

# ***Sharī'a* Supervision of Islamic Mutual Funds**

**Yusuf Talal DeLorenzo\***

## **ABSTRACT**

This paper seeks to identify and discuss issues related to the *sharī'a* supervision of Islamic mutual funds within the context of the variety of *sharī'a*-compliant alternatives that are now, or will soon be, available to Muslims in need of financial services, including banking, insurance, consumer finance, and investments. In its analysis of the issues, the paper will explain the vital relationship of professional *sharī'a* supervision to the credibility and success of Islamic mutual funds and to the entire Islamic financial sector. To ensure profitability, prudence dictates that investors seek out professionally managed Islamic mutual funds that combine performance with accountability and transparency. This paper demonstrates that, in order to ensure that profits from funds are *@alāl*, investors must be satisfied that the funds are supervised and audited by competent *sharī'a* professionals.

## **I. INTRODUCTION**

Islamic mutual funds presently represent one of the fastest growing sectors within the Islamic financial industry. As *sharī'a* supervision is an integral part of the industry, its place in relation to Islamic mutual funds is certainly no less important. The intention of this paper is to discuss in a general way the variety of functions performed by *sharī'a* supervision and their importance. In doing so, observations about the industry and suggestions for a better future will be offered.

## **II. THE CURRENT STATE OF *SHARĪ'A* SUPERVISION**

It is a matter of concern that a significant number of managed Islamic equity funds function without *sharī'a* supervision of any sort. In fact, according to the data available on the ninety or so Islamic mutual funds, less than one half actually retain their own *sharī'a* supervisory boards.<sup>1</sup> This is an alarming circumstance that, for reasons that will be discussed in this paper, needs to be remedied. Ideally, if management is slow to address the issue, then the remedy will come from the investors themselves. In fact, as Muslim investors grow in number and sophistication, they expect more from the professionals who manage their money. Then, in terms of performance—always the bottom line—and in terms of customer service, and in terms of *sharī'a* compliance, Muslims have already begun to expect more and more from their funds. In terms of *sharī'a* supervision, a great deal can be expected.

Particularly now, with the opening of retail markets to middle-class Muslim investors, Islamic mutual funds find themselves if not in direct competition, then at least subject to direct comparison, with the host of conventional mutual funds available to consumers. Today, funds offer all manner of services to investors, from virtual office space on their Web sites, to real-time performance updates, to regular reports, to the ability to customize a portfolio by using a personal identification number and selecting new fund options online or over an automated phone system. In short, the mutual fund industry has progressed from its beginnings as almost a closed sort of country club operation that catered to a financial elite, to its present service-oriented state that is driven by competition. Our new generation of Islamic equity funds is a part of this market, and certainly subject to many of the trends that move it. It is for this reason that, by way of example, the Azzad/Dow Jones Islamic Index Fund offers its investors a host of online facilities, in addition to regular reports by management, independent auditors, and a *Sharī'a* Supervisory Board. Then, with standards of service, accountability and transparency rising to keep pace with the market, and with sophistication and expectations on the rise among Islamic investors, Islamic funds that fail to upgrade will certainly be bested by funds that succeed in doing so. Moreover, when retail Islamic funds begin to offer so much to their clients, investors in the other Islamic funds, institutions and high-net-worth individuals will not fail to take notice and, ultimately, either move their assets or insist that management take measures to give them more value for their money.

---

\* Independent *Sharī'a* Consultant, Ashburn, Va.

There are, however, instances of Islamic funds that have found other ways to see to the *sharīʿa* supervision of their businesses. For example, some funds have retained the services of a single *sharīʿa* supervisor. The author finds nothing wrong with such an arrangement, especially if the fund is set up to track an Islamic index like one of indexes from the Dow Jones Islamic Market Indexes family. Obviously, such an index fund will require less *sharīʿa* supervision for its portfolio than an actively managed portfolio because its investable universe will already have been screened by the *Sharīʿa* Board of the index provider. Then, with the active support and cooperation of management, a single *sharīʿa* supervisor should suffice to ensure *sharīʿa* compliance and assume responsibility for the other aspects of *sharīʿa* supervision. Even so, the presence of a full board would undoubtedly be more assuring to investors, and quite possibly more effective as well.<sup>ii</sup>

Another way that an Islamic fund may ensure *sharīʿa* supervision without retaining the services of a *Sharīʿa* Supervisory Board is for it to appoint a *sharīʿa* scholar to the fund's Board of Trustees. Then the scholar may either chair a subcommittee or work alone to supervise the fund for *sharīʿa* compliance and oversee the other *sharīʿa*-related matters. Thus, while the ideal situation will always be for a fund to retain the services of a full *Sharīʿa* Supervisory Board, with three or more members, there are other ways of accomplishing the requisite *sharīʿa* supervision.

