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The Middle East Periodic Bulletin

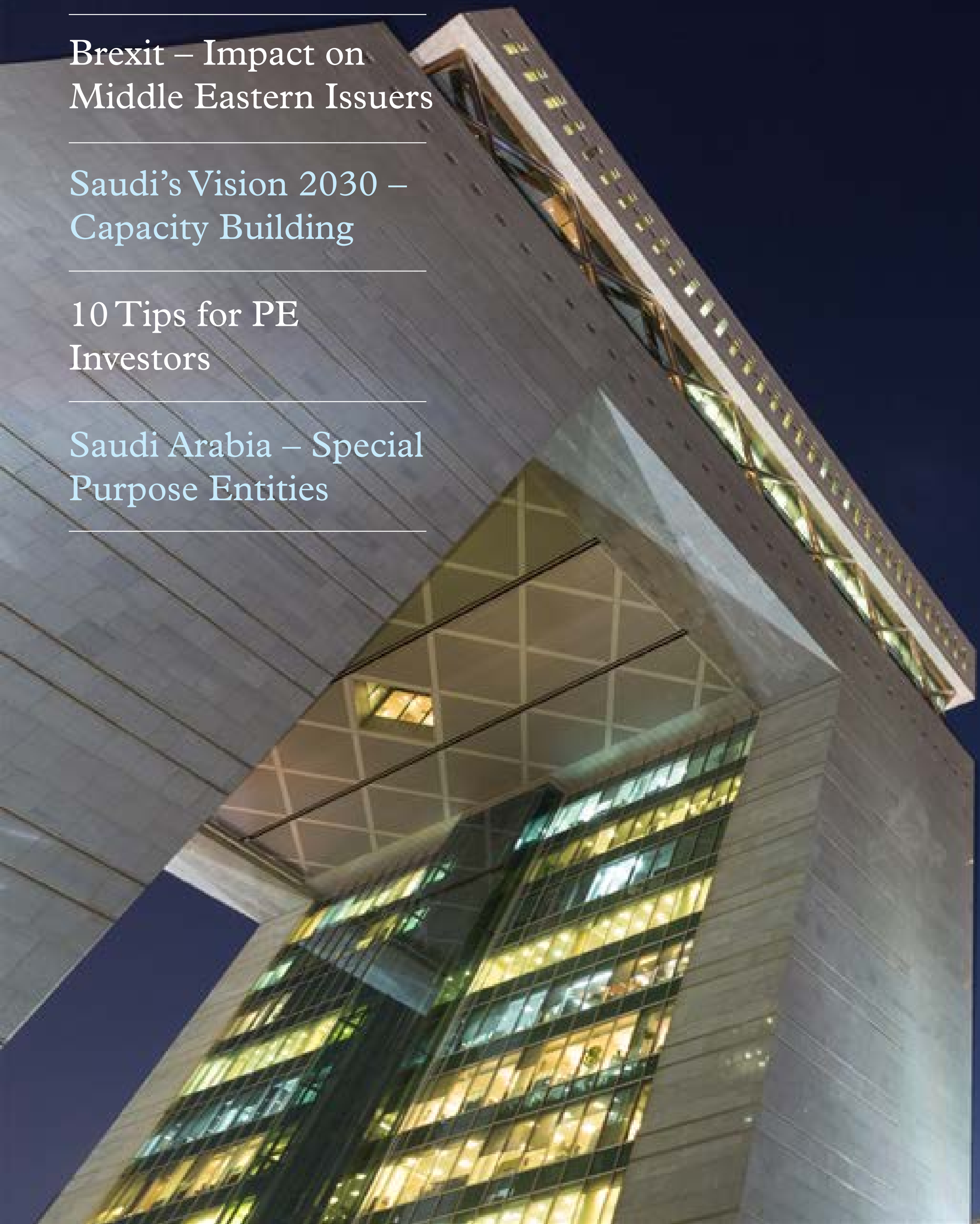
Summer 2016

Brexit – Impact on Middle Eastern Issuers

Saudi's Vision 2030 – Capacity Building

10 Tips for PE Investors

Saudi Arabia – Special Purpose Entities



Foreword

Welcome to the second-quarter 2016 issue of *measure*, King & Spalding's Middle East and Islamic Finance practice group quarterly newsletter. We will, in this issue, cover a range of interesting developments across the Middle East and wider legal landscape, as follows:

- The UK's decision to leave the EU in June, referred to as "Brexit", has been the source of much debate in the international business and legal community. Whilst the long-term impact of Brexit is difficult to predict with any degree of certainty, it is clear that the decision is likely to have far-reaching consequences. In this issue, Rizwan Kanji and Hamed Afzal discuss the possible impact of Brexit on Middle Eastern issuers accessing the UK and European capital markets;
- Saudi Arabia's wide-ranging economic road map, dubbed "Vision 2030", has been received with much praise from the business world. Leroy Levy discusses the importance of a strong capacity-building program to achieve the objectives set out in "Vision 2030";
- Nabil Issa and Osama Audi examine some of the common issues faced by commercial parties, particularly private equity and venture capital investors, purchasing Middle East-based companies in the popular healthcare, education and food and beverage sectors, with a focus on companies in Saudi Arabia and the UAE; and
- Rizwan Kanji and Hamed Afzal discuss the draft rules issued by Saudi Arabia's Capital Market Authority designed to regulate the establishment and operation of Special Purpose Entities, a new type of corporate entity proposed to be used in certain financing transactions in Saudi Arabia.

