

Convergence of Corporate Governance and the Islamic Financial Services Industry: Toward an Islamic Financial Services Securities Market

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Like most of the growing financial markets, capital markets in Muslim majority countries (“Muslim countries”) are undergoing continuous regulatory standardization. With a view on making capital markets more attractive for domestic and foreign investment, Muslim countries are taking serious initiatives to ensure higher transparency and accountability within financial markets, particularly with respect to publicly traded firms. Issuance of regulatory guidelines and codes of corporate governance illustratively represent this process. In general, Muslim countries are pursuing a common regulatory policy of developing strong securities markets, and appear to be serious in upgrading the corporate governance regime.

Since the *shari‘a* stands as either a binding or persuasive source of legislation in Muslim countries, its role in legislative and regulatory development in such countries is highly significant. Therefore, reliance on *shari‘a* for any possible future implementation of corporate governance, whether in the form of codes or regulations, appears highly likely. Any future codifications of fiduciary duties and related ethical practices are most likely to be derived from *shari‘a*. However, it remains to be seen if *shari‘a*-based codes of corporate governance will help achieve the expected level of transparency and accountability with comparatively economical agency costs. This paper will attempt to explore, among other issues, whether designing *shari‘a*-based codes of corporate governance is necessary in the first place.

Generally, Islamic finance scholars have discussed corporate governance from the perspective of transactional validity—primarily

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revolving around avoiding interest and related moral hazards—for the Islamic financial services industry (the “IFS industry”). Issues such as regulatory concerns over agency problems, investor protection, and contemporary debate over convergence or divergence of corporate governance have not received much attention from Islamic finance scholars. Appropriate response to such issues is crucial for the IFS industry not only for its global competitiveness, but also, as will be discussed below, for ensuring proper *shari‘a* compliance.

This paper presents a new perspective to existing scholarly debate on corporate governance and the IFS industry, and seeks to briefly highlight aspects of the contemporary corporate governance debate by analyzing *shari‘a* and investigating how the IFS industry may increase its potential.² It is argued here that convergence to modern corporate governance practices in Muslim countries, insofar as they seek to increase corporate accountability and transparency, to further investor protection, and to reduce agency costs, may be consistent with *shari‘a*. It is argued that such convergence is highly likely. However, convergence to modern transactional practices may not be consistent with *shari‘a*, primarily because modern transactions, despite their efficient role in the financial markets, may not prove valid under *shari‘a*. Therefore, more transactional divergence will lead to more transactional innovation in the IFS industry. The paper further suggests that Islamic finance scholarship should analyze modern governance practices separately from the transactional aspect. Finally, the paper argues that establishment of an exclusive homogenous securities market is essential for the IFS industry, and briefly highlights the benefits of such a market.

Accordingly, this paper discusses (1) the available literature on agency problems and convergence or divergence of corporate governance, (2) corporate governance and the IFS industry, and (3) the need for an IFS Securities Market.

AGENCY PROBLEMS AND CONVERGENCE OR DIVERGENCE OF CORPORATE GOVERNANCE

Today, financial globalization enables international investors to better share risks, allows capital to flow toward the most productive markets, and

² See Ali Adnan Ibrahim, “Developing Governance and Regulation for Emerging Capital and Securities Markets,” (unpublished LL.M. supervised research paper, Washington University, May 19, 2006), <http://lsr.nellco.org/cgi/viewcontent.cgi?article=1001&context=georgetown/gps>. The paper surveys the issues involved and analyzes contemporary scholarship, highlighting well-informed legal reforms in contrast to unwise transplantation.

enables the participating countries to reap the benefits of their comparative advantages.³ However, this requires a structure of corporate governance that not only recognizes property rights, but also provides effective enforcement to safeguard them. As discussed below, such safeguards emanate primarily from laws and regulatory and judicial enforcement mechanisms. Furthermore, confirming prior studies that financial development and development in debt and equity markets promote economic growth, empirical studies have established a link between the legal system and economic development.⁴

Agency Problems: Self-Dealing and Investor Protection

In general, the foundations of the market system include compelling transparency, prohibiting insider-dealing, and policing self-dealing.⁵ Corporate governance “deals with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment,” and it also “deals with the agency problem: separation of management and finance.”⁶ Investor protections and market development go hand in hand in the real world, and if protections are absent, “one-sided deals flourish, and outside equity capital either becomes more expensive or dries up altogether.”⁷

To counter the agency problem, one argument is that small investors can only be attracted to the business of financing companies if legal protections against expropriation by managers and large investors are available.⁸ Greater protections for shareholders strongly predict stock

³ Rene M. Stulz, “The Limits of Financial Globalization,” *Journal of Finance* 60 (2005): 1595.

⁴ Rafael La Porta et al., “Law and Finance,” *Journal of Political Economy* 106, no. 6 (1998): 1113, 1152. Although there were inconsistencies found in the data gathering and coding techniques, the study remains a pioneering work. See generally Holger Spamann, “On the Insignificance and/or Endogeneity of La Porta et al.’s ‘Anti-Director Rights Index’ under Consistent Coding,” Harvard Law School Program on Corporate Governance, Discussion Paper No. 7 of 2006, http://www.law.harvard.edu/programs/olin_center/fellows_papers/pdf/Spamann_7.pdf.