In this context, however, I would like to point out a serious misunderstanding that appears to have been repeated by a number of different Islamic mutual funds, though very likely with the best of intentions. This misunderstanding is based on the assumption that a fund licensed by an index provider with a *Sharīʿa* Supervisory Board of its own will not require *sharīʿa* supervision of any sort: not in the form of a board, and not in the form of a single supervisor. Writing in a recent issue of *New Horizon*, a Muslim financial professional observed,

The arrival of the Dow Jones Islamic Market Index is seen as a cure all for banking houses who wish to broaden their success in placing equity funds with wealthy Muslims. The requirement, however, that they must still contract a *Sharīʿa* Board of their own to supervise their own behavior does not appear to be widely understood.<sup>iii</sup>

Obviously, an Islamic mutual fund will become a licensee to an index provider with its own *Sharīʿa* Supervisory Board for the reason that the fund wants assurance for its investors that its choice of stocks will be *sharīʿa*-compliant. However, there is a great deal more to *sharīʿa* supervision than the review of stock choices from a *sharīʿa* perspective. Then, even if the fund is licensed to an index like the Dow Jones Islamic Market Index, it will still require *sharīʿa* supervision and advice. This paper shall attempt to explain why this is so by examining a number of different areas in which the participation of a *sharīʿa* scholar is essential.<sup>iv</sup> It will also speak of the need for proactive involvement in fund affairs by *sharīʿa* supervisor(s) of the fund. Finally, it will make some recommendations on the future of *sharīʿa* supervision that, it is believed, will add value to every Islamic mutual fund.

### III. CONSUMER ADVOCACY

It is of primary importance to understand *sharīʿa* supervision as consumer advocacy. By taking every possible step to ensure that an Islamic mutual fund represents a *@alāl* investment for Muslims, the services performed by *sharīʿa* supervisors are directed toward the investor. Undoubtedly, as a result of these efforts, the fund and its management will also benefit. But the primary beneficiary is the Muslim investor who can rest assured that his/her money is being put to use in ways that accord with the teachings of Islam and its message for all of humankind. So, while the functions of a *sharīʿa* supervisor may be compared to those of an independent financial auditor, in the sense that regulatory compliance is ensured, there is a further and far more vital aspect to the role of a *sharīʿa* supervisor. By assuming responsibility for the *sharīʿa* compliance of a fund, including its components and its management, the *sharīʿa* supervisor places himself in a position of directly representing the religious interests of the investor. In discussing the different aspects of *sharīʿa* supervision, it will become clear that a *sharīʿa* supervisor functions in many different ways as a consumer advocate with both religious and fiduciary responsibilities. By performing these functions, the *sharīʿa* supervisor adds significant value to the fund(s) with which he works.

It has already been stated that there is far more to the *sharīʿa* supervision of an Islamic mutual fund than the screening and selection of equities. Let us now examine some of the different *sharīʿa* supervisory functions that are inseparable from the success of an Islamic mutual fund. One of the most important of these functions has to do with purification, which actually takes place at two different levels: at a fiscal level and at a moral level.

#### IV. PORTFOLIO PURIFICATION: FISCAL AND MORAL

It should not be necessary to explain that *zakāt* and purification are two entirely different, though not unrelated, matters. After all, the literal meaning of *zakāt*, which will be discussed later in this paper, is “purification.” But the purification intended for discussion here is the cleansing from an investment portfolio of impure elements.

Many Muslims are familiar with the practice of “purifying” their checking accounts, for example, by simply donating the amounts listed as “interest earned” to charity. Thus, our concern from a *sharī'a* perspective is with amounts of money earned by the corporations in which our Islamic mutual fund has invested, money earned by means deemed unacceptable by *sharī'a* principles and teachings. Such “impure” earnings must be quantified and then purified.

Of course, the assumption here is that these are stocks that have cleared the various screens for *sharī'a* compliance. Thus, the sources of such income might include non-operating income from interest-bearing investments, or earnings from prohibited business activities that are beyond the scope of a company’s primary business. Oftentimes, such earnings will result from corporate diversification and new acquisitions. Whatever their source, the fact remains that even *sharī'a*-compliant equities will often yield small percentages of income that is considered impure by *sharī'a* standards, and that must then be purified.

