

Structuring and offering Sukuk products involving assets in the US: challenges and opportunities

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The continued integration of the Islamic banking industry into the wider global banking community is resulting in some of the world's most sophisticated commercial and legal jurisdictions increasingly having to address the needs of Islamic investors and acknowledge the special nature of Shariah compliant investment products while, at the same time, subjecting such products to the same legal and disclosure thresholds that pertain to conventional products. This article highlights key considerations relating to the selection of a jurisdiction in which Islamic investment products, particularly Islamic bonds (or Sukuk), can be offered. In particular, it addresses the issues involved in avoiding registration under the US federal securities laws and discusses the East Cameron Gas Sukuk transaction (ECG Sukuk), which was the first Sukuk transaction backed by assets in the US.

Forum selection considerations

The decision to domicile a Shariah compliant investment vehicle in a particular jurisdiction will necessitate detailed legal analysis with respect to structuring, regulatory and tax issues.

Structure

Selecting the most appropriate legal form for an investment vehicle will involve assessing the advantages and disadvantages of each form available in a particular jurisdiction. Issues relevant in that assessment will include: the time, difficulty and cost required to establish an entity; capital requirements; how the entity is to be controlled or managed; the liability of the members or shareholders; and the periodic or annual reporting requirements.

Analysis of the availability of attractive ownership structures should also be undertaken. In common law jurisdictions, assets can be held in a 'trust', allowing investors to beneficially own the assets of the underlying fund. Islamic special purpose vehicles are increasingly being established in tax-friendly common law jurisdictions to take advantage of this form of ownership structure which is important in the issuance of Sukuk.

Regulation

Regulatory requirements, including know-your-customer and other compliance requirements, also differ jurisdictionally. A number of offshore jurisdictions have enacted and implemented strict compliance policies, particularly in the context of Shariah compliant investment funds and investment products within member states of the EU. In recent years, promoters of investment funds and products have been attracted to jurisdictions such as Bahrain and Malaysia, which offer comprehensive regulations

applicable to the establishment of collective investment schemes, both conventional and Islamic, tax-friendly environments and increasingly strict compliance policies.

Tax

Tax issues are particularly important in deciding where to domicile any investment vehicle, whether Shariah compliant or not. Tax advice will be required to understand the taxation treatment of both the establishment and operation of the investment vehicle. At the establishment stage, the promoters of a structure that will initially involve multiple asset transfers will require tax advice to determine the taxation treatment of such transfers. Tax advice is also necessary in order to confirm the favourable tax treatment of a particular jurisdiction to all aspects of the business and operation of the investment vehicle.

For example, in the ECG Sukuk, which was backed by oil and gas assets in the Gulf of Mexico, the structure utilised a funding arrangement that was heavily driven by US tax considerations. Legislation in some jurisdictions requires, in connection with the conveyance of title in real estate or property transactions (which would be required in the context of an *Ijara wa iktinaa*, or sale-lease-back structure), that the sale contract and the resulting title transfer be recorded in a real estate register and that a transfer of title fee or tax be paid.

Nature of the assets

Notwithstanding the jurisdiction of the relevant pool of assets, the assets themselves must be Shariah compliant for a Sukuk issue to withstand Shariah scrutiny. Islamic investors may only invest in activities which are in strict compliance with Shariah precepts. Investments in sectors and industries such as the

manufacture, packaging or distribution of alcohol, tobacco or pork products; entertainment; conventional financial services; or the manufacture and sale of weapons, are impermissible. The focus of most Sukuk offerings has historically been on real estate development projects and, generally, on acquiring real property. There is, however, a recent trend towards new sectors, such as energy (both oil and gas) and renewable energy. There is also growing interest in investing in assets located in non-Islamic jurisdictions, particularly Western jurisdictions, such as the US oil and gas assets that underpinned the ECG Sukuk. This trend has less to do with the abundance of the relevant energy resources in such jurisdictions (at least as compared to the Middle East) and more to do with the fact that such jurisdictions offer a legal and regulatory environment that is more amenable to private-sector investment, as evidenced by a proven track record of successful conventional offerings of securities that are backed by energy rights.

Other issues

Specialised legal advice is also required in order to identify other issues that may be relevant in deciding

to domicile a Sukuk issuer in a particular jurisdiction, including conducting a bankruptcy analysis and testing the degree to which the local legal environment would accommodate certain Shariah investment paradigms.