We are pleased to announce the further growth of our team in the region, with associate Dora Chan joining us in Dubai, focusing on investment funds, financial services regulation and private equity matters.

Our Middle East team continues to serve our clients in creatively and innovatively structuring transactions to help meet our clients' objectives. Recent awards we have won in the past several months include the following, presented to us by *Islamic Finance News*:

1. Best Law Firm in Asset Management for 2015;
2. Best Law Firm in Project Finance for 2015; and
3. Kuwait Deal of 2015, in respect of National Industries Holding's KWD 85 million Commodity Murabaha and KWD 11.5 million Sukuk.

We look forward to helping you keep abreast of further developments, and stay tuned for our Q3 issue of *measure*. In the meantime, as always, we welcome your comments and feedback.

Jawad I. Ali
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Courtesy of iStock by Getty Images; View from the ground of Dubai International Financial Center

Brexit – Assessing the impact on Middle Eastern issuers accessing the UK and European Capital Markets

Many companies and other entities in the Middle East tap the UK and/or European debt and equity capital markets as part of achieving their corporate funding and broader strategic objectives.

Whilst the precise legal and regulatory impact that the UK's recent decision to leave the European Union (EU), dubbed Brexit, will have on the corporate finance market will depend on a number of factors, most notably the terms of withdrawal that are negotiated with the EU and the consequential impact on applicable legislation, we will examine some preliminary matters to be borne in mind.

Regulatory regime and "Passporting"

Many issuers in the Middle East elect to list their debt or equity securities on European exchanges, particularly in London. Currently, the prospectus disclosure, listing and reporting regime is harmonised across the EU, by virtue of the Prospectus, Transparency and Market Abuse Directives, providing many advantages for issuers, most notably allowing for prospectuses to be "passported".

The prospectus "passporting" regime currently allows issuers to use their prospectus approved by the competent authority in one member state to offer equity or debt securities into another European Economic Area (EEA) member state or to list securities on a regulated market in another EEA member state (or vice versa). For example, a United Arab Emirates - based issuer that wanted an IPO and listing in London would currently be able to use its Financial Conduct Authority approved prospectus to offer securities in any other member state. As a result of Brexit, in the absence of any analogous mutual recognition system negotiated with the EU, such "passporting" would no longer be available. If no such mutual recognition arrangement is negotiated, different prospectus and listing requirements in the UK from those in the EU would make it difficult and costly for issuers to make public offers of equity and debt securities both in the UK and Europe.

However, the European Commission does have the power to approve a non-EEA prospectus if it meets international standards which are equivalent to EU requirements, and so could make a finding of "equivalence" with respect to any future UK prospectus, albeit this would depend on whether the UK Treasury left in place the existing UK implementing legislation which mirrors the EU regime. This may become problematic over time, however, in case the two sets of rules deviate.

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Prospectus disclosure and risk factors

Following Brexit, issuers may wish to consider Brexit related risk factor disclosure in their prospectuses to the extent that Brexit is likely to have a material impact on their business and/or the securities being offered.

Validity of documents

The majority of debt capital markets transactions in the Middle East are governed by English law. It is difficult to see how Brexit could impact the validity of an English law governed contract, whether by resulting in the contract becoming frustrated or otherwise. For an English law governed contract to be frustrated, it must become impossible or illegal to perform or require either party to perform something radically different to what was originally agreed as a result of an unforeseen event outside the parties' control. It seems unlikely therefore that the requirements for frustration would be satisfied by Brexit, and Brexit is otherwise unlikely to cause any other such validity issues.

Default provisions in bond/sukuk terms and conditions

It is very unlikely that the terms and conditions of any debt financing transactions, including bonds and/or sukuk, would have specifically contemplated Brexit as being an event of default or dissolution event. Similarly, it is difficult to see how the usual events of default and/or dissolution events typically included in bond and/or sukuk terms and conditions would be triggered by Brexit.

Whether Brexit would, in and of itself, trigger a material adverse change provision in a subscription/ underwriting agreement would depend on the drafting of the particular clause. However, such clauses usually apply during the offer period of a particular offering, and it seems highly unlikely that any such offerings would have been launched immediately before or after the referendum.

Choice of governing law and jurisdiction

As noted above, the majority of debt capital markets transactions in the Middle East are governed by English law, and often provide for any disputes to be submitted to the jurisdiction of the English courts.

On the matter of governing law, by virtue of the Rome I and Rome II Regulations, the courts of member states (other than Denmark) currently apply a harmonised set of rules to determine what law should apply to most commercial disputes, which generally provide that party autonomy is to be respected. Such Regulations continue to apply with direct effect in the UK for so long as the UK is a member state.

Going forward, in the event of the UK's withdrawal from the EU, the UK could either revert to the conflict of laws rules which the Rome Regulations replaced or simply adopt the Rome Regulations into English law. It is, in our view, unlikely that the English courts would change their general approach to respecting a choice of English law, given the English courts' long-held position of respecting contract party autonomy over choice of law. Member state courts are also likely to continue to uphold English governing law and English jurisdiction clauses, subject to the usual exceptions.

Similarly, the jurisdiction of member states' courts in civil and commercial disputes and the enforcement and judgments is also currently harmonised and regulated by the Brussels Regulation. In the event of Brexit, the UK may well sign up to another regime in its own right, which will have substantially the same effects and benefits as the Brussels Regulation; for example, the Hague Convention on Choice of Court Agreements to which the EU is already a party, or the Lugano Convention. As an alternative, the UK may seek to secure for itself individual arrangements with existing EU countries, to govern the mutual recognition and enforcement of judgments, but this of course remains to be seen.

