THE ROLE AND RESPONSIBILITIES OF SHARI'AH BOARDS IN THE CONTEXT OF ISLAMIC FINANCE AND THEIR POSITION IN LAW

BY

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Declaration

I declare that the work presented in this thesis is solely my own work other than where I have clearly indicated that this is the work of others.

Abstract

This study seeks to investigate the role of Shari'ah boards in the context of Islamic finance and defines their legal position in law. It explains ambiguity over the concept of Shari'ah and its implications for the responsibilities of Shari'ah boards in the context of Islamic finance. In this regard, it investigates the history of Islamic law to explain the crucial role of Shari'ah jurists in the interpretation and implementation of Shari'ah principles in terms of legitimacy-making for commercial transactions. Shari'ah supervisory board as the second layer of governance bears a trust-like relationship with the Islamic financial institution and investors. This thesis establishes a fiduciary place for Shari'ah boards to explain their responsibilities according to common law and statute. It endeavours to explain the implications of value-creation and the success of the company for Shari'ah boards' fiduciary duties.

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All praise and thanks are due to God, who endowed me with the will, strength and means to complete this project. Without His bounty, grace and mercy this work would never have been accomplished. There are many people without whom I could not have written the present study.

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Dedication

To my parents

List of Abbreviations/Acronyms

AAOIFI - Accounting and Auditing Organisation for Islamic Financial Institutions

BCBS – Basle Committee on Banking Supervision

ETF – Extended Traded Fund

FSA – Financial Services Authority

ICMA - International Capital Markets Association

IFSA - Islamic Financial Service Act 2013

IFSB - Islamic Financial Services Board

IIFM - International Islamic Financial Market

IIRA - International Islamic Rating Agency

IMF – International Monetary Fund

ISDA- International Swaps and Derivatives Association

IOSCO – International Organisation of Securities Commissions

LMA - Loan Market Association

LMC - Liquidity Management Centre

LSE – London Stock Exchange

MIBA – Malaysian Islamic Banking Act 1983

OECD- Organisation for Economic Co-operation and Development

SCM – Securities Commission Malaysia

UK – United Kingdom

US – United States

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Securities Act of 1933 (US)

Securities and Exchange Act 1934 (US)

Bank Act 1983 (Malaysia)

Malaysian Islamic Banking Act 1983

Takaful Act 1984 (Malaysia)

Finance Act 2013 (United Kingdom)

Islamic Financial Service Act 2013 (Malaysia)

List of Arabic Terms

Al kharaj bildaman – Risk of loss

Al-'uqd al-mu'ayyana – Nominated contract

Aqd bay' – Valid contract of sale

Ariya – Loan

Daman - Guarantee

Dhimmi – Non-Muslims

Fiqh – Islamic Jurisprudence

Ghaban – Misleading descriptions

Ghalat - Error

Gharar – Uncertainty in contracts

Hadith - Tradition

Halal – Permissible activity

Haram – Prohibited activity

Hawala – Assignment of debt

Hisbah – Market inspector

Hudud - Statutory punishment

Hukm – Judgement

Ibah – Permissibility

Ihtikar – Monopoly

Ijara - Lease

Ijma¯c - Consensus

Ijtiha¯d – Literary effort

Ikhrah – Coercion

Iktinaz - Hoarding

Iman – Faith

Isma – Legal bond

Istisna – Commissioned manufacture

Kafala – Personal surety

Khalifah – Caliph, successor of the prophet Muhammad

Kiaar (khiyar al Majis) - Doctrine of options

Maga'sid alsharia – Doing what is good to people

Magbun - A contracting party who suffers something to his great disadvantage

Maslaha – Doctrine of public interest

Muamalat – Transactions

Mudaraba – Passive partnership

Mudharib - Person charged with the actual management of the investments

Muhtasib – Market inspector

Musharaka - Profit and risk sharing scheme

Muzara – Sharecropping

Najash – False bidding

Qadi - Judge

Qardh hasan - Benevolent or non-interest bearing loan)