⁵ William W. Bratton and Joseph A. McCahery, “Comparative Corporate Governance and the Theory of the Firm: The Case against Global Cross Reference,” *Columbia Journal of Transnational Law* 38, no. 2 (1999): 213, 296-297.

⁶ Andrei Shleifer and Robert Vishny, “A Survey of Corporate Governance,” *Journal of Finance* 52 (June 1997): 737, 773.

⁷ Bratton and McCahery, “Comparative Corporate Governance,” 297.

⁸ Shleifer et al., “Survey of Corporate Governance,” 737, 769.

market development.⁹ Effective regulation of self-dealing is the fundamental element of shareholder protection¹⁰ that also results in dispersion of ownership.¹¹

On-going disclosure of self-dealing transactions benefits stock market development.¹² The best strategy for avoiding self-dealing appears to be the reliance on “extensive disclosure, approval by disinterested shareholders, and private enforcement.”¹³ Furthermore, quality of information regarding the value of a company’s business and confidence about preventing self-dealing are preconditions to strong public securities markets.¹⁴ Studies have examined anti-self-dealing measures and their relationship to financial markets development.¹⁵

Convergence or Divergence of Corporate Governance

Many scholars have proposed reform agendas for developing securities markets in economies in transition. The most debated approach is to introduce U.S. laws to such economies in order to develop a U.S.-style securities market, expecting that doing so would be essential to triggering economic growth.¹⁶ While some scholars strongly suggest that convergence of the corporate governance regimes to the U.S. model is a good way forward, others argue against this notion, highlighting the point that the peculiar institutional make-up of the U.S. securities market cannot be exported merely by changing the laws on the books.¹⁷ The scholars

⁹ Simeon Djankov et al., “The Law and Economics of Self-Dealing,” National Bureau of Economic Research, Working Paper No. 11883 (2005), 34.
<http://papers.nber.org/papers/w11883>.

¹⁰ *Ibid.*, 35.

¹¹ La Porta et al., “Corporate Ownership around the World,” *Journal of Finance* 54, no. 2 (1999): 471, 496.

¹² Djankov et al., “Law and Economics of Self-Dealing,” 37.

¹³ *Ibid.*, 38.

¹⁴ Bernard S. Black, “The Legal and Institutional Preconditions for Strong Securities Markets,” *UCLA Law Review* 48 (2001): 781-855, 783.

¹⁵ Djankov et al., “Law and Economics of Self-Dealing,” 2.

¹⁶ Troy A. Paredes, “A Systems Approach to Corporate Governance Reform: Why Importing U.S. Corporate Law Isn’t the Answer,” *William and Mary Law Review* 45 (2004): 1055. (Quoting the works of La Porta et al.)

¹⁷ See Katharina Pistor et al., “Law and Finance in Transition Economies,” *Economics of Transition* 8 (2000): 325; Bernard S. Black et al., “Final Report and Legal Reform Recommendations to the Ministry of Justice of the Republic of Korea,” *Journal of Corporate Law* 26 (2001): 546; Black, “Legal and Institutional Preconditions,” 781; Cally Jordan, “The Conundrum of Corporate Governance,” *Brooklyn Journal of International Law* 30 (2005): 983; Paredes, “A Systems Approach,” 1055; Bratton and McCahery, “Comparative Corporate Governance,” 213.

arguing against convergence also highlight significant socio-economic and political features of each society that may resist the transplanted reforms and continue to resist them even after the implementation of such reforms. Among these scholars, some have further suggested that it is important to recognize deep-rooted local culture before embarking upon reform initiatives.¹⁸

For transition economies, there is a desire to catch up with western standards, often leading to the wholesale transfer of commercial laws to the transition economies.¹⁹ This practice generally follows the argument that laws matter for developing strong capital and securities markets. This argument is known as the “law matters thesis.”²⁰ Many scholars suggest that convergence of this nature limits channels of corporate evolution.²¹ Reforming corporate governance is a matter of comparative institutional analysis.²² The indiscriminate mixing of legal rules may result in a dysfunctional or unbalanced system lacking certainty. Scholars have expressed serious doubt about the ability to succeed in transplanting reforms without developing “complementary institutions.”²³

As mentioned above, scholars arguing against convergence have highlighted the distinct features of societies that may resist transplanted reforms. A renowned scholar has noted an intermediate position.²⁴ This position predicts that “formal institutional variations in corporate law and practice will remain, but will be overshadowed by an increasing degree of functional convergence.”²⁵ Unlike corporate laws, securities laws are more likely to functionally converge, by way of “stealth convergence.”²⁶ Such convergence is generally achieved by modifications (or up-gradation) in the listing regulations by the front-line regulators. Amending corporate laws is a time-consuming process, and is less influenced by the regulatory competition and issuers’ choice. Because the functional or stealth

¹⁸ Amir N. Licht, “The Mother of All Path Dependencies: Toward a Cross-Cultural Theory of Corporate Governance Systems,” *Delaware Journal of Corporate Law* 26 (2001): 147, 203.