What is more certain is the position on arbitration - Where there are arbitration clauses in place, Brexit should not affect English seated arbitral proceedings subject to the Arbitration Act 1996, nor should it have any impact on enforcement of arbitral awards under the New York Convention.

The timing for transactions

Given the volatility in financial markets following Brexit, issuers and their advisers will need to carefully consider the timing for launching securities offerings. For issuers looking to undertake an initial public offering in London or elsewhere in Europe, which will also be offered in the US, as is often the case, in 2016, they will continue to watch the markets closely to establish whether launching the transaction in the typical window of September to mid-November (assuming the IPO will be based on audited interim results) would be optimal.

Conclusion

It is important to note that until the UK's withdrawal from the EU is fully concluded, the UK will remain an EU member state and the status quo, as far as the legal and regulatory environment for European capital market transactions is concerned, will be largely maintained.

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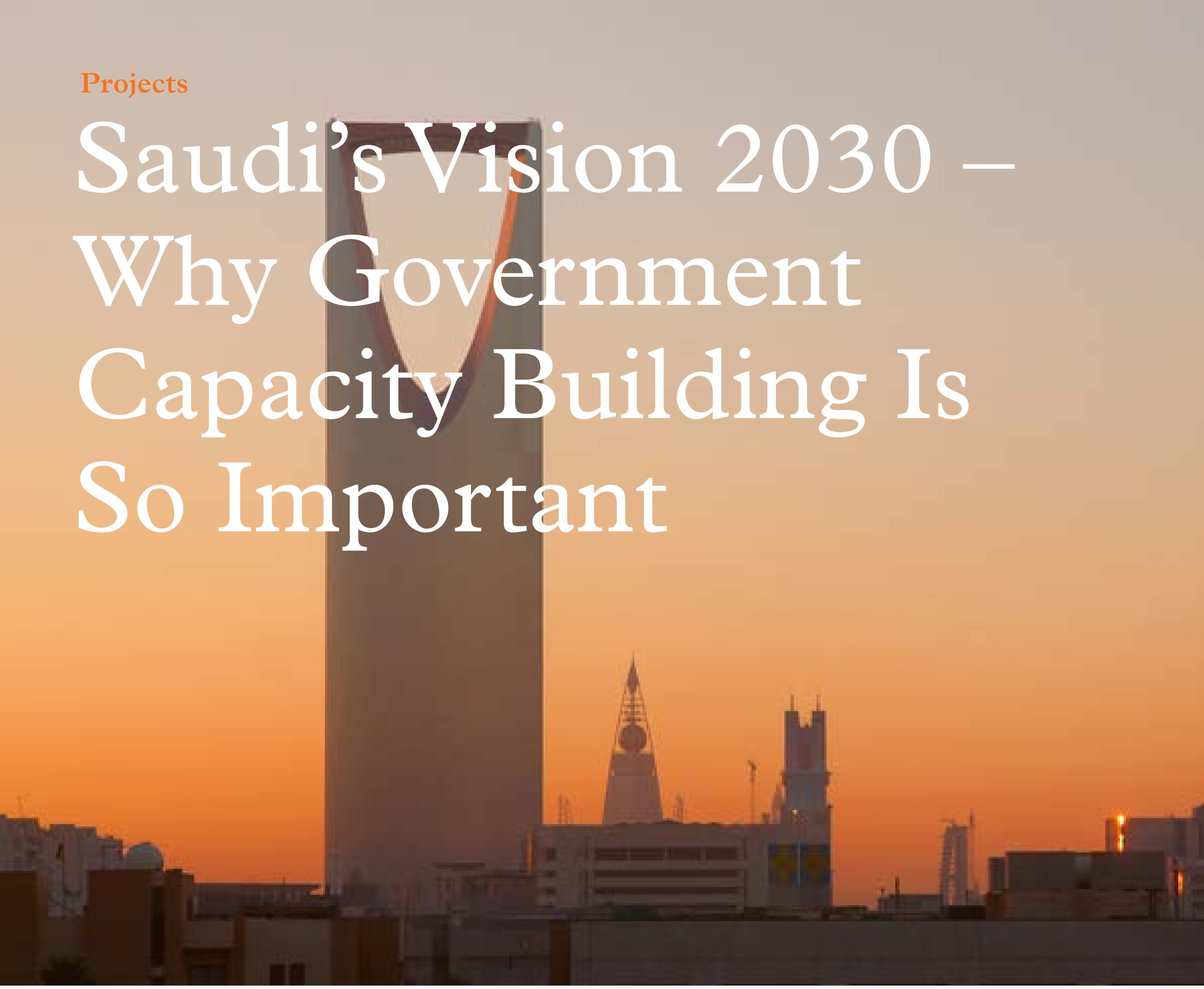
Saudi's Vision 2030 – Why Government Capacity Building Is So Important



INTRODUCTION

Considering the complexity involved in developing a national PPP program, it is generally accepted that governments do not typically have the internal skill sets required to plan, implement and regulate such programs. The required skills include developing public policy, identifying appropriate projects, commercial and financial structuring, running the procurement process, negotiating contracts and overseeing the private sector's implementation of each PPP project. Saudi Arabia's Vision 2030 has been received with much praise from the international commercial community. However, without a strong capacity-building program involving the establishment of strong PPP institutions, a robust regulatory regime, clear PPP procurement procedures and well trained government personnel, implementation will prove to be challenging.