The responsibility of the *sharī'a* supervisor in this regard is to ensure that all such income is calculated by the fund, and that a corresponding percentage is deducted from the earnings, passed on to investors through dividends, thereby ensuring that these are free of impurities and completely *Ḍalāl*.<sup>v</sup> The methodologies for calculation may differ from fund to fund, or from one *Sharī'a* Supervisory Board to another, where scholars, for whatever reasons, have preferences in the matter. This, however, is of secondary importance. Of primary importance is that the fund is actually committed to and regularly engaged in such purification. On behalf of the investor, then, it is the *sharī'a* supervisor who will ensure that purification takes place, and that it takes place in a manner that accords with Islamic law.

The tangible results of such fiscal purification are that amounts of money begin to pile up. Generally speaking, it is recommended that funds sweep these amounts into separate accounts. With the advice and counsel of the fund’s *Sharī'a* Supervisory Board, these amounts may be distributed among suitable charities, or a charitable fund may be established for the purpose; again, under the supervision of the *sharī'a* scholars.

Of course, it is certainly possible that the matter of purification be left entirely to the individual investor. Nonetheless, when we are speaking of adding value to a fund, it is clear that the fund’s performance of this function will relieve the investor of the responsibility, and the considerable time and effort required to perform it. In fact, it is clear that this is a service that is much more effectively performed by the fund itself, particularly when the calculation process, including the collection of relevant data, is not a simple matter for those not equipped to undertake it.

The second half of the purification equation is what is termed “moral purification,” and it is no less important than the fiscal purification of earnings. When speaking of fiscal purification, the thing that comes immediately to mind is that we are dealing with an amount of money that has been earned by means we find unacceptable, and is therefore in need of purification. So, in our haste to put aside the offending percentage, we often overlook our moral and religious responsibility in the matter. This responsibility is perhaps best understood in the context of the Qur’anic concept of “enjoining the right and prohibiting what is wrong.”<sup>vi</sup>

The ways to discharge this particular responsibility are varied. But modern corporate democracy has provided Muslim investors with every opportunity to share with management their views and sentiments with regard to corporate practice and policy. By law, in fact, publicly owned corporations are required to hold annual meetings for their shareholders, and these provide opportunities for Muslim investors, or for the *sharī'a* supervisors who look after their interests, to voice their concerns to management as vocally and as directly as they feel necessary. Of course, it is impractical to suppose that *sharī'a* supervisors will attend every annual meeting of every holding in the fund’s portfolio. But it is still possible to participate in the process of corporate governance by means of proxies and absentee ballots. It is likewise possible, at any time, for shareholders to raise issues with management, and to initiate positive change, by means of corporate shareholder resolutions. When a fund with substantial holdings brings up an issue, management will surely listen.

In an Islamic fund’s strategy of proactive engagement with companies, the participation of *sharī'a* scholars is essential. It is essential, in the first place, to ensure that the fund be concerned with moral purification on behalf of its investors. And it is essential, thereafter, to ensure that issues of importance to Muslims, from an Islamic perspective, are represented accurately and effectively to the management of major corporations. As Islamic mutual funds grow larger, and begin to hold larger and larger blocks of shares, the attention they receive from corporations

will grow proportionately. It is of all the more importance, then, that Muslims represent their way of life in the best and most effective manner possible.

## V. PORTFOLIO SELECTION: SCREENING STOCKS

Undoubtedly, one of the most important functions of a *Sharī'a* Supervisory Board is its scrutiny of equities for compliance with established, *sharī'a*-based criteria. Much has been written on this subject in recent years, and much more remains to be written.<sup>vii</sup> For the purposes of this paper, however, suffice it to say that if an Islamic fund is not licensed to an Islamic index with a full *Sharī'a* Supervisory Board, then it will undoubtedly require the services of a *Sharī'a* Supervisory Board to oversee its choice of investments. Such choices cannot be made on the basis of software, or by simply applying the published criteria of another fund, or index. So, when an Islamic equity fund is licensed to such an index, it may at least rest assured that the stocks it invests in will accord with the guidelines for prudent Islamic investing. Even so, it will still require *sharī'a* supervision.