Qiyas – Analogy

Rab al-mal - Investor

Rahn - Pledge

Rashwa - Prohibition of bribery

Riba - Interest

Sad al-dharai – Duty to eradicate the means to an evil deed

Sadaqa - Alms

Sahifa al madina – Charter of Madina

Salam – Forward purchase/sale

Sarf – Currency exchange

Sha'b (groups with common ancestry or geography

Sharika - Partnership

Shura - Consultation

Sing qobbani - Instrument used by such a weigher or a type of steelyard

Sirket-i Hayriya – Auspicious company

Tadlis – Deceit/fraud

Taradi – Mutual consent

Tasi'ir – Price regulation

Tazir - Discretionary punishment

Umma – Muslim citizens/community

Urbun – Option contract

Wadi – Deposit

Wakala – Agency

Waqf – Donated assets held by a charitable trust

Zakah – Wealth tax

Chapter One

Introduction

This study examines the nature of Shari'ah boards' responsibilities on the one hand and their position in law on the other hand. Research and scholarship relating to the roles of Shari'ah boards is relatively patchy and comments are mainly focused on the description of the general responsibilities of Shari'ah boards rather supply evidence to explain the nature of their functions and their implications for the operation of Islamic financial institutions. This study attempts to define the legal position of Shari'ah supervisory board with regard to the governance of Islamic financial institutions according to conventional law. In this regard, it delves into the common law and the Companies Act 2006 to characterize the duties of Shari'ah boards in terms of value-creation and the success of the company. This entails in a first instance, explaining the fiduciary position of Shari'ah boards and then showing how their fiduciary duties require them to function for the best interest of the company. The fiduciary duties of Shari'ah board to the company require the examination of board of directors' roles in strategy-making and controlling the company as well. In this regard, since Shari'ah compliance as the ultimate goal of the Islamic finance industry is interpreted in terms of Shari'ah boards' fatwas, it is necessary to examine the implications of fatwas for the discretionary power and fiduciary duties of directors in the governance of Islamic financial institutions.

The company laws of most jurisdictions like UK provide no privilege or specific regulation for the operation of Islamic financial institutions. Consequently, the legal structure of governing bodies of all companies in terms of rights and responsibilities of board of directors bears no religious characteristic. However, the institutionalization of Shari'ah supervisory board as the second layer of governance has raised many questions over its influence on the operation of Islamic financial institution. In other words, the conventional regulation does not define any legal positon for Shari'ah supervisory boards with regard to their duties to the company and investors. Although, International standard setting organizations such as the Islamic Financial Services Board have produced many standards in terms of Shari'ah boards' duties, they are not mandatory and only carry a customary quality. Further, they do not define any legal position for Shari'ah boards and only present regulatory principles over their conducts.

In every legal system predictability and certainty are the crucial elements of the rule of law as they support the sound operation of all institutions and accordingly secure their long-term success. In this regard, ambiguity over the legal position of Shari'ah boards in terms of their responsibilities and liabilities has exposed the UK financial industry to further risks such as fraud. Also, due to the lack of a legal position for Shari'ah boards in company law, there is no clear concept and scope for the Shari'ah compliant operation of Islamic financial institutions. In this context, to preserve and reinforce investors' confidence in the sound operation of markets, it is imperative to define the responsibilities and liabilities of Shari'ah boards according to the legal institutions of each jurisdiction.

As noted above, the aim of this study is to find answers for the questions over the position of Shari'ah boards in law, their duties with regard to the success of the Islamic financial institutions and accordingly their relation with directors' prescriptive duties determined in Company law. In this regard, this thesis adopts the doctrinal analysis to clarify ambiguities and find answer for the aforementioned questions. The main sources relied upon by this thesis are rules and judgments derived from the common law and statutes. Also, the clarification over the sources of Islamic finance and the role of Shari'ah jurists in the history of Islam requires this study to examine the Quran, Sunnah and the principles of Islamic *fiqh*.

This thesis is divided into ten chapters. This chapter (1) has introduced the study with discussion about the research background, as well as the aim and objectives of the study and the questions that it addresses. It also discusses the importance of this research and the methodology employed by the researcher. It concludes with a brief overview of the respective chapters. Chapter 2 explains the development of the Islamic financial industry. It examines the concept of *Shari'ah* and its sources in the context of Islamic finance in terms of the strong juristic quality of Islamic jurisprudence. At last, it discusses the implications of legalistic approach in the interpretation of *Shari'ah* for the development of Islamic finance industry.

Chapter 3 examines the significance of Shari'ah boards in the development of Islamic finance. It discusses the evolvement of Shari'ah boards' role from pure endorsement to auditing. It explains the ambiguity over the concept of Shari'ah compliance and its implications for Shari'ah certification and auditing as the main functions of Shari'ah supervision. In this regard, it examines the application of legalistic interpretation of *Shari'ah* in the engineering of innovative financial products such as derivatives and its efficiency in terms of risk management.