POLICY OBJECTIVES

The starting point of a capacity building discussion is policy. Capacity is required to ensure that the PPP policy is properly implemented. The economic and social policies of the government should be at the heart of policy development. In some jurisdictions, the focus has been narrow with the objective of simply removing the public expenditure burden from the balance sheet of the government. This has often created a windfall for the private sector at the expense of the credibility of the government.

Value for money has been the key driver in many jurisdictions. This is important as PPP projects are for the public good. The services provided under a PPP project would typically be provided by the government. A service should only ever be provided on a PPP basis if the public good can continue to be served and the private sector is incentivized to provide that service at a level materially higher than that of the government. Left to itself, the private sector is not incentivized to achieve these policy objectives. It is governments' responsibility to ensure that policy objectives are achieved, and this requires highly developed capacity.

HOW TO BUILD CAPACITY

Establishment of a PPP Unit

A PPP Unit can be an effective way of pooling government resources into a centralised body around a group of civil servants and government officials with the principal objective of ensuring that PPP policy is developed, implemented and, over time, reformed and improved.

Where the government is at the beginning of its PPP journey, a PPP unit can play a key role in developing the market. This will normally involve working closely with other government institutions and raising both national and international awareness of the up and coming PPP program. Although Saudi Arabia does not have a formal PPP unit, the teams dedicated towards the development of PPP policy within the Ministry of Economy and Planning have begun this process through the announcement of Vision 2030.

Project delivery is also important. A university hospital PPP project, for example, would typically involve liaison with multiple government institutions. This might include the Ministry of Education, Ministry of Health, Ministry of Commerce and Ministry of Finance. A PPP unit can play an important coordinating role to ensure that each project is properly conceived and has the full support of all arms of government.

PPP units often perform a monitoring role. This is principally to ensure that value for money is achieved on an ongoing basis. To the extent that value for money is not reflected in the implementation of PPP projects, the PPP unit can initiate the process of reforming policy and ensuring that value for money is indeed obtained. This could be achieved through the amendment of the relevant regulatory regime or changes to the procurement process.

PPP units do not have to be limited to a centralised function. Individual ministries or government owned procuring entities can develop their own units. These units would principally be involved in the procurement of individual projects and subsequently reviewing implementation. The centralised unit would not have to manage the procurement process, but it could nonetheless provide a support role, working closely with the local units procuring the individual projects.

National training program

National PPP training programs are intended to build the expertise of government officials. The emphasis would be on a combination of learning about PPP theory and developing practical transaction based experience. This could involve:

- providing policy training at the ministerial and senior decision-making levels;
- seconding PPP professionals from other jurisdictions into the PPP unit of the host country;
- seconding government officials from the host country into PPP units from other jurisdictions;
- providing long term foundation courses for government officials working within the PPP unit;
- in the medium and long term, providing an MBA program focussing on PPP projects.

The above could be carried out for both centralised and local PPP units and involve the training of hundreds of Saudis within the Kingdom.

There would still be a need for external consultants, but with time, the reliance would reduce.

Regulation

Well constructed regulations create consistency and certainty. It is also one of the most powerful tools to ensure that government PPP policy is effectively and efficiently implemented so that

Where the government is at the beginning of its PPP journey, a PPP unit can play a key role in developing the market.

its economic and social objectives are achieved. The key to regulation, is flexibility. Rather than taking a detailed prescriptive or even prohibitive approach, regulation should focus on achieving outcomes, whilst preserving the ability of the private sector to be innovative.

A typical PPP process can be complex and time consuming. This can be exacerbated where regulations are inadequate. In this situation, the private sector will often seek to mitigate the uncertainty through the negotiation of complicated contractual provisions resulting in delay and additional costs.

Gaps in the regulatory regime can prove to be particularly costly for the government. If the government decides to amend a regulation in order to address an area that was originally missed, the private sector is typically able to obtain compensation under the PPP agreement on the basis that the law has changed. If the oversight is substantial, the objective of achieving value for money can be seriously eroded. Regulation should therefore not just be a tool to attract private sector direct investment, but a means to facilitate the achievement of government policy and the building of government capacity.

Procurement

Adopting an appropriate PPP procurement regime is important as part of the capacity building process. At the heart of the issue is the use of standardized PPP agreements. Such standardization fosters familiarity and accelerates the contractual learning process of government officials. Expertise within government can be created much faster. This quickly leads to a greater degree of confidence, resulting in a greater likelihood of achieving government policy, including value for money.

Given the various types of commercial structures that are often found in PPP projects, it is unlikely that a single standardized contract would be sufficient and there may be a need to have more than one. However, the aim should be to restrict the number to the absolute minimum.

CONCLUSION

Implementing a PPP program and executing individual PPP projects can be notoriously complex. This has been the experience of many governments around the world and in some cases there have been basic flaws in the establishment of the PPP program. These

At the heart of the issue is the use of standardized PPP agreements. Such standardization fosters familiarity and accelerates the contractual learning process of government officials.

cases work to the advantage of Saudi Arabia as there are ample examples of what not to do. However, an appreciation of this and the successful development and implementation of a program in the Kingdom requires placing capacity building at the very top of the government's PPP list of priorities. PPP projects are not merely about moving assets off the balance sheet of a government. This is too simplistic. Nor should it be an opportunity for the private sector to make windfall profits. PPP projects are about delivering public services and at the heart of the delivery of such services is the public interest and the national good.