¹⁹ Pistor et al., “Law and Finance in Transition Economies,” 325, 327.

²⁰ Paredes, “A Systems Approach,” 1055.

²¹ John C. Coffee, Jr., “The Future as History: The Prospects for Global Convergence in Corporate Governance and Its Implications,” *Northwestern University Law Review* 93 (1999): 641, 646.

²² Paredes, “A Systems Approach,” 1155.

²³ See Ronald J. Gilson, “Globalizing Corporate Governance: Convergence of Form or Function,” *American Journal of Comparative Law* 49 (2001): 329; and Paredes, “A Systems Approach,” 1055.

²⁴ Gilson, “Globalizing Corporate Governance,” 329.

²⁵ See the discussion of formal and functional convergence in Coffee, “The Future as History,” 641, 646.

²⁶ *Ibid.*, 705.

convergence may be the result of market efficiency, the emerging securities markets may have to rely more on formal convergence in order for them to achieve efficiency. However, the form of convergence that can promise efficiency to the emerging securities markets is an issue that remains largely unanswered. The market response will provide a good indication of whether and when to introduce any modern reforms.

As for the law matters thesis, it is about “strong shareholder property rights, as reflected in the control that shareholders are allocated over the enterprise and the legal limits that constrain managerial and directorial discretion, all pointing in the direction of ensuring that shareholders do not have their wealth expropriated.”²⁷ The law matters thesis, therefore, suggests that minority shareholders will emerge pursuant to laws safeguarding their property rights. To this extent, the law matters thesis addresses the core issue, but transplanting foreign laws into an alien legal system does not appear to be the best way to achieve this goal. The legal systems in developing economies often have customary or religious preferences, and such customary or religious undercurrents may react negatively to the wholesale transplantation of the laws.

In order to achieve a legal framework that encourages entrepreneurs to raise capital from the securities market, modern reforms that deal with the agency problem, transparency, and other issues should take into consideration the customary or religious preference of a particular society. With respect to Muslim countries, the principles of Islamic finance serve as the people’s customary or religious preference for doing business.

CORPORATE GOVERNANCE AND THE ISLAMIC FINANCIAL SERVICES INDUSTRY

Generally, developed financial markets work in a manner that encourages and supports entrepreneurial initiative by making available easy access to finance. Developed financial markets represent a set of institutions that complement each other, and thus support the financial superstructure of an economy. For instance, the legal system, including courts, lawyers, and financial intermediaries, works in a sophisticated harmony to complement the efficient market. The unprecedented growth of U.S. securities markets is a more specific example of the coordination between the legal system and market institutions.²⁸

²⁷ Paredes, “The Importance of Corporate Law: Some Thoughts on Developing Equity Markets in Developing Economies,” *Global Business & Development Law Journal* 19 (2007): 401.

²⁸ Paredes, “A Systems Approach.”

Continuing Growth and the Challenges Facing IFS

Recent scholars have emphasized resolving moral hazard issues facing the IFS industry in order to enhance and ensure *shari'a*-compliant governance.²⁹ The emergence of the moral hazard debate highlights the hybrid nature of the IFS industry, that is, the prevalence of religious and secular norms within the industry.

The future success of the IFS industry depends not only on its compliance with *shari'a*, but also on its global competitiveness. Reaching beyond the “core group of religious depositors”³⁰ appears inevitable and requires “ambitious innovation.”³¹ Another initiative to be taken includes “developing doctrines governing the creation and regulation of an Islamic public financial market.”³² For further growth, scholars now consider international and regional cooperation to be vital to enhance the efficiency of the IFS industry.³³ The development of supporting market institutions and standardization appears equally essential. As these institutions emerge and develop, standardization is likely to follow.

Defining Corporate Governance in *Shari'a*

According to *shari'a* scholars, the objective of corporate governance is “to ensure ‘fairness’ to all stakeholders to be attained through greater transparency and accountability.”³⁴ Agreeing on the content of the definition, however, does not help us understand how corporate governance of a *shari'a*-compliant business differs from its secular counterpart. Secular governance practices are not relevant for the transactions that a firm would make in the ordinary course of business. However, *shari'a* would first look at the transactional structure to see whether the transaction involves elements that invalidate the gains or profits. Corporate law in the secular context does perform a similar

²⁹ See Ibrahim Warde, “Corporate Governance and Islamic Moral Hazard,” in *Islamic Finance: Current Legal and Regulatory Issues*, ed. S. Nazim Ali (Cambridge: Harvard Law School Islamic Finance Project, 2005), 15-25.

³⁰ Frank E. Vogel and Samuel L. Hayes, *Islamic Law and Finance: Religion, Risk, and Return* (Boston: Kluwer Law International, 1998), 293.

³¹ *Ibid.*, 295.

³² *Ibid.*, 293.

³³ Ahmad Mohamed Ali, “The Emerging Islamic Financial Architecture: The Way Ahead,” in *Proceedings of the Fifth Harvard University Forum on Islamic Finance* (Cambridge: Harvard Law School Islamic Finance Project, 2002), 147, 155.