Chapter 4 analyses the legal relation between Shari'ah boards and Islamic financial institutions. It explains the legal position of Shari'ah boards in terms of fiduciary duties they owe to the Islamic financial institutions and investors. It examines their fiduciary characteristics according to factors explained in common law. Further, this chapter examines the discretionary power of Shari'ah boards in terms of their access to critical resources such as confidential information. It shows the influence of dual quality of Shari'ah boards' discretionary power on their *ex ante* and *ex post* functions. In this regard, it explains the relation between fiduciary duties of Shari'ah boards and directors' fiduciary duty to promote the success of the company.

Chapter 5 examines the general duties of Shari'ah boards in the context of Islamic finance. It explains the influence of the authority of Islamic Schools of thought on Shari'ah boards' members' duties in terms of the interpretation of *Shari'ah*. It explains the imitation regime in Islamic law and its relation to the legalistic interpretation of Shari'ah compliance. In this regard, it analyses the auditing and advising duties of Shari'ah boards in terms of Shari'ah non-compliance risk management. It explains the role of Shari'ah boards in Shari'ah risk management and controlling losses resulting from operational risk. At last, it discusses the concept of Shari'ah audit and its issues in the context of Islamic finance.

Chapter 6 examines the implications of Shari'ah boards' opinions for directors' duty to promote the success of the company. In this regard, it explains the influence of their opinions over the prescriptive duties of directors in terms of their roles in strategy-making and controlling the company. It reviews the historical root of board of directors and defines its functions. Further, it examines legitimacy-making as the main function of directors in terms of Shari'ah compliance and analyses their strategy-making and controlling roles in terms of their fiduciary duties reflected in the Companies Act 2006 and common law.

Chapter 7 discusses the legal consequences of the breach of Shari'ah boards' opinions by directors. It explains the fiduciary and non-fiduciary duties of directors in terms of Shari'ah compliance. In this regard, it examines the relation between investor protection and Shari'ah compliance with regard to Shari'ah boards' opinions. It explains the role of fiduciary duty of loyalty as an accountability mechanism against directors' non-Shari'ah compliant decisions. It reflects on the positive and negative approaches in the definition of loyalty and their implications for directors' decisions. Further, it examines the liability of directors for their non-Shari'ah compliant decisions in terms of duty of care, skill and diligence. At last, it explains objective and subjective standards of care reflected in the company law in terms of directors' decisions.

Chapter 8 discusses the role of Shari'ah boards in the Shari'ah governance of Islamic financial institutions. It defines corporate governance in a broad sense and explains its economic role in value-creation. Further, it explains similarities between principles of conventional governance and Islamic law in terms of ownership. Then, it examines the concept of Shari'ah governance and the role of Shari'ah boards in monitoring the Shari'ah compliant operation of Islamic financial institutions. In this regard, it reflects on the lack of transparency in the process of Shari'ah governance and its implications for the probity of the company operation.

Chapter 9 examines the issue of professionalism in the functions of Shari'ah boards and its implications for their regulation. It reflects on the concept of profession and its characteristics in the context of modern world. At the end, it analyses the lack of professionalism in Shari'ah boards' functions through the explanation of its elements.

Chapter 10 concludes this study with an assessment of the research undertaken. It shows how the aim and objectives were achieved and recommendations for further studies are made.

Chapter Two

Islamic Finance in the Global Financial Services Industry

2.1 Introduction

This chapter addresses the place of Islamic finance in the Global financial services industry. It explains the principles of *Shari'ah* and their applications in the global markets. Further, it seeks to explicate the concept of *Shari'ah* and its place in the context of modern Islamic financial industry and examines the implications of international regulatory standards for the operation of Islamic finance. Also, it discusses the principles of Islamic financial law in light of classical and modern Islamic jurisprudence (*fiqh*), and describes different types of Islamic financial institutions and their characteristics in terms of financial intermediation in the context of financial markets.