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10 Tips for Private Equity and Venture Capital Transactions in the Middle East

Nabil Issa and Osama Audi are based in King & Spalding's Dubai and affiliated Riyadh offices. In this article they set out some of the common issues faced by parties, particularly PE and VC investors, purchasing Middle East-based companies in the popular healthcare, education and food and beverage sectors with a focus on companies in the Kingdom of Saudi Arabia and the United Arab Emirates (UAE).

1. Purchasers need to understand the regulatory issues relating to their nationality and the sector in which they are investing prior to making such investment. If a purchaser has any non-GCC national ownership at any level of its equity capital structure, time will need to be spent confirming if the target sector is open to investment (and if investment is limited in the relevant sector whether such limitation applies to non-GCC nationals as well or to nationals of the country in which investment is being undertaken) and the relevant percentage which can be acquired by, as applicable, a 'non-GCC' purchaser or a national of a country other than the country in which the activity is being undertaken. For example, in Saudi Arabia a non-GCC investor can directly invest in a hospital with more than 100 beds or in an entity manufacturing medical devices, but cannot directly own a stake in a medical or dental clinic as health care clinics in Saudi Arabia can only be owned by Saudi nationals. In addition, non-GCC national investors can often invest in a business engaged in wholesale or retail sale of goods (including consumer goods) but not if such entity is a registered distributor of such goods. In Saudi Arabia, additional limitations will apply to quite a few other commercial activities including, among others, retail pharmacies, education, logistics, and security services. Even with regulatory hurdles, counsel should be able to explore alternative legal means through which a purchaser can acquire an interest in a target in such sector through alternative legal investment structures such as a fund or sukuk. The structure also may influence the ability to create a robust employee stock option plan, particularly if employees include non-GCC nationals.

2. While fronting arrangements are common, anti-fronting legislation must be complied with nonetheless. Purchasers should shy away from typical nominee structures that may result in a party running afoul of a relevant anti-fronting law and, depending on the jurisdiction, if reported could face civil or criminal penalties. For example, the stated objective of the UAE Anti-Fronting Law is to prevent non-UAE nationals – whether natural or juristic persons – to practice any economic or professional activity that is not permissible for them to practice in accordance with the law and decrees of the UAE. Despite the existence of such laws in Saudi Arabia and the UAE, some lawyers have advocated for the use of simple side agreements. We are aware that certain lawyers in the UAE often point to the fact that there is actually evidence that the highest courts in the

Emirates of Dubai and Abu Dhabi have historically upheld "side" agreements and focused on the economic rather than statutory relationship of the parties. Moreover, the argument has also been repeatedly made that if "side" agreements were invalidated such would result in adversely affecting foreign investment in the UAE and would be contrary to various declarations by the governments at the federal and emirate level that the UAE is encouraging foreign investment. We note, however, that the Union Supreme Court in Abu Dhabi in late 2012 decided that "side" agreements are not valid, and any agreement to vary the economic or other rights of the shareholders in a UAE joint venture should be in the registered articles and/or be recognized by a local notary public and undergo the normal recognition of the licensing authorities in the relevant Emirates. While such case does not have precedential value in creating binding precedent as in a common law jurisdiction, foreign parties need to be mindful that there are examples of the judiciary invalidating such agreements and that such "side" agreements likely violate the anti-fronting law. Moreover, there are often legal means of achieving economic control. For example, in the Emirate of Abu Dhabi it is possible to have the registered articles provide that the foreign 49% registered owner is entitled to at least 90% of the dividends. Further in Saudi Arabia, the local authorities are regularly prosecuting parties violating the Saudi Arabian Anti-Fronting law and actually reward parties for reporting those engaged in this activity. We also understand that auditors in Saudi Arabia are now required to report the extent they are aware of not only registered owners but of "beneficial" owners of a business in their filing with the

Department of Zakat & Income Taxation. Finally, there are greater demands and a higher level of liability on directors under the new companies laws in Saudi Arabia and the UAE and such directors should carefully review the legality of the ownership of companies and operation of such companies prior to agreeing to act as directors.

3. Term Sheet.

Purchasers often wish to enter into a term sheet, memorandum of understanding or offer letter before documenting a complex share purchase agreement and, if applicable, shareholders' agreement. We find, however, that parties can sometimes gloss over key-terms at the offer letter stage and, accordingly, do not have a true "meeting of the minds" which can lead to significant resources being expended on a deal that was never truly agreed. For example, we find parties will agree to certain points in a term sheet and not consider the fact that they may not be enforceable, such as drag/tag provisions, ability to get certain reserved matters in the registered articles, liability caps, time limits for raising warranty claims, employee stock options, escrow arrangements, acquisitions being subject to financing, etc. By spending more time at the term sheet stage, parties can ensure that there is a clear understanding of the requirements of both purchasers and sellers.