³⁴ See M. Umer Chapra and Habib Ahmad, *Corporate Governance in Islamic Financial Institutions* (IRTI Publication Management System, Jeddah, Saudi Arabia), <http://www.irtipms.org/PubDetE.asp?pub=93>.

function, in order to ensure that corporate transactions do not transgress the corporate charter and cross the line that the law has drawn. A general absence of codification that declares a non-*shari'a* practice or transaction to be illegal *ipso facto* broadens the role of *shari'a* governance to even review a firm's transactional conformity.

Without admitting that convergence of corporate governance is the most profound legal reform strategy, the IFS industry's ability to be internationally competitive relies, to a large extent, on recognizing international governance practices. In this context, the IFS industry is likely to adopt certain governance practices of the developed markets. It is therefore important to examine the scope of convergence, and also which areas are likely to stay divergent.

Corporate governance may have two-tier implications for its scope within *shari'a*. Since *shari'a* is concerned not only with the substance but also with the form of the business,³⁵ we may, for the sake of this discussion, term the objectives of a firm's business as the substance, and the ways of conducting the business as its form. While scholars have focused mainly on the substance of a *shari'a*-compliant business, guidance as to the use of contemporary corporate governance best practices in the IFS industry is not readily available. More specifically, the question would be whether the modern corporate governance practices are consistent with *shari'a*, and if so, whether a convergence to the modern regime is likely within the IFS industry.

Separating form (the governance structure in general) from substance (the objectives of the firm's business) will significantly further our understanding of the issues related to the IFS industry vis-à-vis modern corporate governance practices. Doing so, as discussed below, will also help us analyze an overall consistency between the objectives behind the modern corporate governance practices and the *shari'a* emphasis on business ethics.

As for governance structure, teachings of *shari'a* enjoin fairness and honesty as the primary principles for any conduct, including transactions.³⁶ The prohibition of fraud, misstatement, misappropriation and other forms of dealings that result in exploitation and deprive someone of her/his property without consent complements *shari'a*-compliant financial conduct.³⁷

³⁵ See Mahmoud El-Gamal, *Islamic Finance: Law, Economics, and Practice* (Cambridge: Cambridge University Press, 2006).

³⁶ See Mushtaq Ahmad, *Business Ethics in Islam* (Islamabad: International Institute of Islamic Thought, 1995), 143-147.

³⁷ *Ibid.*

Recent studies emphasize more disclosures to and rights of the shareholder, and firm enforcement of such rights.³⁸ Protection of minority interests is therefore considered essential for stronger capital markets. Substantive legal protections for minority shareholders and strict enforcement of such protections encourage local and international investors to invest in emerging securities markets. Thus the cornerstones of modern corporate governance regimes include safeguarding property rights, ensuring transparency, and bringing about effective accountability.

Shari'a has always attached similar or higher importance to such concerns in doing business. Incorporating higher standards of minority protection against expropriation, more disclosures and transparency, and effective accountability into *shari'a*-based corporate governance regimes will only help achieve compliance with *shari'a* injunctions and business ethics. With this perspective, and given that *shari'a* does not specify any upper limit for better regulation, the contemporary drive for accomplishing higher standards in corporate governance does not appear to be inconsistent with *shari'a*. Accordingly, convergence to the modern corporate governance regimes is highly likely within the IFS industry. However, a question needs to be explored: would such convergence be most beneficial if it occurred gradually or quickly?³⁹

As of today, the IFS industry is largely comprised of the banking sector. Increased local and international participation in IFS products will provide greater business opportunities within financial markets in Muslim countries, and with adherence to the modern (or modernized) corporate governance practices, the IFS industry is likely to grow beyond the banking sector. Once that growth takes place and non-banking IFS firms become successful, the availability of equity financing is likely to increase substantially, which will not only provide entrepreneurs with comparatively easier access to financing, but would also cater to those who may view the legitimacy of earnings through the banking sector of the IFS industry with skepticism.

Financial Regulation: Objectives and Emerging Markets

Both non-governmental R&D support and governmental regulations have contributed significantly to the current growth of the IFS industry. Financial regulation benefited from non-governmental R&D initiatives that were often sponsored by various public sector agencies of Muslim

³⁸ Djankov et al., "Law and Economics of Self-Dealing," 1.

³⁹ In this regard, an indigenized analysis by each local/national IFS market appears to be a better way to move forward.

countries. However, financial regulation of the IFS industry is largely comprised of prudential banking regulation, and does not form part of securities regulation. The future growth of the IFS industry in the securities markets is likely to depend upon bridging this regulatory gap.

As stated above, the future growth of the IFS industry may also rest upon another factor: a securities market that is homogeneous and specializes in the IFS industry. Securities markets significantly help the growth of debt and equity markets, and the broader spectrum of financial regulation strengthens the financial markets. The discussion below offers illustration of this perspective.

