arise which can create some volatility in the market. Up until 2008, whilst the lack of standardisation was being voiced by many within the industry, no one could have quite predicted the impact and turbulence a single statement from AAOIFI could have on the market as a whole.

Comments made by a prominent scholar in 2008 questioning the Shari'a compliance of 85% of sukuk issued stimulated the Shari'a scholars of AAOIFI to hold meetings on 13 and 14 February 2008 following which AAOIFI published the AAOIFI Statement where it set out six principles relating to particular aspects of sukuk:

– sukuk tradability;

– the corporate responsibility of the sukuk manager;

– the permissibility of having a reserve account;

– the purchase of assets under musharaka, mudaraba and wakala structures at their net rather than nominal value; and

– the ongoing duty of Shari›a scholars to oversee the implementation of funds and investments in a Shari›a-compliant manner and not to limit their involvement to issuing fatwas at the time of the sukuk issuance itself[34].

It is difficult to gauge to what extent the AAOIFI Statement was responsible for the recent slowdown in the sukuk market. However, there is no doubt that the AAOIFI Statement effected the market and led many experts to revisit musharaka, mudaraba and wakala structures with a view to structuring them in accordance with the principles laid out in the AAOIFI Statement whilst maintaining the same economic position as a conventional bond. Whereas in 2007 musharaka and mudaraba structures were prevalent, 2008 saw a decline of 83% and 68%, respectively and sukuk al-ijara became the dominant structure being used.

In the AAOIFI Statement, AAOIFI essentially argued that musharaka, mudaraba and wakala sukuk are profit-and-loss sharing

[34] Source: Moody's.

partnerships that are akin to an equity instrument and therefore it is not Shari'a compliant to have a purchase undertaking from the managing partner, mudarib or investment agent to purchase the assets at an amount that is equal to the face amount of the sukuk (plus any accrued but unpaid profit). The emphasis being that such a purchase undertaking effectively amounts to a guarantee of return for the investors and thereby removes the risk-sharing element of the sukuk which is necessary from a Shari'a perspective. AAOIFI stressed that any such purchase of assets on maturity or otherwise should be for a price equal to the market value of those assets at that time (and not the face amount of the sukuk).

As a result of the AAOIFI Statement, musharaka and mudaraba structures have been developed with appropriate mechanical enhancements to mitigate against the risk, which Shari'a requires investors to take. For example, surplus profits on any Periodic Distribution Dates can be held in a reserve account and amounts held in such reserve account can be drawn to fund any shortfalls in future Periodic Distribution Amounts or in the Exercise Price on maturity or early redemption of the certificates. Secondly, the provision of third-party Shari'a-compliant liquidity funding can be accommodated into the structure to also cover any such shortfalls, although, it is important to note that any such third-party provider can only have the right, and must not be obliged to provide such Shari'a-compliant liquidity funding. As the market recovers from the global credit crunch, and structures are more strictly scrutinised than before by Shari'a scholars, it is expected that sukuk structures (in the forms described earlier in this Guide) will continue to develop and evolve.

In addition to the above, certain elements of the AAOIFI Statement particularly focused on the market value and the risk that must be taken by investors on the assets and appeared to encourage a movement towards "asset-backed" structures as opposed to "asset-based" structures. As the market develops, and in light of recent sukuk defaults where concerns have been raised with respect to recourse to the underlying assets (see below for further information), a move towards Islamic securitisations similar to the recent sukuk issuance in connection with a true sale securitisation by Abu Dhabi-based Sorouh Real Estate PJSC appears likely. These structures are likely to be more acceptable to Shari'a scholars who regard the underlying assets and the risks taken by investors in those assets as a fundamental part of the underlying Shari'a structures.

4. Sukuk Defaults

When sukuk first came to the market they were billed as more secure than conventional bonds because they were backed by real assets. However, recent defaults have left investors nervous as to whether they have a claim over the assets underlying the issuance or not. With the exception of Islamic securitisations, the majority of sukuk in the market are "asset-based" as opposed to "asset-backed". Assets are generally only placed in the underlying sukuk structures primarily to facilitate Shari'a requirements and to generate periodic coupon payments. 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 affected by the sukukholders exercising their rights against the originator under the purchase undertaking.

Essentially, whilst from a Shari's perspective sukuk certificates represent an underlying ownership interest in an asset, the commercial and economic reality is that most sukuk that are issued are unsecured and equivalent to conventional bonds (i.e. corporate credit-risk instruments). Although historically this had never been a concern, the global financial turbulence has resulted in a number of recent high-profile defaults by originators that have spawned a debate as to whether or not sukukholders have any recourse to the underlying assets. This will inevitably result in a better understanding by investors, bankers and lawyers of what would happen in the case of a default and therefore lead to further innovation and development of existing structures.

Conclusion

Despite the fact that sukuk issuances were almost at a standstill in 2008, 2009 has seen some activity. In April 2009, Indonesia issued its sovereign sukuk for US$650 million and was the largest dollar-denominated sukuk outside the GCC. In the Middle East the Saudi Electric Company issued its US$1.86 billion sukuk which was three times oversubscribed; the Central Bank of Bahrain's sukuk was eight times oversubscribed, and the US$1.25 billion sukuk by Tourism Development & Investment Company, advised upon by Clifford Chance LLP, was six times over-subscribed.

Notwithstanding the recent defaults, Shari'a concerns and market conditions, a number of jurisdictions, including the United Kingdom, France and Japan, have introduced legislation or amended existing legislation to facilitate Islamic financing techniques with a view to promoting these instruments domestically. Most notably, in the UK the recent amendments to the Finance Act have sought to alleviate sukuk al-ijara transactions of UK stamp duty land tax.

In conclusion, the outlook for the sukuk market remains positive with Standard & Poor's indicating that the total amount of sukuk issued or being talked about in the market is estimated to be about US$50 billion. There remain hurdles in the market itself which may impede growth of the market in the short-term, but it is envisaged that in the long-term these hurdles will be addressed and resolved to the overall benefit of the market itself and the investors and originators that participate in sukuk resulting in further globalisation of the market, innovation and development of existing structures and drawing in issuers from a number of jurisdictions.

DIFC

Dubai International Financial Centre (DIFC)
The Gate, Level 14
P.O.Box 74777, Dubai, UAE
Tel: +971 4 362 2222
Fax: +971 4 362 2333
Email: info@difc.ae
Web: www.difc.ae