4. Nominee Owners/Third Parties.

As with many other sectors, quite a few healthcare, education and food & beverage transactions involve the participation of either nominee owners or historically passive owners. We often find that when such owners become aware that a private equity group, strategic investor or fund is keen to acquire the underlying business that such nominees or passive owners suddenly wish to become actively involved and expect to sell their shares at a significant premium. In a UAE or Saudi limited liability company, from a practical perspective, one shareholder cannot sell without obtaining the written consent of all other shareholders. If one party does not provide written consent they can effectively hold their shares ransom until they feel they are adequately compensated. Thus, a purchaser may wish to negotiate a break-fee if sellers cannot complete a sale due to an uncooperative nominee/owner. Break-fees often at least include expenditures and some agreed amount to compensate the purchaser for lost time spent on the transaction. Also, indemnities should be carefully crafted to address issues which may arise as a result of a previous nominee owner being deemed to have been in violation of the relevant jurisdiction's anti-fronting law. Purchasers will often want to ensure they are indemnified for the legal violations as a result of the way in which the previous owner held the asset.

5. Exclusivity.

A company that is in negotiations to sell a minority or majority stake to a reputable purchaser may attempt to shop an offer letter to other potential purchasers. Despite confidentiality clauses, the Middle East is a relatively small market and other potential buyers will likely inevitably learn that a stake in a company is for sale. Therefore, it is critical that the concerned buyer negotiate a well drafted exclusivity clause with an enforceable termination or break-fee if sellers breach the exclusivity arrangements. In addition, depending on the governing law used in the offer letter, parties should consider whether a provision requiring parties to negotiate in good faith should be included in the offer letter. We have seen purchasers successfully demand payment of a break-fee when a seller changes its mind or pursue new purchasers. Depending on the governing law and jurisdiction used in the term sheet, the break-fee can be a liquidated damages clause that must be carefully crafted so as to not be interpreted as a punitive penalty clause which may not be enforced.

6. For transactions in Saudi Arabia, the Ministry of Labor's Saudization program adds complexity and, if ignored, can lead to significant issues.

Since the launch of Saudi Arabia's Nitiqat Saudization program, labor intensive businesses have faced challenges trying to comply with the program without significantly increasing their overheads. In general, the program categorizes all businesses as either 'red', 'yellow', 'green' or 'platinum' depending on the number of Saudi nationals employed by such company and the activity/job description of such employees with a certificate being issued by the Saudi Ministry of Labor setting out each company's current status. Depending on the color-coding of a target company, the Ministry of Labor will provide certain incentives or penalties (e.g. residency visa processing and renewals are quicker for 'platinum' companies while such services are not permitted for 'red' companies). Thus, a purchaser should be prepared to invest in a Saudization program to recruit and train Saudi nationals.

7. Competition approvals may be required for your transaction.

Purchasers should be aware that while competition approvals have been a long-standing feature of M&A/PE transactions in many jurisdictions, the competition approval processes in most regional jurisdictions are relatively new and untested. That being said both Saudi Arabia and the UAE have competition authorities to which certain transactions must be submitted and approved as a condition to closing.

8. Governing Law and Jurisdiction.

Not infrequently a foreign buyer will agree to arbitration in London to settle any disputes arising under the joint venture, and perhaps will even agree to use English law as the governing law for the shareholders agreement. A foreign shareholder may initially feel elated at this "win," but the reality may be different. There are only a handful of recent examples of arbitral awards rendered outside of the Gulf Cooperation Council countries ever being enforced in the UAE or Saudi Arabia. It may be preferable for the foreign partner to carefully consider whether to have the arbitration conducted in the English language under the DIFC-LCIA rules at the Dubai International Financial Centre (DIFC). While it is common to have the acquisition documentation governed by one law (e.g. English law) and, to the extent applicable, a shareholders' agreement governed by another law (e.g. UAE or Saudi law), purchasers should discuss with counsel the benefits and detriments that a particular governing law and jurisdiction can have on their transaction. Parties should also be mindful that the official language of the GCC is Arabic and that should consider adding provisions in the relevant agreement that it will solely appoint a licensed translator in the event such documents require translation.

9. Consider utilizing the DIFC to improve enforcement.

Because the articles of association of limited liability companies incorporated on-shore in the UAE and in Saudi Arabia do not permit much flexibility or customization, purchasers acquiring less than 100% of a target will typically enter into a separate shareholders' agreement setting out, amongst others, buy-sell provisions, or put and call options, or restrictive covenants of one sort or another. It is important to note, however, that courts in the UAE or Saudi Arabia rarely, if ever, grant specific performance – which is to say that they will not make anyone do anything. Instead they may choose to award money damages for something done or not done, but that raises the question of the quantum of harm done.

One common provision in many shareholders' agreements which deals with "deadlock" in decision making, or serious disputes between shareholders, is to provide for a buy-sell mechanism, whereby one party names a price at which the joint venture interest could be bought or sold. The other party may either buy-out or sell to the first party at the named price. Another common provision is the concept of dilution: if one partner refuses to contribute equity capital as needed, the other partner can contribute and dilute the interests of the first, possibly removing some voting rights or board representation in the process. Neither of these provisions will work in Saudi Arabia, where any change in shareholding must be consented to by all existing shareholders, all of whom must appear in front of a notary public to sign amended articles of association that specify the new shareholding.

Buyers should consider moving all or part of their acquisition structure to an offshore jurisdiction such as the Cayman Islands or, if the target must be at least GCC-owned, to the DIFC. We have found that many GCC jurisdictions, including Saudi Arabia, Kuwait and Dubai, view the DIFC as being in the GCC to the extent such entity is GCC-owned. Thus, in many cases, it may make sense to establish a joint venture in the DIFC and create an English law joint venture agreement. Such will dramatically improve the ability to enforce put and call options, dilution provisions, have different classes of shares, enforceable employee stock option plants, reserved matters, pledge of shares, etc.