The objectives of financial services regulation include protection of public investors, elimination of externalities from the failure of intermediaries, redistributive policies, equitable norms and consideration of political economy,⁴⁰ and “elimination of financial crime and international terrorism.”⁴¹ There are three fields of financial regulation: corporate governance, securities regulation, and regulation of financial institutions.⁴² As for emerging markets, a combination of market institutions and regulations ensures effective corporate governance.⁴³ However, overregulation is likely to make raising capital costly.⁴⁴

In a post-globalization scenario, with lowered barriers to capital and instantaneous information flow, securities markets are in competition with each other. Issuers choose the market on which to list their securities, and are then subject to one set of liability standards and enforcement remedies.⁴⁵ Taking advantage of this trend, issuers, particularly from transition economies, may raise equity capital from the market of their choice.⁴⁶ In this regard, listing at the London Stock Exchange or in the United States, for example, will subject IFS firms to higher standards to

⁴⁰ Howell E. Jackson, “Regulation in a Multi-sectored Financial Services Industry,” *Washington University Law Quarterly* 76 (1999): 319, 332-339.

⁴¹ This has been added to the list recently. See Howell E. Jackson, “Variation in the Intensity of Financial Regulation: Preliminary Evidence and Potential Implications,” 12-14, Harvard Law School Program on Corporate Governance, Discussion Paper No. 521(2005), http://www.law.harvard.edu/programs/olin_center/papers/pdf/Jackson_521.pdf.

⁴² Howell E. Jackson, “Centralization, Competition and Privatization in Financial Regulation,” *Theoretical Inquiries Law* 2 (2001): 649.

⁴³ Black et al., “Final Report,” 546.

⁴⁴ *Ibid.*

⁴⁵ John C. Coffee, Jr., “Racing Towards the Top?: The Impact of Cross-Listing and Stock Market Competition on International Corporate Governance,” *Columbia Law Review* 102 (2002): 1757, 1759-60; and Hal S. Scott, “Internationalization of Primary Public Securities Markets,” *Law & Contemporary Problems* 63, no. 3 (2000): 71.

⁴⁶ Coffee, “Racing Towards the Top?” 1759-1760.

corporate governance regimes, and thus make them more attractive for investment.

In addition to legislative and regulatory measures, the stock exchanges, as frontline regulators, may improve corporate governance practices by protecting investors and maintaining the integrity of the securities market.⁴⁷ Well-regulated stock exchanges may, therefore, make raising finance comparatively convenient in the emerging economies.

However, when IFS firms list abroad, neither the IFS industry in general nor the financial markets in Muslim countries are able to benefit from foreign investment. In the absence of sufficient legal and regulatory infrastructure, the transition economies cannot offer a sophisticated and internationally competitive securities market.⁴⁸ Owing to the lack of competitiveness of the emerging markets, foreign investors from developed economies might choose to stay home.⁴⁹ On the other hand, the lack of international competitiveness may prompt the issuers from the emerging markets to opt out of their home jurisdictions in favor of any developed market, making it more difficult for the emerging markets to develop such competitiveness.

Specialized markets

Scholars have highlighted the likelihood that different markets should specialize in trading securities of a particular type of firm.⁵⁰ This phenomenon may be developed in the emerging markets where firms eyeing particular incentives invest in specialized industrial sectors. Given the nature of incentives in various sectors offered by the transition economies, the emerging markets may develop specialized trading expertise in the securities of a particular sector or industry. A specialized IFS securities market could therefore be one that Muslim countries can develop.

⁴⁷ Robert Todd Lang et al., "Special Study on Market Structure, Listing Standards, and Corporate Governance," *Business Law* 57 (2002): 1487, 1558. The article suggests that the stock exchanges should do this with the help of the stakeholders.

⁴⁸ This includes the use of technology for more optimal arrangements at the level of primary market. See Scott, "Internationalization of Primary Public Securities Markets," 71, 104.

⁴⁹ Frederick Tung, "Lost in Translation: From U.S. Corporate Charter Competition to Issuer Choice in International Securities Regulation," *Georgia Law Review* 39 (2005): 525, 532.

⁵⁰ Coffee, "The Future as History," 652.

Integration and regionalization

The prediction of specialized stock exchanges serving different clienteles of listed corporations may also occur at the regional level in emerging markets.⁵¹ The divergence of investment opportunities in the transition economies may also lead to competition to attract foreign investment. Depending on the success of foreign investment policies in specific industrial sectors, regional securities markets may develop to attract listing in the specialized sectors. Empirical evidence in this regard remains to be explored.

The IFS industry shares a common customary law (that is, a set of rules that will have binding force in a society in the absence of any overriding legal system), although with juristic variations, within various Muslim schools. With *shari'ah* as a valid source of law in many Muslim countries, the capital and securities markets of those countries may simultaneously benefit from the growth of IFS products, and therefore pursuant interactions among various Muslim countries could lead to an integrated securities market in Muslim countries.

The law of one price provides another possibility for the emerging markets to have integrated arrangements.⁵² Before achieving regionalization or integration, emerging markets may also consider harmonization, multi-jurisdictional disclosure systems, and an offshore free zone to increase their competitiveness.⁵³

Scholars have recommended regional cooperation among the emerging securities markets, focusing specifically on Latin America,⁵⁴ Sub-Saharan Africa,⁵⁵ and Eastern Europe.⁵⁶ Likewise, Middle-Eastern

⁵¹ Coffee, "Racing Towards the Top?" 1830.