Legal framework for the offering of Sukuk in the US

Elements of investment management are inherent in most Sukuk structures. Entities undertaking investment management activities in the US are required to comply with the requirements of the United States Investment Company Act of 1940, as amended (the '1940 Act'). The 1940 Act governs the registration and activities of investment companies. It prohibits any investment company from publicly offering securities in the US unless it is registered or expressly exempt therefrom. An investment company registered under the 1940 Act is subject to requirements covering virtually every aspect of operations. A foreign investment company may register under the Act only after petitioning the SEC for an order. In practice, it has proved virtually impossible for foreign issuers to register under the

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1940 Act and to date only a handful have been able to do so.

Unregistered investment companies are precluded from conducting a public offering of securities in the US, but foreign investment companies may make limited private placements in the US as long as either (i) the offering creates no more than 100 US security holders in the issuer or (ii) the securities are sold to an unlimited number of 'qualified purchasers' (i.e. individuals who own at least US\$5m in investments or institutions that own or invest, on a discretionary basis, at least US\$25m in investments).

Separately, the offer and sale of units of Sukuk in the US must generally be registered under the US Securities Act of 1933 (the 'Securities Act') or structured so as to take advantage of an exemption from US registration. The principle exemptions from registration are provided by Section 4(2), Rule 144A and Regulation S.

Section 4(2) - Traditional private placement

The US private placement market is one of the world's leading securities markets and plays a major role as a source of finance in the US. Investors in this market are almost exclusively institutional and the placement of securities is mostly through investment banks.

One of the most significant exceptions to the registration requirements of the Securities Act is Section 4(2) which exempts "*transactions by an issuer not involving any public offering*", i.e. private placements. This exemption is based on the fact that investors in the private placement market are the type of investors who do not need the protection of the registration provisions of the Securities Act as a result of their ability to obtain from the issuer the information needed for their investment decision, as well as their financial capability to bear the economic risk of the investment and their degree of sophistication as investors.

There are no specific disclosure requirements for private placements when the only investors are so-called 'accredited investors' (i.e. banks, insurance companies, investment companies, employee benefit plans, trusts, the issuer's directors, executives or partners, corporations over a certain size and certain individuals with high incomes or net worths), but there is a requirement under Regulation D for information, largely akin to that required in a registered transaction, to be supplied to all non-accredited purchasers. Aside from whether non-accredited investors are included in the private placement, whether a disclosure document is prepared or publicly available information is used will depend on marketing considerations, the type of placement (debt, equity and size) and how well the

issuer is known. The issuer has liability for information which contains material misstatements or omissions under the Securities Act. It is rare for US securities counsel to render disclosure opinions on documents used in this context.

The ECG Sukuk was marketed and sold, including into the US, with an extensive private placement memorandum that largely benchmarked against US disclosure requirements. Rarely, in the history of Sukuk offerings, the ECG Sukuk private placement memorandum included a detailed Management's Discussion and Analysis of Financial Condition and Results of Operations (or 'MD&A'), a particularly US-centric part of the document that sets forth an expansive discussion of management's view of the underlying drivers of the Sukuk originator's financial results and position and the reasons for changes.

The law relating to private placements remains somewhat complex, and there are restrictions on the resale of privately placed securities. In part, in reaction to these resale restrictions, the SEC adopted Rule 144A, discussed below, to facilitate both the development of the primary market, as well as the liquidity of the secondary market, in privately placed securities.

Rule 144A

Rule 144A provides an exemption from registration for resales of units of Sukuk to qualified institutional buyers - commonly referred to as 'QIBs' - as long as such units are not listed on a US securities exchange or quoted on a US automated inter-dealer quotation system. Rule 144A provides both a mechanism for the distribution of securities to QIBs, as well as a regime for secondary market traders among QIBs, who typically trade through a screen-based closed trading system called PORTAL. A QIB is an institution that, at the end of its most recent fiscal year, owned and managed with discretion at least US\$100m in securities of non-affiliated issuers. Banks and savings and loan associations must also have a net worth of at least US\$25m in order to qualify for QIB status. There are four conditions to relying on Rule 144A which are outside the scope of this article. One of those conditions requires that the reseller take reasonable steps to ensure that the buyer is aware that the reseller may rely on Rule 144A in connection with the resale. This is typically done by way of a legend on the security, a statement in the private placement memorandum or other offering document, and a restricted CUSIP number.

Rule 144A securities are almost always underwritten by investment banks that conduct full due diligence on the issuer and receive disclosure opinions on the prospectus from US securities counsel. The prospectus is typically written to comply

with US disclosure standards and contains 'MD&A' financial disclosure (discussed more fully above).

