A new benchmark

Updated issuing and trading standards are a key part of Dubai's strategy to increase global investors' confidence in *sukuk* structures

The Dubai Financial Market (DFM) has recently published comprehensive standards for issuing and trading *sukuk*. The new standards were issued by the DFM's Shari'ah and Fatwa Supervisory Board following a consultation period with a broad range of experts from the Islamic finance and capital markets industries. They address *sukuk* classification, transaction structuring and Shariah parameters. They are intended to encourage standardisation in the Islamic capital markets and complement the previous standards published by the DFM in 2007.

The new standards have been issued in the wake of a rapidly expanding regional *sukuk* market. The total value of *sukuk* listed on Dubai's capital markets increased 103% to $18.6 billion by the end of the first quarter of 2014. This compares with $9.2 billion during the same period in 2013. Global *sukuk* issuance has, for the most part, grown exponentially over the past several years. According to a Thomson Reuters study released last month, volumes are projected to hit $237 billion in 2018, up from an estimated $100 billion this year.

However, despite the growing prevalence of *sukuk* as a debt-raising instrument in the GCC [Gulf Cooperation Council] region, certain challenges in this market remain. These include the lack of consensus among Shariah scholars on *sukuk* structures and the absence of an integrated secondary market due to the relatively limited number of *sukuk* issuances compared to conventional instruments. Differences of opinion between scholars, issuers and investors over what types of structures are permissible has arguably hampered the growth of the *sukuk* market. The DFM hopes that introducing new standards for global investors will attract more international business to its market, which competes with other financial centres such as London and Kuala Lumpur.

Malaysia remains, by far, the global leader in *sukuk* issuances, accounting for around 68% of total global issuance in 2013. In comparison, Saudi Arabia accounted for 12% of global issuance and the UAE, the third biggest *sukuk* market globally, accounted for around six percent. Malaysia's *sukuk* industry is significantly more standardised by regulation, with relatively prescriptive rules and guidelines regarding *sukuk* issuance. While observers do not expect the new standards to carry the force of law in the UAE, the standards represent a positive step towards the Malaysian regulatory model, which caters to an extremely active and successful *sukuk* market, particularly in relation to secondary trading.

The standards

The DFM standards address a number of key items, including:

- *sukuk* structuring;
- Shariah requirements in respect of an issuance;
- information to be included in the prospectus prepared in connection with an issuance;
- the procedures and rules for trading and redemption of *sukuk;*
- clarification of *sukuk* holders' entitlement to gains and liability for losses;
- defining ways to protect *sukuk* holders' rights and hedge the risk of their investment; and
- setting out the permissibility of the periodic calculation and payment of incentives to the *sukuk* manager.

The standards also state that, in respect of any principles not addressed therein, the ultimate point of reference should be the standards issued by the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI). This body prepares accounting, auditing, governance, ethics and Shariah standards for Islamic financial institutions and the industry.

Sukuk structures

The standards classify *sukuk* into three principal categories: finance, *ijara* and investment *sukuk*. Detailed requirements in respect of each of these structures are set out in the standards. The categories can be summarised as follows:

- finance *sukuk*: these involve financing the purchase of an asset to generate a return. The standards further divide this category into *murabaha*, *istisna'a* and *salam sukuk* structures;
- *ijara sukuk*: these involve a sale and leaseback contract in respect of a particular asset, upon which rental payments are made. The standards further divide this category into structures involving the sale and leaseback of leasable assets (or usufruct rights thereof), services, operating leases and financial leases;
- investment *sukuk*: these involve financing a particular investment which is intended to realise an investment return. The standards further divide this category into, among others, *mudaraba*, *wakala* and *musharaka sukuk* structures.

Shariah requirements

The standards set out various Shariah requirements which market participants should consider when structuring any *sukuk* transaction.

Special purpose vehicle

The special purpose vehicle (SPV) issuing the *sukuk* should have financial liability independent of the liability of the *sukuk* originator or owners. The SPV's financial liability should cover its purposes of acting as the *sukuk* holders' trustee in holding title of the *sukuk* assets, and as their agent in directing the *sukuk* issuance realised funds towards investing them in what they were issued for. It should also cover its purpose of contracting with the investors of the *sukuk* proceeds. The SPV must maintain regular accounts of its operations, which should be audited by at least one chartered accountant. If the *sukuk* structure involves either a sale or leaseback to oneself or any other conflict of interest, the SPV may not be owned or managed by the *sukuk* originator. Although the SPV must exercise its best efforts to

> The new standards have been issued in the wake of a rapidly expanding regional *sukuk* market

protect the rights of the *sukuk* holders, the SPV may appoint an experienced party to handle its various responsibilities.