⁵² Amir N. Licht, "David's Dilemma: A Case Study of Securities Regulation in a Small Open Market," *Theoretical Inquiries in Law* 2 (2001): 673, 687. Licht argues that the law of one price curbs arbitrage profits—under-priced buying and overpriced selling.

⁵³ Scott, "The Future as History," 78, 92. Scott argues against the viability of harmonization and a multi-jurisdictional disclosure system for the international securities market, but recommends establishing an offshore free zone.

⁵⁴ Les Riordan, "Three Proposals for a Latin American Stock Exchange, Private Offshore Market, or a Computerized Financial Information Service," *University of Miami Inter-American Law Review* 27 (1996): 585.

⁵⁵ Evelyn Bradley, "A Regional Stock Exchange: Hope for Sub-Saharan Africa Stock Markets," *MSU-DCL Journal of International Law* 8 (1999): 305. For a criticism of the strategy in this regard, see Charles R. P. Pouncy, "Stock Markets in Sub-Saharan Africa: Western Legal Institutions as a Component of the Neo-Colonial Project," *University of Pennsylvania Journal of International Economics* 23 (2002): 85. On economic cooperative initiatives in Africa, see Claire Moore Dickerson, "Harmonizing Business Laws in Africa: OHADA Calls the Tune," *Columbia Journal of Transnational Law* 44 (2005): 17.

economies are on their way to a regional securities market.⁵⁷ Furthermore, to launch a world-class financial center in the Middle East, Dubai established the Dubai International Financing Centre, a free-trade zone with an independent regulatory authority to oversee the activities related to the Centre.⁵⁸ In addition to international sponsorship, a culturally sensitive regulatory framework and regional cooperation could promote the success of a securities market in a developing country.⁵⁹

Specialization, regional cooperation, and integration of securities markets may be achieved by establishing a securities market exclusively for the IFS industry, which is elaborated upon in the third section of this paper.

Financial Regulation: Regulation of the IFS Industry Today

Standardized regulation of Islamic finance is one of the main issues facing the IFS industry today. No single regulator exists to perform the task of standardized regulation. Therefore, the regulation of the IFS industry takes place at two levels: by the respective national regulators where the IFS firms are domiciled, and by various industry-sponsored or industry-specific entities.

The governments of various Muslim countries and the industry have taken numerous initiatives. Malaysia established its National Syariah

⁵⁶ William C. Philbrick, "The Paving of Wall Street in Eastern Europe: Establishing Infrastructure for Stock Markets in the Formerly Centrally Planned Economies," *Law & Policy in International Business* 25 (1994): 565.

⁵⁷ Paul A. Mackey et al., "Internal Securities and Capital Markets," *International Law* 39 (2005): 373. These economies are also committed to reforming their capital markets and continue to look for the right guideline for the reforms. For instance, the Director General of the Dubai International Finance Centre announced the establishment of a Regional Institute of Corporate Governance to improve the regional securities and financial markets. Dr. Omar Bin Sulaiman maintained:

Transparency and governance is critical in delivering the knowledge, capital, and skills that will enable the region to diversify its economies away from oil and gas, and to grow the wealth of its people, which will lead to political and social stability. As we raise our corporate governance levels, it will increase trust in the region's financial sector, and contribute to attracting foreign direct investment, as well as encouraging local and regional banks to provide financing to SMEs and entrepreneurs.

For complete coverage of the above announcement by Dr. Omar Bin Sulaiman, see <http://www.ameinfo.com/73238.html>.

⁵⁸ Mackey et al., "Internal Securities and Capital Markets," 373-374.

⁵⁹ Jason Gottlieb, "Launching the Phnom Penh Stock Exchange: Toward a Legal Framework for Launching a Stock Exchange in an Underdeveloped Country," *Columbia Journal of Asian Law* 14 (2000): 235, 275.

(*Shari'a*) Board to harmonize Islamic finance practices and advise the Malaysian Central Bank.⁶⁰ Pakistan also established a *shari'a* board within the State Bank of Pakistan for similar objectives, and the UAE, Bahrain, and others followed suit. In general, the IFS industry in Muslim countries is governed by a special regulatory regime, while conventional banking continues to be regulated under a different regime. The Muslim countries thus have a dual regulatory system catering to both Islamic banks and conventional banks.⁶¹

As for industry-oriented non-governmental initiatives, advisory bodies have been established that include the Institute of Islamic Research at Al-Azhar University (established in Cairo in 1961), the Islamic Jurisprudence Council of the Muslim World League (established in Makkah in 1979), and the Fiqh Academy of the Organization of the Islamic Conference (established in Jeddah in 1984).⁶² Although it does not play any formal role in regulating the IFS industry, the practices of the Islamic Development Bank are also taken as industry standards.⁶³ Such industry-oriented bodies include the International Association of Islamic Banks (which requires every financial institution offering Islamic financial services to have a board of *shari'a* scholars⁶⁴), the Accounting and Auditing Organization of Islamic Financial Institutions (AAOIFI),⁶⁵ the Islamic Financial Services Board (IFSB),⁶⁶ the International Islamic

⁶⁰ Ibrahim Warde, *Islamic Finance in the Global Economy* (Edinburgh: Edinburgh University Press, 2000), 230.