While what has now become common knowledge in regard to the *sharī'a* screening of equities will not be repeated here, one should bear in mind that beyond the quantitative screening of securities is the highly subjective matter of ethics, and what is socially responsible. Again, from the perspective of enjoining the good and prohibiting what is wrong, it is the responsibility of *Sharī'a* Supervisory Boards to work on these issues, even after a fund has been licensed to an investable universe through an index. Muslim investors, with their spiritual, cultural, and family ties to what is politely termed the developing world, are more intimately concerned with, and sensitive to, the practices and policies of multinationals.

A company's ethics, unlike its primary business and capital structure, are highly subjective and not easily quantified. In considering issues of this nature, it is important that the fund's *Sharī'a* Supervisory Board work closely with management on policies and guidelines that will adequately cover these issues. Islamic investing has much in common with the modern forms of investing known as ethical investing, socially responsible investing, faith investing, and green investing. Each of these investment sectors, or subsectors, has much of value to contribute; and each has something in common with the teachings of Islam. It is therefore important for *Sharī'a* Supervisory Boards to keep abreast of what is happening in these areas. The Internet is an excellent tool for the purpose of research into these forms of investing, the organizations that support and implement their principles, and the issues that concern them. Perhaps the most encouraging thing for Muslim investors to note about the funds that have grown up around these concepts is that they have been very successful, and that they are the fastest growing sector of the market.<sup>viii</sup> Given the affinities shared by these groups and Muslim investors, it is important that Islamic funds begin to build bridges. In this effort, the participation of *Sharī'a* Supervisory Boards will be all-important.

## VI. PORTFOLIO MONITORING

Beyond selecting stocks is the equally important task of monitoring stocks. In the business world, there is very little that remains the same. A company with non-operating interest income of less than 5% for the present quarter may show earnings in excess of 15% for the next. Obviously, vigilance is required in these matters to ensure that all of the fund's holdings remain within the limits of the prescribed *sharī'a* filters. Again, when a fund is licensed to an index, information of this nature will be passed on by the index provider as a matter of course. In such cases, the responsibility of the *sharī'a* supervisor will be to verify the removal of the security from the fund's portfolio. In the case, however, that the fund is not licensed or otherwise positioned to receive such information, even more vigilance is required.

Fund management will generally assign this responsibility to their portfolio managers or research analysts. The author's own experience to date with portfolio managers is that they are very diligent about these matters. Even so, it is the responsibility of *sharī'a* supervisors to ensure that this sort of vigilance is maintained. Very recently, specialized software has been developed that allows management, and *sharī'a* supervisors, to track portfolios with ease. Such software, when connected to the Internet, will also provide real-time access to portfolios, as well as a host of third-party information. To the author's knowledge, very few Islamic funds have actually provided their *Sharī'a* Supervisory Boards with this sort of access. Here again, though, the funds that do so will have a competitive edge.<sup>ix</sup> In the future, Allah willing, every Islamic fund will have this facility. In fact, work is underway on even more sophisticated software. By the time this paper is published, it is expected that the beta versions will be up and running. In the final analysis, however, no matter how powerful the search engine or how seamless the links in the software, the expertise of *sharī'a* supervisors will be required to make the final call. The software will identify the problem, the *Sharī'a* Supervisory Board will solve it.

## VII. MONITORING MANAGEMENT

The *sharī'a* supervisory function includes vigilance in relation to the management of the Islamic equity fund as well. Among the most important issues in this regard is the fund's cash-to-assets ratio. Fund or portfolio managers may keep a large cash portion on hand if, for example, they are bearish on the market, or if they are unable to find attractive securities to buy, or, in the case of an index fund, if they are temporarily unable to purchase the stocks needed to match the index. Of course, the reason for the concern of the *Sharī'a* Supervisory Board under these circumstances is the possibility that idle cash will lead to interest.

Likewise, *Sharī'a* Supervisory Boards must be especially vigilant when, owing to adverse market conditions, management decides to assume temporary defensive positions. These may occur as the result of political, economic, or a host of other reasons. The important thing, however, is that the Board ensure that the strategy not include recourse to the conventional, knee-jerk strategies of moving into high-quality, short-term securities and money market instruments, or commercial or agency paper, or T-bills, or CDs. At such times, it will be best for management to convene a meeting of the *Sharī'a* Supervisory Board, or at least to confer with the members either individually or by whatever other means, for the purpose of discussing to what lengths the fund may go. Obviously, when such situations occur, it is the expertise of the portfolio managers and analysts that will determine the defensive strategy. It is the *Sharī'a* Supervisory Board, however, that will determine whether or not that strategy is a lawful one from a *sharī'a* perspective.