10. Restructuring for eventual exit.

A buyer must carefully consider its structure for making an investment. Buyers should create a structure that will maximize exit options. For example, a party outside of Saudi Arabia that holds shares directly in an unlisted company will be subject to a 20% capital gains tax on exit. By creating another SPV between the buyer and the target company, such capital gains tax can be eliminated resulting in a much lower taxation on exit. A buyer may also wish to agree upfront with the seller and remaining shareholders how an exit will work or the need to convert the company to a joint stock company for an eventual initial public offering.

Conclusion

To protect their rights, investors should retain experienced counsel who understand both Western documentation and local law implications. The region is witnessing an increase in transactions especially in healthcare, education, food and beverage, and real estate/hospitality transactions. Regional governments are also working to support startups and small business through funding programs and will likely focus on such sectors of employment for nationals for economic diversification and a means to empower the young and increasingly educated populations. We also note that a number of public private partnerships are emerging in the healthcare, education, power, transportation and other sectors throughout the GCC.

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Structured Finance

Regulatory Framework for Special Purposes Entities – further paving the way for Securitisation and Sukuk in Saudi Arabia?

Background

On 29 May 2016, the Capital Market Authority ("CMA") of the Kingdom of Saudi Arabia (the "Kingdom") issued draft rules (the "Draft Rules") designed to regulate the establishment, licensing and operation of Special Purposes Entities ("SPEs"), a new type of corporate vehicle intended to facilitate the issuance of certain categories of debt securities in the Kingdom. The CMA commenced a 60 day consultation period in respect of the Draft Rules which expired on 23/10/1437H (corresponding to 28/7/2016G) allowing market participants the opportunity to review and comment on the Draft Rules before they are passed.

Scope and Application

The Draft Rules would apply to, and impose obligations on, the SPE itself, directors of the SPE and individuals who have applied to become directors of the SPE, the sponsor of the SPE (i.e. effectively the obligor or originator responsible for sponsoring the SPE) and any custodian required to be appointed by the Draft Rules in connection with an SPE's debt securities.

Under the Draft Rules, an SPE can be established to issue the following three categories of debt instruments:

- Asset-backed debt instruments ("Asset Backed Securities"), which are defined as being debt instruments under which a) the entitlement to a return is wholly and solely dependent on the returns generated by the SPE's assets, and b) the sponsor is not obliged to pay any amounts due on the debt instrument (whether by way of guarantee or otherwise). This permitted category would seemingly include traditional securitisation or asset backed *Sukuk* structures;

- Asset-linked recourse debt instruments ("Asset Linked Securities"), which are defined as being debt instruments under which a) the entitlement to a return is defined by reference to the returns generated by the SPE's assets, and b) the sponsor is obliged to pay any amounts due on the debt instrument (whether by way of guarantee or otherwise). This permitted category would seemingly include traditional asset based Sukuk under structures relying on a pool of assets (e.g. Sukuk Al-Wakala) where the returns to certificateholders are typically expressed by reference to returns generated from an underlying portfolio of assets but where the originating entity is ultimately liable for repayment of capital and profit to the certificateholders; and
- Debt-based recourse debt instruments ("Non-Asset Based Debt Securities") which are defined as being debt instruments under which a) the entitlement to a return is not defined by reference to the returns generated by the SPE's assets, b) the sponsor is obliged to pay any amounts due on the debt instrument (whether by way of guarantee or otherwise), and c) repayment of all capital is to be made to the holder at or before the maturity of the security. This permitted category would seemingly include traditional asset based Sukuk which does not rely on an underlying pool of assets (e.g. Sukuk Al-Murabaha) or other non-recourse debt instruments.

Requirement for a sponsor

An SPE and each financing transaction undertaken by it must be sponsored by a single sponsor under the Draft Rules. The sponsor is required to be either:

- A Saudi joint stock company that complies with the requirements of the Saudi Corporate Governance Regulations, to the extent that the SPE proposes to issue Non-Asset Based Debt Securities; or
- A CMA authorised person "whose business profile covers all securities business activities to be undertaken in connection with the activities of the SPE", a bank or a finance company, in each case to the extent that the SPE proposes to issue Asset Backed Securities or Asset Linked Securities.

The shares of the SPE are required to be issued to its sponsor or a third party approved by the CMA. However, the Draft Rules provide that neither the SPE's sponsor nor any of the sponsor's affiliates has an interest in or may claim against the assets of the SPE other than in respect of paid up securities issued to such persons or as are otherwise disclosed in any offering documentation published by the SPE.

Establishment and Operation

The Draft Rules provide that SPEs are required to be licensed with the CMA and that the SPE's sponsor is responsible for filing a licensing application with the CMA and ensuring that the SPE satisfies the applicable licensing conditions. One of the licensing conditions is that the SPE's bye laws are in a standard CMA-approved form, a draft of which the CMA has published with the Draft Rules (and any deviations from which will require the CMA's approval). An SPE will also be required to have a minimum paid up share capital, albeit the precise quantum of this has not yet been set out in the Draft Rules.

Independence from sponsor

The Draft Rules contain detailed requirements in respect of an SPE's directors, in particular that an SPE's directors must be independent of its sponsor (where the SPE proposes to issue Asset Backed Securities or Asset Linked Securities). The Draft Rules also, again for SPEs issuing Asset Backed Securities or Asset Linked Securities, require information barriers to be put in place where the registered office or place of business of the SPE is the same as its sponsor.