⁶¹ Philip Molyneux and Munawar Iqbal, *Banking and Financial System in the Arab World* (New York: Palgrave MacMillan, 2005), 162-63.

⁶² El-Gamal, *Islamic Finance*, 32.

⁶³ See Mohamed Rafe Md. Haneef, "Recent Trends and Innovations in Islamic Debt Securities: Prospects for Islamic Profit and Loss Sharing Securities," in *Islamic Finance: Current Legal and Regulatory Issues*, 29-60.

⁶⁴ Warde, *Islamic Finance*, 226-227. Warde quotes the International Association of Islamic Banks to have required: "It is formed of a number of members chosen from among jurists and men of Islamic jurisprudence and of comparative law who have conviction and firm belief in the idea of Islamic Banks. To ensure freedom of initiating their opinion the following are taken into account: (a) They must not be working as personnel in the bank. That means: They are not subject to the authority of the board of directors; (b) They are appointed by the general assembly as it is the case of the auditors of accounts; (c) The general assembly fixes their remunerations; (d) The Legitimate Control Body has the same means and jurisdictions as the auditors of accounts."

⁶⁵ El-Gamal, *Islamic Finance*, 9; Molyneux and Iqbal, *Banking and Financial System*, 149-151. Molyneux and Iqbal explain that the role of the Organization includes adapting international standards that are relevant to the IFS industry.

⁶⁶ See www.ifsb.org; and Molyneux and Iqbal, 149-151, noting that the primary role of the Board includes prudential regulation for Islamic financial institutions.

Financial Market,⁶⁷ the Liquidity Management Centre,⁶⁸ and the International Islamic Rating Agency.⁶⁹ Despite the emergence of these institutions, no single institution could be regarded as the central point of reference for guidance on the issues of compliance with Islamic law. Therefore, the central role of the *shari'a* board of each IFS institution continues to drive the bulk of industry innovation. However, opinions from Al-Azhar University, the Islamic Jurisprudence Council of the Muslim World League, and the OIC Fiqh Academy have been decisive on various controversial transactional issues.⁷⁰ If any IFS institution has launched a product relying on any opinion of its *shari'a* board or any of the above institutions, competitor IFS institutions invariably adopt the same structure,⁷¹ thereby extending the opinion and implicitly confirming its validity. This also signifies the cardinal role that an Islamic legal opinion plays in the IFS industry today. These industry-sponsored or industry-specific entities collectively represent a *de facto* quasi-regulatory body.

Additionally, *sukuk* issued at the international markets have usually been in the conventional global bond format. U.S. Regulation S and Rule 144A have been particularly preferred recently.⁷² This trend is growing and presents a pronounced effort by the IFS industry to comply with modern corporate governance practices. This trend also underscores “*de facto*,”⁷³ “functional” or “stealth convergence,” as noted above.

ISLAMIC FINANCIAL SERVICES SECURITIES EXCHANGE

The establishment of an IFS securities exchange will ensure a specialized provision of services and uniformity of transaction costs. Being a homogeneous market place, the securities listed at the exchange will not be affected by the liquidity and other constraints faced by any single stock

⁶⁷ See www.iifm.net; and Molyneux and Iqbal, 149-151, explaining that the need for establishing the market includes research for strategizing the liquidity issues facing IFS institutions.

⁶⁸ See Molyneux and Iqbal, 149-151. The Center was established by the International Islamic Financial Market with the aim of efficiently managing the short term liquidity needs of IFS institutions.

⁶⁹ *Ibid.* The authors explain that the Agency supplements the conventional rating industry by providing the Islamic law compliance of the rated IFS products.

⁷⁰ See El-Gamal, *Islamic Finance*, 9, 15, 33, 34, 41.

⁷¹ *Ibid.*, 11-13.

⁷² Haneef, “Recent Trends,” 31. Haneef notes that Regulation S format *sukuk* include the Islamic Development Bank’s issue of \$400 million in 2003, the State of Qatar’s \$700 million in 2003, and the Kingdom of Bahrain’s \$250 million in 2004.

⁷³ Prof. Jackson employed this term while discussing various aspects of regulatory convergence. See Jackson, “Centralization, Competition and Privatization,” 30-31.

exchange. The homogeneous nature of the IFS securities exchange will facilitate consistent growth within the IFS industry. At the IFS exchange, entrepreneurs and suppliers of finance would be able to make transactions in accordance with the principles of Islamic finance.

Facilitated by modern information technology, the IFC securities exchange could be connected to the specialized secondary market open to the investors world-wide. However, a sophisticated cross-jurisdictional dispute resolution mechanism would need to be in place to avoid any legal uncertainty with regard to the functioning of the exchange. The IFS securities exchange may be incorporated by the stock exchanges that list the IFS products or, alternatively, set up by any number of willing regional exchanges. The IFS Securities Exchange will serve to provide capital sources within the IFS product region, in line with the investment policies of various Muslim countries. Governmental support is also essential in this regard.⁷⁴ Collaboration with the international organization will provide the requisite expertise required to develop the foundational regime.