Another thing that *sharī'a* supervision will watch for is the purchase of equities on margin. While managers are aware that such purchases are not permitted, oftentimes their brokers are not. It is for this reason that *sharī'a* supervisors must be on guard for such seemingly innocent mistakes.

In monitoring management, as in monitoring the portfolio, the use of software is particularly helpful. Obviously, this is the trend of the future. In mentioning this, these remarks are directed to both the management of Islamic equity funds and to the members of the various *Sharī'a* Supervisory Boards. In the future, one may expect that a further qualification for *Sharī'a* Supervisory Board members will be computer literacy.<sup>x</sup>

As a sort of a footnote to this section, the author should like to discuss another matter of consequence. Everyone recognizes the need for a working relationship between the members of the *Sharī'a* Supervisory Board and the management of the fund. What people often fail to realize, however, is that relationships between the Board and the portfolio managers, the brokers, the accountants, and the auditors are equally important. When the fund management is openly Muslim, and makes its preferences and practices known to those with whom it works (portfolio managers, brokers, analysts, etc.), there is clearly less likelihood on the part of those colleagues of lapses leading to non-compliance with *sharī'a* precepts. Even so, the possibility remains. And when fund management is non-Muslim, the likelihood is greater. Thus, in both cases, it is important to establish relationships between these business associates and the *Sharī'a* Supervisory Board. Perhaps the best way to accomplish this is to simply introduce the members of the *Sharī'a* Supervisory Board to the business colleagues of the fund. A short face-to-face meeting for the purpose of getting acquainted is all that is required. Thereafter, if any issues arise, these may be discussed in a manner befitting professionals who have actually made each other's acquaintance and share a genuine interest in the success of the fund. Such face-to-face meetings can easily be scheduled around an annual meeting of the *Sharī'a* Supervisory Board, for example, and may even take place at a lunch or a dinner.

In this regard, it might be helpful to relate an example from personal experience. When Azzad's *Sharī'a* Supervisory Board decided that a certain fund needed to liquidate its position in a certain stock, the decision was passed by management to its broker and the stocks were sold. Moreover, the accountants were instructed to sweep the profits from dividends and capital gains into the fund's charitable account. In a matter of days, the fund's auditors contacted management to question the liquidation of such a lucrative equity, and the justification for separating its earnings. At the request of management, the author spoke on the phone with the auditor, who agreed that the author should subsequently inform the auditor's firm in writing of the action the fund had requested, and the reasons for it. Thus, a potentially confusing and time-consuming situation was settled in a simple and straightforward manner. It went as smoothly as it did because a relationship of collegiality had been established, so that there was nothing awkward or hesitant about the exchanges that occurred between the auditor and the firm's *sharī'a* representative. Similar relationships have led to the author's receiving tips from portfolio managers concerning peripheral involvement in prohibited business on the part of certain firms whose stock was held by funds that the author supervises.

## VIII. MONITORING FEES

Certainly, from the perspective of the individual investor, one of the most important of all the different functions performed by a *Sharīʿa* Supervisory Board is its ensuring that the consumer is made aware of the fund's fees and how these are structured. Here again, the *Sharīʿa* Supervisory Board finds itself in the role of consumer advocate. While there is generally no formal channel for communication (other than quarterly or annual reports) between the Board and those who invest in the Islamic fund, the responsibility in this regard is not so much consumer education as it is a matter of the Board's satisfying itself of two essential matters. Firstly, that the fee structure is a reasonable one and, secondly, that the fees are clearly stated in the fund's literature and otherwise communicated without ambiguity to investors.

As the market for Islamic mutual funds grows, investment professionals (and even conventional brokers) will become familiar with the various offerings, and will explain all of the nuances and differences between them to their clients. At the present time, however, most Muslim investors approach Islamic funds directly, and purely on the basis of their understanding that the product offered is *@alāl* and will yield *@alāl* results only. Under such circumstances, it is very important that Islamic funds clearly state their fees, especially when the middle-class Muslim investor may be less inclined to be meticulous on the matter.<sup>xi</sup> Then, while the author is confident that there is no real danger of unscrupulous practices on the part of funds, the real concern is that investors fully understand what sorts of fees they are expected to pay. For example, even in the United States, where the regulatory atmosphere is so strict, the annual expense ratio, or annual fee, does not appear on the client statements of most conventional funds. As a result, most consumers are not even aware of it. So, if people invest in a no-load fund, and then sees no mention of fees on their client statements, they might very well suppose that they are paying nothing to their funds.