Regulation S

Securities offered outside the US to non-US persons generally do not need to be registered under the Securities Act. Regulation S provides an issuer safe harbour. Two general conditions apply to this safe harbour: first, the offer and sale must be an 'offshore transaction', which generally means the buyer is not someone in (or a resident of) the US and, secondly, there are to be no 'directed selling efforts', which generally means that there should be no conditioning the market for the securities in the US. In connection with the prohibition on directed selling efforts, promoters of investment funds and products must refrain from publishing information or statements, or conducting publicity efforts that refer to the offering of units of Sukuk (i) in publications with a general circulation in the US; (ii) in the speeches, seminars or presentations (live or taped) to groups of investors inside the US or specifically targeted to US citizens residing abroad; (iii) in advertisements on radio or television stations broadcasting into the US; or (iv) in brochures or other printed materials mailed to investors inside the US or specifically targeted to US citizens resident abroad.

In the disclosure documents of Islamic and conventional investment funds and products, where the promoters wish to avoid the registration requirements of the US securities laws, detailed declarations and notices are incorporated, as well as in the related subscription agreements, to ensure that investors represent and warrant that they are not US persons, and that the requirements of Regulation S are met.

ECG Sukuk structuring considerations

The ECG Sukuk transaction was the first transaction in which US oil and gas law was applied in the context of what was essentially an Islamic finance product. The success of that Sukuk offering was attributable to a number of factors, including that the nature of oil and gas rights under US law facilitated the utilisation of Sukuk instruments in the context of a US asset-based lending, as well as the fact that it was purchased by both Islamic investors and conventional Western investors in a combined Regulation S international offering and a US private placement. The Sukuk was underwritten and arranged by banks in both London and Beirut, with legal assistance provided by counsel in Dubai, London and Houston.

The proceeds of the ECG Sukuk were used to support capital and operating costs associated with drilling and operating wells in the Gulf of Mexico for a US oil and gas company. The proceeds of the offering

were utilised to repay the vast majority of the originator's outstanding conventional debt, hence leaving the originator with a debt-equity ratio that was considerably lower than the maximum threshold set by Islamic law.

In structuring the ECG Sukuk, a number of obstacles needed to be overcome, including improving the tax effectiveness of the structure and its bankruptcy remoteness, while, at the same time, maintaining the Shariah compliance of the transaction. A detailed analysis of US oil and gas law was conducted with the result that a royalty interest was selected as the interest to be held by a US special purpose vehicle (SPV) that was funded by the Sukuk issuer entity itself a Cayman Islands exempted limited liability company. The US SPV took part in the conduct of the drilling or production on the property (achieved through the originator) but held only a passive and non-working interest that entitled it, hence the Sukuk holders, to a portion of the stream of income generated by the sale of production from the burdened leases.

In compliance with the requirements of Shariah, the Sukuk offering was 'non-recourse' in that the ultimate issuer (the oil and gas operator) was not obligated to repay the Sukuk holders if the royalty could not generate sufficient funds. The Sukuk holders received a fixed return consisting of periodic payments of profit-sharing from the income generated from the royalty, as well as payments toward the amortisation of the principal. In addition to a comprehensive due diligence exercise, including a detailed oil and gas reserve report and an audit of that report, the structure included a number of mitigating factors and credit enhancements to reduce risk, including reserve accounts, security interests, conservative modelling, as well as some Shariah compliant hedges.¹

Conclusion

US federal securities laws do not distinguish between conventional and Islamic products. To date the focus of Islamic institutions, as well as institutions active in the development, offering and marketing of Islamic products, has been on non-US investors, despite the growing demands of the Muslim community in the US to participate in Shariah compliant investment products. The requirements of the Securities Act provide no meaningful obstacle to the development of suitable Shariah compliant investment products to be offered to US investors. To that end, regulatory bodies in the US have been supportive of the development of an Islamic financial industry, and recently the US Congress has hosted round table discussions to discuss various modes of Islamic financing, such as asset-backed finance.

The Islamic banking industry will continue to evolve into a more sophisticated and modern industry as promoters of Shariah compliant investment products and their professional advisers work together to solve the structural, regulatory and legal challenges that continue to arise, as well as to educate finance officers of companies that are seeking to sell Shariah compliant products abroad as to the regulatory requirements in the relevant jurisdictions. To meet the worldwide demand for advanced and sophisticated Islamic products, the industry and its advisors, together with many different regulators, will continue to create legal structures within which to operate in a secure and Shariah compliant manner in a variety of jurisdictions.

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Notes:

¹ For more information on the ECG Sukuk transaction please see: Khaleq and Richardson, New Horizons for Islamic Securities: Emerging Trends in

Sukuk Offerings, Chicago Journal of International Law, Volume 7 Number 2 (Winter 2007.)

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