KING & SPALDING

Client Alert

Global Islamic Finance & Investment Practice Group
Capital Markets - Financial Institutions Area of Focus

May 3, 2017

For more information, contact:

Rizwan H. Kanji
+971 4 377 9905
rkanji@kslaw.com

Terry D. Novetsky
+1 212 556 2328
tnovetsky@kslaw.com

Michael Urschel
+1 212 556 2285
murschel@kslaw.com

Anthony P. Mechcatie
+1 212 556 2104
amechcatie@kslaw.com

Hamed Afzal
+971 4 377 9906
hafzal@kslaw.com

King & Spalding
Dubai
Al Fattan Currency House
Tower 2, Level 24
DIFC | Dubai International
Financial Centre
P.O. Box 506547
Dubai, UAE
Tel: +971 4 377 9900
Fax: +971 4 377 9955

New York
1185 Avenue of the Americas
New York, New York 10036
Tel: +1 212 556 2100
Fax: +1 212 556 2222

www.kslaw.com

RISK: To Retain or Not Retain in Sukuk?

Introduction

17 C.F.R. Part 246, adopted jointly by the United States Securities and Exchange Commission (the "***SEC***") and other federal agencies in October of 2014 (the "***U.S. Risk Retention Rule***") was adopted in response to the requirements of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "***Dodd-Frank Act***"). The risk retention regime in relation to residential mortgaged-backed securities came into effect in December 2015 and, on December 24, 2016, the final rules implementing the risk retention regime for all other asset-backed securities came into effect in the United States.

In an effort to comply with the U.S. Risk Retention Rule, the prospectus disclosure of the recent Kingdom of Saudi Arabia (the "***Kingdom***") Trust Certificates Issuance Programme (the "***Saudi Trust Certificates Programme***"), established as a U.S. Rule 144A Programme, provided that 5 percent of the issue size of each issuance under the Saudi Trust Certificates Programme would be held by the sovereign for risk retention purposes. As a result, the inaugural issuance of US$9 billion under the Saudi Trust Certificates Programme required the Kingdom to purchase and retain US$450 million of its own trust certificates, and to hold this amount for the entire tenor of the instrument, in accordance with provisions of the U.S. Risk Retention Rule. Against this backdrop, an in-depth discussion has taken place amongst sukuk industry practitioners around the subject of risk retention in sukuk issuances more generally, in particular whether compliance with the U.S. Risk Retention Rule is actually required for the asset class.

In this note, we briefly analyse the key features of a typical sukuk instrument, and then look at the requirements of the U.S. Risk Retention Rule to establish if it should, in fact, apply to an asset-based (as opposed to asset-backed) sukuk transaction. In our view, it should not.

What is a Sukuk?

In order to establish the application of the U.S. Risk Retention Rule to a sukuk, it is important to first understand one of the key general principles of a typical sukuk. As is widely known, a sukuk is a capital markets instrument which is akin (at least economically) to a conventional fixed-income instrument, but structured in a manner that complies with principles of Shariah. Due to the prohibition of interest under Shariah, the sukukholders' returns are generated from underlying transactions in respect of certain assets underpinning the sukuk, but without exposure or reference to the underlying credit of those assets. Sukuk may be further classified as being either "asset-based" or "asset-backed." This client alert primarily deals with asset-based sukuk transactions, as opposed to asset-backed sukuk transactions, and does not address other risk-retention regimes (in particular the EU risk retention rules).

An asset-based sukuk incorporates the general underlying asset principle discussed above, with the important limitation that sukukholders do not have legal recourse to the underlying assets under any circumstance. Such sukuk are considered to be senior unsecured obligations of the obligor, and sukukholders accordingly take obligor credit risk. This is economically akin to a senior unsecured conventional fixed-income instrument. On the other hand, an asset-backed sukuk also incorporates the general underlying asset principle described above, but, in addition, also provides that sukukholders have recourse to the underlying assets in a default scenario. As such, an asset-backed sukuk reflects features more typical to asset-backed securities ("***ABS***") in the U.S. given that, as is the case with noteholders in an ABS, sukukholders in such structures would take credit risk in relation to the underlying assets (rather than the obligor), while those in an asset-based sukuk do not. At this juncture, it is worth noting that, approximately 95 per cent. of global sukuk issuances are asset-based (i.e. senior unsecured obligations of the obligor) rather than asset-backed—an important distinction for the application of the U.S. Risk Retention Rule to sukuk issued to U.S. investors.