Even aside from the annual fees and the different sorts of loads, funds will generally charge fees for a number of other services. For example, investors who move money between funds in the same family of funds (from a growth to an income fund, for example) may generally do so without any additional load. There may, however, be a fee for doing so, as well as a tax liability. It should be the responsibility of the Islamic fund to provide investors with a clear picture of their responsibilities in these instances. Such a "schedule of fees" should also include information on breakpoints or volume discounts, on the investors' rights of accumulation, on surrender fees (contingent deferred sales charges), on the facilities accorded by the fund for letters of intent (including the terms of retroactive collection in the event that the LOI is not fulfilled), and on special items like performance incentives and thresholds. The concern of the *Sharīʿa* Supervisory Board in these matters is simply that the investor be apprised of factors that may be of significance to him/her when investing Islamically. By looking out for the interests of the consumer in this manner, the *Sharīʿa* Supervisory Board is actually adding value to the fund. This is because when all the fees are carefully spelled out for investors, there is far less chance of unpleasant surprises and the resulting ill will that might be generated by even the simplest of misunderstandings. In today's service-oriented markets, this should be more than obvious.

## IX. MONITORING FUND DOCUMENTATION

Perhaps more than monitoring, this function of a *Sharīʿa* Supervisory Board is actually one of assisting management in the preparation of filings for regulatory agencies such as the Securities and Exchange Commission, subscription agreements, private placement memoranda, fund prospectuses, and the like. Obviously, in the preparation of such documentation, references will have to be made to the *sharīʿa* and its interpretations. For this reason, it is essential that the expertise of *sharīʿa* scholars be accommodated. It is clearly of inestimable importance that the documents that define the Islamic mutual fund and the ways it works be in complete consonance with *sharīʿa* precepts. The only way to ensure this is to have the *Sharīʿa* Supervisory Board involved in the drafting and review of all pertinent legal and business documentation.

In fact, this paper will go one step further and suggest that *sharīʿa* supervision be extended to include marketing materials, such as brochures, advertisements, Web sites, and even multimedia presentations. In all of these, reference of one sort or another is sure to be made to the *sharīʿa* and the Islamic nature of the fund. In order to warrant that all such references are made correctly, especially in view of the fact that these will be made public, the involvement of the *Sharīʿa* Supervisory Board is essential.

## X. MONITORING THE INDUSTRY

As academics, the members of *Sharī'a* Supervisory Boards will naturally keep abreast of scholarship in their respective fields and specializations. As professionals, it is equally essential that they remain informed of developments in the industries they supervise. In order to comprehend fully the sorts of issues that require the attention of *Sharī'a* Supervisory Boards, it is important to understand the issues in the broader context of the marketplace in general. From this perspective, the attention brought to bear on the issues by the Board will certainly be more pertinent, with the result that the Board's decisions will be more informed and ultimately of more value to the investor. This is not to say that *Sharī'a* Supervisory Boards should tell management how to run their business. Rather, a Board that is sensitive to the business environment is an effective Board.

In order to maintain this edge, *Sharī'a* Supervisory Board members need to understand the stock market and its various indicators. They also need to be able to use the tools that will allow them to follow the stock market and the factors that influence it. Thus, at the level of fund and sector performance, the Dow Jones Islamic Market Indexes and the Financial Times/TII Indices are indispensable tools. Specialized Web sites like Failaka.com, IslamiQ.com, and Muslim-investor.com are important sources of information about the Islamic investing sector, as are a handful of specialized publications such as *New Horizon*, *The Islamic Banker*, and others. Finally, at the level of the mutual fund industry in general, the sources of information are seemingly limitless, whether in print, online, or over the airwaves. Finally, academic and professional forums, such as the Harvard University Forum on Islamic Finance, may have much to contribute to this important aspect of *sharī'a* supervision.

## XI. PRODUCT DEVELOPMENT

While the issue of product development is more commonly associated with Islamic banks, there is nonetheless a certain amount of scope for it in Islamic mutual funds as well. With the goal of mitigating risk through portfolio diversification, an Islamic fund might consider turning to markets other than the stock market, or to target other asset classes, such as real estate investment trusts (REITs). The fund may also want to do something different as part of a defensive strategy for a bearish market, or as a way to manage short-term liquidity. Whatever the case, there will be a clear need for the expert advice and assistance of a *Sharī'a* Supervisory Board.