Modern business institutions, including the securities markets, do not necessarily conflict with *shari'a*. Rather, if their role facilitates the curbing and alleviation of poverty and promotes economic welfare by enhancing purchasing power in an economy, they serve a noble purpose.⁷⁵ It is often argued that stock exchanges favor the rich and encourage monopoly by corporations while discouraging small enterprise,⁷⁶ and that they present a place for insider trading and excessive transaction costs. While agreeing that insider trading is a form of exploitation—and that no financial market can prosper in its presence—it is essentially a regulatory issue and a regulatory response could effectively counter this practice. Furthermore, transaction costs (in particular, service charges for financial intermediation) represent someone's labor and expertise, attaching credibility to an issue and maximizing chances of success in the market. The agreed price for service or labor appears in accordance with *shari'a*. However, there may be discouraging effects of excessive transaction costs for small enterprises. But that too would be an economic policy and regulatory issue, and not one that would affect the transaction costs' legitimacy according to *shari'a*. As a measure to promote the small enterprise, suggesting a specialized market or a stock market for small businesses is appropriate at this time.⁷⁷

⁷⁴ Bradley, "A Regional Stock Exchange," Governmental support was regarded as essential for the Sub-Saharan African regional stock market as well.

⁷⁵ Ahmad, *Business Ethics in Islam*.

⁷⁶ Saad Al-Harran, ed., *Leading Issues in Islamic Banking and Finance* (Petaling Jaya: Pelanduk Publications, 1995), 143-151.

⁷⁷ *Ibid.*

For an Islamic stock market, transactional transparency and the absence of market manipulations, short selling, insider trading, contra deals, and excessive financial exposure are essential. Scholars view such practices as immoral or unethical.⁷⁸ Transactional transparency and compliance with *shari'a* also applies to market participants, and as argued, includes the fair intention to carry out the transaction.⁷⁹

The establishment of an IFS securities exchange may also seem closer to the objectives of *shari'a* for its potential to spread the financial benefits to a greater portion of the population.

CONCLUSION

This paper has discussed the significance of corporate governance for the IFS industry. Furthermore, it has predicted that the IFS industry is likely to converge to modern governance practices. The paper has also argued that the industry needs to have a homogenous and specialized regional IFS securities market for the IFS industry to realize its full potential.

The IFS industry is successfully crossing the conceptual barriers and will, hopefully, attain the market efficiency that comes with the continuation of a business entity, despite the fact that continued business entities have not existed in Muslim countries.⁸⁰ Scholars have provided guidelines for organizing limited liability business organizations including the form of a modern corporation.⁸¹ However, the role of a corporation in society still needs further examination in light of *shari'a*. The question of whether a corporation serves the society from its profits, or serves solely the interests of its shareholders, needs scholarly response. A socially responsible corporation may yield lesser profit to the shareholders, and this feature is likely to affect its competitiveness. Without fully resolving such issues, the Islamic financial markets are far from a reality.

The findings of the Islamic Capital Task Force noted that the Islamic capital market is a part of the global securities markets, and its regulation is needed in order to nurture and support its growth. The findings also noted that for its regulation, it should comply with IOSCO's Objectives

⁷⁸ Syed Othman Al-Habshi, "Towards an Islamic Capital Market," <http://vlib.unitarklj1.edu.my/staff-publications/datuk/Nst19feb93.pdf>.

⁷⁹ Ibid.

⁸⁰ Timur Kuran, "The Absence of the Corporation in Islamic Law: Origins and Persistence," *American Journal of Comparative Law* 53 (2005): 785-834.

⁸¹ Imran Ahsan Khan Nyazee, *Islamic Law of Business Organizations: Corporations* (Islamabad: The Islamic Research Institute Press, 1998).

and Principles of Securities Regulation.⁸² The findings noted the absence of any international body providing directions on the Islamic capital markets issues, and emphasized the convergence of divergent *shari'a* interpretations.⁸³ Efforts to streamline the divergence are under way. It remains to be empirically examined whether or not a particular school of *shari'a* interpretation is becoming more popular than the others, and what might be the repercussions of such preferences.

No single regulatory authority exists for the regulation of the IFS industry, which continues to be regulated by the dual regulatory structure. That is to say, the industry is subject to the regulatory regime of the respective national laws where IFS firms are domiciled, and the IFS-specific international quasi-regulatory entities, as described above. Thus, it is difficult to analyze the extent of actual regulatory convergence within the industry. However, the principles and standards issued by the AAOIFI and the IFSB are becoming increasingly significant in the industry. Examining the degree of convergence in such principles and standards would be an important follow-up study, and a future work will analyze whether the principles and standards sponsored by the aforesaid institutions support the arguments of convergence, as discussed here, and, if so, to what extent.

As noted above, functional, *de facto*, or stealth convergence in the form of the issuance of *sukuk* in accordance with the U.S. regulatory formats confirms the scholarly predictions on regulatory convergence. The voluntary adoption of U.S. regulatory formats also supports the argument made here.

⁸² "International Organization for Securities Commissions," Report of the Islamic Capital Market Task Force, July 2004, <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD170.pdf>.

⁸³ *Ibid.*