The U.S. Risk Retention Rule

The Dodd-Frank Act enacted various changes to the financial regulatory system in the United States, to redress certain weaknesses discovered in the context of the credit crisis. The key objective of the U.S. Risk Retention Rule, in particular, is that the economic interests of the originator in an ABS, and those of the investors are required to be, to a degree, aligned. The U.S. Risk Retention Rule seeks to achieve this by requiring a sponsor of an ABS to retain 5 percent of the credit risk of the pool of assets being securitized (referred to as having "skin in the game"). This seeks to mitigate the risk of originators pooling assets of poor credit quality and repackaging and selling them as ABS to investors without retention of risk of loss.

Broadly, the U.S. Risk Retention Rule applies to any security falling within the definition of an "asset-backed security" as defined in Section 3(a)(79) of the United States Securities Exchange Act of 1934 (the "***Exchange Act***") and the offer of sale of ABS into the United States (subject to a certain limitations).

The Exchange Act defines "asset-backed security", in pertinent part as follows: "a fixed-income or any other security *collateralized* by any type of self-liquidating financial asset (including a loan, lease, mortgage or other secured or unsecured receivable) that allows the holder of the security to receive payments that depend *primarily on cash flows from the asset . . .*" (emphasis added).

Risk Retention in an Asset-Based Sukuk?

Based on the description of an asset-based (as opposed to asset-backed) sukuk set forth above, and the definition of ABS in the Exchange Act, below are some of the key points to consider in determining the application of the Section 3(a)(79) of the Securities Exchange Act of 1934 to asset-based sukuk transactions.

No Recourse to Underlying Assets

A key point to note is that the definition of ABS under the Exchange Act refers to "collateralization". In our view, this clearly envisages that, in order for a particular security to fall within the U.S. Risk Retention Rule, the holder of such security should have recourse to the underlying assets. In an asset-based sukuk, it is typically clearly stipulated in the applicable offering documentation that investors have no such recourse to the underlying assets, and that no steps may be taken to legally perfect a transfer of such assets to investors (or for their benefit).

Additionally, the disclosure in the applicable offering documentation of an asset-based sukuk is limited to the disclosure of the business of the obligor, and not of the underlying assets. This is in contrast to a typical conventional ABS, where detailed disclosure of the assets and their credit profile and performance would be expected. It would of course be the case that relevant regulatory/listing authorities would require disclosure of the underlying assets in an asset-based sukuk offering, if indeed credit risk was being taken by investors of, or by reference to, the underlying assets, but this is typically not the case. An asset-backed sukuk may well be analysed differently under the U.S. Risk Retention Rule, but in a typical asset-based sukuk transaction, it is our view that the lack of collateralization or recourse to the reference assets (and lack of exposure to the credit of the reference assets) should weigh toward non-application of the U.S. Risk Retention Rule.

No Risk Transfer

The U.S. Risk Retention Rule also requires that an originator/sponsor retains a proportion of the ABS risk being transferred, also referred to as having "skin in the game". In an asset-based sukuk, no credit risk of the underlying assets is being transferred; it is therefore unclear how an originator could retain "skin in the game" in such a structure. Again, the result may be different in an asset-backed sukuk transaction.

A separate—but perhaps related—point relates to the definition of a "sponsor" under the U.S. Risk Retention Rule. The U.S. Risk Retention Rule provides that a sponsor "*organizes and initiates a securitization transaction by either selling or transferring assets, either directly or indirectly, including through an affiliate, to the issuing entity*". In an asset-based sukuk, by definition, it is arguable that no entity initiates a securitization (given that asset-based sukuk may not be categorised as such due to lack of collateralization as set forth above), and therefore it could be argued that the U.S. Risk Retention Rule should not apply on this basis.

Reliance on Cash Flows from Assets

The Exchange Act definition of ABS also implies that holders of ABS to which the U.S. Risk Retention Rule applies should rely on cash flows generated from the underlying assets for their returns. In an asset-based sukuk, as noted above, the credit risk of payment is that of the obligor, and the documents governing an asset-based sukuk are framed accordingly. The sukukholders do not take the risk of performance of the underlying asset for their returns.

Conclusion – Not to Retain for Asset-Based Sukuk

As discussed above, the U.S. Risk Retention Rule applies to ABS as defined in the Exchange Act (likely including asset-backed sukuk transactions) which are being offered into the United States. However, it seems quite clear, for the reasons discussed above, that the U.S. Risk Retention Rule should not apply to asset-based sukuk (which constitute the vast majority of sukuk transactions globally), and was likely not intended to capture similar asset-based transactions where a mere reference to an asset-based transaction does not itself create collateralization or recourse to those assets or the credit profile thereof.

Celebrating more than 130 years of service, King & Spalding is an international law firm that represents a broad array of clients, including half of the Fortune Global 100, with 1,000 lawyers in 19 offices in the United States, Europe, the Middle East and Asia. The firm has handled matters in over 160 countries on six continents and is consistently recognized for the results it obtains, uncompromising commitment to quality and dedication to understanding the business and culture of its clients. More information is available at www.kslaw.com.