Shariah approval

The standards also formalise requirements in relation to Shariah approvals for *sukuk* issuances, which, notably, are already generally followed in the market. *Sukuk* issuances must be approved by a three member Shariah committee, each holding a PhD in Islamic law, or two members with a PhD in Islamic law and one with a PhD in economics or finance. The Shariah committee is responsible for giving a Shariah opinion on the *sukuk* - endorsing the proposed structure, contracts and prospectus - as well as ensuring that the *sukuk* issuance proceeds and the distribution of the *sukuk* returns from issuance to redemption are used in accordance with Shariah rules.

Incentive for sukuk manager

The *sukuk* manager (the *mudarib*, partner or investment agent, depending on the *sukuk* structure) is entitled to all or part of the profit that exceeds a certain level, as an incentive for its good management, in addition to the fees or profit share the *sukuk* manager is originally entitled to. The *sukuk* manager's incentive should be calculated for the *sukuk* term upon the maturity of the *sukuk*. However, the standards permit advancing the *sukuk* manager some payments on the account of the incentive during the term of the *sukuk*, and prior to their maturity. These advanced payments should be offset against the realised incentive upon the maturity of the *sukuk*. The standards do permit, however, the final calculation and payment of the incentive for each profit distributing period after a constructive liquidation.

Prizes in respect of investment sukuk

The *sukuk* manager is not permitted to distribute prizes on lot basis to the *sukuk* holders from the profit distributable to them. This is because *sukuk* holders are partners and assigning some profit to some partners is against the very spirit of profit sharing. However, the *sukuk* manger is permitted to distribute prizes from its own fund, provided the distribution is on a pure donation basis and is not the primary objective of the *sukuk* issuance.

Prospectus

The standards set out various requirements for the prospectus to be prepared in relation to a *sukuk* issuance. Most notably, the prospectus should include a feasibility study of the underlying project or venture to be financed by the *sukuk* proceeds. This should include a description of the project or venture, the total cost of setting up or developing the project or venture, its management, components, phases, potential risks and mitigants, as well as expected profits. The feasibility study should be endorsed by an independent financial adviser who is certified by the securities regulator in the relevant jurisdiction. The prospectus should also include a copy of the fatwa issued by the Shariah committee, as well as a section describing the Shariah committee and its responsibilities in supervising and auditing the transaction, and where the issuance proceeds are invested.

Sukuk guarantees

Sukuk are intended to represent an investment in real ownership. The *sukuk* holders bear the risk of the assets in which the subscription proceeds are invested, rather than a debt liability from the issuer towards the *sukuk* holders. Accordingly, the standards confirm that neither the *sukuk* issuer, nor the *sukuk* manager or *sukuk* originator is permitted to guarantee the face value of their *sukuk* or a certain return on the *sukuk* holders' investment. However, the *sukuk* issuer, manager or originator is permitted to guarantee the value of the *sukuk* assets when the assets are destroyed or damaged, or when the assets fully or partially lose their value without any misconduct, negligence or breach of the issuance conditions on the part of the guarantor. The *sukuk* manager is permitted to give an undertaking to buy the *sukuk* assets at any value except the face value. This undertaking, however, does not bind the undertaker in cases of full or partial damage. The undertaker is bound by his purchase undertaking only if the assets remain in existence at the time of the purchase execution. However, if the assets have been destroyed or damaged then the undertaking is not executable, because selling non-existing assets is invalid.

Cumulative reserve

The establishment of a cumulative reserve is permitted to protect investors in the *sukuk* from investment risk. This reserve can be financed through the deduction of a certain percentage of the *sukuk* holders' share in the realised profits until the reserve reaches a specific limit during the *sukuk's* term. The prospectus should define how to form the reserve from the *sukuk* holders' share in the net profit, how to utilise this reserve and how to distribute the remaining balance among the *sukuk's* owners upon maturity.

Credit rating

The standards state that 'where the nature of the *sukuk* requires', a *sukuk* issuer should obtain an issuance credit rating. While the standards do not specify when such circumstances would arise, this requirement could be compared to the regulatory regime of the Securities Commission in Malaysia, which requires any *sukuk* obtain a credit rating.

Outlook

The *sukuk* market is already a key source of finance for many companies, sovereigns and government-related entities in the GCC region, and deal volumes are widely expected to increase over the next few years. Dubai has also recently encouraged its government-related entities to list domestically. Most recently, the government of Dubai listed its $750 million 15-year *sukuk* on the DFM, its fifth to date on the exchange.

The DFM hopes the *sukuk* market, and ultimately the economy of Dubai and the region as a whole, can benefit significantly from international investors' increasing accessibility to and familiarity with *sukuk* as a debt-raising instrument. By introducing clear, detailed standards for *sukuk*, the DFM hopes global investors — particularly conventional investors in the US such as insurance companies and pension funds — will gain greater confidence to invest in *sukuk*. The new standards, if widely adopted, may lead to a more consistent approach between scholars as to the acceptability of certain *sukuk* structures.

By Latham & Watkins partner Nomaan Raja and associate Basil Al-Jafari in Dubai

Read online at *iflr.com/IFstandards*

"Differences of opinion over over what structures are permissible has arguably hampered the *sukuk* market's growth"