## XII. ZAKĀT

The assumption might easily be made that if Islamic mutual funds are active in purification, then they should surely be doing something about *zakāt*. This, however, is not the case. The matter of *zakāt* is complicated by any number of factors that lie outside the control of Islamic funds (and, for that matter, Islamic banks and other financial institutions as well). Since these factors are particular to the circumstances of each investor, the matter of *zakāt* is best left to the investors themselves. In this regard, one can refer to the *fatwā* of the Islamic Bank of Jordan, which effectively explains the reasons that the matter of *zakāt* should be left to the individual Muslim investor or depositor.<sup>xii</sup>

Even when the matter is left to the individual, the fund may consider requesting its *Sharī'a* Supervisory Board to prepare guidelines for the calculation of *zakāt* on profits earned through investments in funds. These guidelines might then be published in brochure form and mailed to investors, or posted on the fund's Web page as an extra service to its investors. As there is still considerable debate on the details of *zakāt* to be paid on such investments, attention to the matter on the part of *Sharī'a* Supervisory Boards may indeed help bring about a needed consensus on several outstanding issues.

## XIII. REGULAR REPORTS

Finally, one of the most important functions of a *Sharī'a* Supervisory Board is to prepare reports on the status of the fund it supervises. Such reports are best issued quarterly and should address issues of *sharī'a*-compliance in the portfolio and on the part of management. Likewise, the reports should keep investors informed of the purification process and the charitable ways in which purification money has been put to use by the fund. Other issues of relevance to the supervision of the fund might also be mentioned in the reports, such as new software that enables the Board to easily monitor the fund's portfolios, to screen stocks for *sharī'a*-compliance, and so on. In addition, the Board may use the reports to communicate the ways in which it is addressing issues related to socially responsible investing and the business ethics and practices of corporations. Finally, as the goal of these reports is to

promote transparency and full disclosure, they should always be prepared in a straightforward manner. If shortcomings have occurred, they must be mentioned, along with the steps taken to remedy the situation.

#### XIV. CONCLUSION

Throughout this paper, I have alluded to what the future might bring. All such references, I believe, have been made with a degree of optimism. No one doubts that there is a sizeable, and as yet untapped, market for Islamic financial products and services, especially in the United States and Europe, and in Muslim-majority countries with prosperous middle classes. When I consider this market, I see a religious community that is in many ways just as comfortable, and at ease, with the modern world as it is with its own Islamic heritage. The politics of the modern world have provided haven, and its economics have provided comfort. At the same time, Muslims are inextricably tied to Islam. My concern, as an advocate for this community, is that we receive the value that we deserve, not only that we get what we pay for, while the tenets of our religion are respected, not only in the sense of compliance, but in the sense of honor and esteem as well.

It will not be out of place, in our discussion of the future of *Shari'ah* Supervisory Boards, to mention here the need for impartiality and independence. In the same way that independent auditors are brought in to review the finances of a business, *Shari'ah* Supervisory Boards review compliance with *shari'ah* precepts. Independent audits are understood as ways to gain and maintain the trust of investors and consumers. Independent *shari'ah* supervision is the best way to gain and maintain the trust of Muslim investors and consumers.

The call goes out, from time to time, for the establishment of a central, or a unified, *Shari'ah* Supervisory Board that could look after the interests of every Islamic bank or financial institution. Just as often the call is ignored. (Admittedly, an attempt was made in the 1980s to establish such a central board, but for Islamic banks only.) As may be gleaned from the contents of this paper, it is simply impossible for a centralized board to effectively perform all the tasks required for the *shari'ah* supervision of each and every Islamic financial institution. In the early 1980s, when there was only a handful of such institutions, such a notion might have seemed reasonable. But today, when Islamic mutual funds alone number nearly one hundred, the notion is highly impractical.

Not only that, but as the Islamic financial sector looks at ways to provide *shari'ah*-compliant financial services to retail consumers, there is an increasing need for specialization among *shari'ah* supervisory professionals. *takāful* operations, for example, while based on many of the same principles, are nonetheless quite different from banking operations. The operations of commercial banks differ considerably from those of thrifts and investment banks. In the future we can expect to see more specialized *shari'ah* supervision, or supervision geared toward specific sectors within the Islamic financial industry as it grows in size and sophistication. Under these circumstances there is no practical future for a single, central *Shari'ah* Supervisory Board.