Financing Transactions

An SPE may only enter into a financing transaction in relation to an issuance of debt instruments if it obtains the CMA's prior approval. The SPE's sponsor will be required to submit an application for the approval of the proposed

An SPE and each financing transaction undertaken by it must be sponsored by a single sponsor under the Draft Rules.

financing transaction to the CMA, which can be submitted at the same time as the application for the licensing of the SPE. The CMA will only approve a proposed finance transaction if certain conditions prescribed in the Draft Rules are met, including that a custodian is appointed (responsible for overseeing the holding of the SPE's assets), that the transaction documentation relating to the financing will include appropriate arrangements to safeguard the interests of investors and that payments required to be made to or by the SPE are made from a designated bank account held with the custodian.

Provided that any proposed financing transaction complies with the conditions contained in the Draft Rules and is therefore approved by the CMA, there are no restrictions on the type of financing structures which may be used by an SPE. In addition, an SPE is not restricted from entering into multiple financing transactions, provided that the sponsor demonstrates to the CMA that adequate legal safeguards are in place to ensure that investors are not at risk.

Ongoing notification obligations

The Draft Rules place ongoing notification obligations on the transaction parties to notify the CMA of a range of matters in connection with any financing transaction entered into by an SPE, including any proposed material change to the terms of any transaction document.

Amendments to the Listing Rules and disclosure obligations

The Draft Rules seek to amend the CMA's Listing Rules insofar as they apply to any SPE issuing debt instruments by way of public offer, including the disclosure requirements for any such offering. The key principle reflected throughout the proposed amendments to the Listing Rules is that where a public offer is made by an SPE, the SPE's sponsor shall be bound by the Listing Rules as if it were the "issuer" for the purposes of the rules. That is also the case for the CMA's Offers of Securities Regulations in respect of their application to securities offered or issued by SPEs.

The amendments to the Listing Rules also contain additional disclosure obligations for public offerings of Asset Linked Securities, in particular that substantial disclosure be included in the relevant offering document around the assets underlying the Asset Linked Securities, including a detailed description of the assets, any loan to value ratio and a third party valuation.

KEY OBSERVATIONS

Insolvency remoteness of SPE

To achieve the commercial benefits of a securitisation, the special purpose vehicle (SPV) in an international securitisation transaction is typically set up as an "orphan" company. This is principally so that the SPV is not treated as a subsidiary of the originator or affected by the insolvency of the originator. In contrast, the Draft Rules require that the sponsor or a third party approved by the CMA is required to be the sole shareholder of the SPE. Whilst this may give rise to insolvency concerns, the Draft Rules have seemingly attempted to achieve "insolvency remoteness" of the SPE from its sponsor in a number of respects, as follows:

- requiring the appointment of independent directors at the SPE;
- placing restrictions on the activities of the SPE outside what is contemplated in the Draft Rules;
- preventing the shareholder of the SPE (i.e. the sponsor) from exercising any rights it may have as a shareholder without the consent of the majority of the holders of the SPE's debt instruments or disposing of its shares except as disclosed in the offering documentation; and
- providing that neither the SPE's sponsor nor any of the sponsor's affiliates has an interest in or may claim against the assets of the SPE other than in respect of paid up securities issued to such persons or as are otherwise disclosed in any offering documentation of the SPE.

Despite the above protections, it is suggested that the CMA further look to clarify that an SPE's "insolvency remoteness" from its sponsor would be preserved in all circumstances, despite being a subsidiary of the sponsor.

Transactions originated/sponsored by Saudi corporates

Whilst the Draft Rules contemplate that Saudi joint stock companies can establish SPEs for the purposes of issuing Non-Asset Based Debt Securities, the Draft Rules provide that only CMA authorised persons, banks or finance companies may establish SPEs for issuing Asset Backed Securities or Asset Linked Securities. The rationale for this is not entirely clear, and will seemingly impede Saudi corporates from using the new framework to originate a wide range of asset-backed or asset-linked transactions.

Disclosure rules

As noted above, whilst it is contemplated that in public offers by SPEs of Asset Linked Securities or Non-Asset Based Debt Securities, the Listing Rules should be amended such that all disclosure and other obligations of the issuer are also obligations of the sponsor, the same is not proposed for public offers by SPEs of Asset Backed Securities. Whilst the rationale for this may be that ultimately investors will not require a great deal of disclosure with respect to the sponsor as they are not intended to have recourse to it in the context of such securities, investors will certainly require substantive disclosure on the underlying portfolio of assets (which they will have recourse to), in the same way as the holders of Asset Linked Securities are entitled to such disclosure under the Draft Rules.

Level of Regulation

The Draft Rules are intended to facilitate structured debt issuances in the Kingdom whilst at the same time ensuring that investors' rights and interests in any such transactions are preserved. The CMA has sought to achieve this by providing a comprehensive, detailed and prescriptive framework within the Draft Rules for the establishment and regulation of SPEs. As a result, if implemented in its current form, the legal framework for securitisation and structured debt (including Sukuk) involving SPEs will be more heavily regulated and burdensome compared to many other jurisdictions and will take some time for market participants (including service providers such as custodians, to whom the Draft Rules will impose numerous and ongoing obligations in relation to individual transactions) to become sufficiently familiar with the content and interpretation of the proposed framework. Nevertheless, this initiative to deepen the structured debt market in the Kingdom by the CMA will no doubt be welcomed by market participants and will encourage discussion as to the next steps required to further develop the market.

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endnotes

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