To ensure that *Shari'ah* Supervisory Boards remain current, however, it may be preferable to have a professional organization, an industry association if you will, that sets standards for everything of importance to Islamic mutual funds. Such an association might therefore be inclusive of standards and practices for *shari'ah* boards, Islamic funds, and fund management as well. Such an industry association might also look after the interests of membership, and promote understanding and exchange through publications and regular forums. It could also establish relationships with relevant academic, commercial, and professional bodies. The industry appears to have matured to the point where such an association would be of great value to everyone involved in Islamic funds. From the perspective of a consumer advocate, I will strongly recommend the timely establishment of such an industry association.

And it is Allah who prospers and assists.



---

<sup>i</sup> Thanks to Tariq Al-Rifai and <http://www.failaka.com>.

<sup>ii</sup> Indiana University's Kelly School of Business reviewed 27 studies on board size done over 40 years, covering 20,620 firms. "Boards ranged from 6 to 22 directors, and the team concluded there is a positive link between large boards and performance. The benefit of a big board may be a greater ability to obtain critical resources ranging from raw materials to refined information." Wall Street Journal. August 24, 2000. p. 1. Then, although it is highly unlikely that the boards studied included a single *Sharī'a* Supervisory Board, the results are nonetheless indicative of the efficacy of a working plurality. When the Qur'an encourages believers to consult those "in the know," it uses the term *ahl al-dhikr*, which is immediately understood as plural. See Qur'an 16:43.

<sup>iii</sup> Thomas, Abdulkader. "The Islamic Perspective: Making Your Money Work." New Horizon 100 (July 2000). London: Institute of Islamic Banking and Insurance. p. 11.

<sup>iv</sup> Likewise, I consider it folly for an Islamic financial institution to name what is essentially an academic body as its *Sharī'a* Supervisory Board. This is like naming the National Association of Certified Public Accountants as your auditors. The name is impressive, the cumulative experience is staggering, but practically speaking the results will be zero. Institutions that attempt to obfuscate the issue of *sharī'a* supervision by appointing this academy or that council as their *sharī'a* supervisors have missed the point. They are also doing themselves and their investors a major disservice. *Sharī'a* supervision requires the commitment of time and resources. An informal arrangement for a part-time effort is far from satisfactory.

<sup>v</sup> It might be noted here that a company may suffer an operating loss and still declare a dividend, i.e., earnings per share may sometimes total less than the dividend per share. In such cases, a company will draw on reserves to pay the dividends. Obviously, under such circumstances, dividend purification will be rendered meaningless. Even so, *sharī'a* scholars have devised a number of methods for purification when this happens. My purpose in this paper is not to discuss the details of how these things may be accomplished, but how *Sharī'a* supervision is needed to focus on what needs to be accomplished.

<sup>vi</sup> See, for example, 3:104, 110, 114, and 7:157, and 9:71, and elsewhere.

<sup>vii</sup> I believe that the *sharī'a* filters established by the *Sharī'a* Supervisory Board of the Dow Jones Islamic Market Indexes represent the industry standard today. Nonetheless, that Board is careful to point out that its recommendations on the matter should be understood as interim tolerance parameters. Thus, scholarship on the issues is ongoing. As an entire paper might very easily be devoted to this subject alone, I have thought it sufficient here merely to allude to it.

<sup>viii</sup> Social Investment Forum. 1999 Trends Report: Responsible Investing in the United States. p. 3.

<sup>ix</sup> In fact, I recently had the pleasure of informing investors in the Azzad Growth Fund of this development and how it further ensures the efficiency of our Board and, in turn, the *@alāl* nature of the fund's earnings.

<sup>x</sup> It is a sign of the times that I am now able to carry, on the hard drive of my laptop, the equivalent of hundreds of volumes, in Arabic, on subjects like *fiqh*, *usūl*, *tafsīr*, *@adūth*, and the other classical Islamic disciplines. I hope that by this time next year, Allah willing, my own work in four volumes, A Compendium of Legal Opinions on the Operations of Islamic Banks, will be available on CD-ROM.

<sup>xi</sup> From a *sharī'a* perspective, it is essential that contracts remain free of ambiguity, or *gharār*, especially of the sort that may lead to disputes and even litigation.

<sup>xii</sup> al Fatawa al Shar'iyah li al Bank al Islami al Urduni 2. pp. 13-15.