2.2 The Development of Islamic Finance

The development of Islamic finance industry is about the rebirth and readjustment of the *Shari'ah* in the modern world as it endeavours to organize resources on the basis of corporation and participation. At the heart of *Shari'ah* there is a concept of stewardship, which persistently

underlines the importance of integrity of commerce.[1] In this regard, although the existence of various Islamic schools of thought and accordingly the divergent interpretations over looking after others' wealth demonstrates a disparate tradition, their interactions with global financial system reflect the crucial place of *falah* (well-being) in the *Shari'ah*.[2]

Islamic finance industry has experienced different phases of development. In the Bretton Woods' era, a few experiments preceded the formal start of modern Islamic banking.[3] In this regard, the first formal phase of Islamic finance coincided with the evolutionary change of the global financial system as it was shortly after the elimination of the gold backed exchange system of Bretton Woods.[4]The oil boom and increase in wealth encouraged Muslim countries to revive and follow Islamic principles in financial system, and it also had the effect of spurring the new Islamic financial institutions and research centres for faster development.[5]

The globalization of financial markets in the 1990s marked the dawn of the second phase of Islamic finance. Deregulation, liberalization and rapid innovations in financial systems expanded the number of market participants and enhanced financial integration.[6]Consequently, Islamic financial investment order based on profit and loss sharing converged with conventional finance

[1] Barry A. K. Rider, 'Islamic Financial Law: Back to Basics' in *the Changing Landscape of Islamic Finance* (Islamic Financial Services Board 2011) 103-140.
[2] Muhammad Akram Khan, *an Introduction to Islamic Economics* (International Institute of Islamic Thought 1994) 33.
[3] For a further account See Rodney Wilson, *Banking and Finance in the Arab Middle East* (St. Martin's Press 1983) 75; Rodney Wilson, 'Islamic Development Finance in Malaysia' in Saad Al-Harran (ed) *Learning Issues in Islamic Banking and Finance* (Pelanduk Publications 1995) 65.
[4] Filippo Cesarano, *Monetary Theory and Bretton Woods* (CUP 2006); Kern Alexander, Rahul Dhumale, and John Eatwell' *Global Governance of Financial Systems* (OUP 2006) 20-23; Olorogun Lukman Ayinde, 'The Substitution Dilemma in Islamic Finance: Contemporary Muslim Legal Thought on the Use of Paper Money' (2012) 1 (2) Aceh International Journal of Social Sciences 58.
[5] Ibrahim Warde, *Islamic Finance in the Global Economy* (2nd edn, Edinburg University Press 2010).
[6] Hossein Askari, Abbas Mirakhor and Zamir Iqbal, *Globalization and Islamic Finance* (Wiley Finance 2009) 26-28.

and moved to a more pragmatic and diversified path.[7] The convergence between Islamic and conventional financial systems led to a growing global network between two systems. Many Conventional banks started providing their Muslim or non-Muslim clients with Islamic financial products and services through their Islamic subsidiaries and Islamic windows.[8] Simultaneously, Islamic financial institutions presented their sophisticated Shari'ah-compliant products nationally and internationally, and started investing and working closely with other conventional banks and stock markets such as London Metal Exchange.[9]

The third phase of Islamic finance can be characterized as a period of harmonization and competition. Remarkable developments involved Innumerable commercial, regulatory and standard-setting initiatives such as the creation of the Islamic Finance Services Boards (IFSB), the International Islamic Financial Market (IIFM), the Liquidity Management Centre (LMC), and the Islamic International Rating Agency (IIRA).[10] Further, in spite of the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) endeavours, new harmonized accounting and auditing rules and standards for Islamic contracts came into existence.[11] In this regard, the financial meltdown resulted in a strong competitive spirit among Islamic institutions that paradoxically has evolved alongside the harmonizing initiatives.[12] As a consequence of this

[7] It is worth noting that globalization led to the new Islamic finance hubs with different approaches. For instance, while Development of Islamic finance in Malaysia is driven by development policy focused on finance for industrialization, Middle Eastern countries' approach is primarily driven by oil boom's surpluses. As a consequence Islamic finance is mainly concerned with asset management. See Warde (n 5) 82.
[8] ibid 83-85.
[9] ibid.
[10] ibid 86-87.
[11] The growing integration of the Arab and Malaysian Islamic finance models is also an important development in the industry. See Ibid.
[12] Maher Hassan and Jemma Dridi, 'The Effects of Global Crisis on Islamic and Conventional Banks: A Comparative Study' (2010) International Monetary Fund Working Paper WP/10/201, 15-22 < http://www.imf.org/external/pubs/ft/wp/2010/wp10201.pdf> accessed 4 January 2012; Peter Vayanos and others, 'Competing Successfully in Islamic Banking' (2008) Booz & Co. Report <

competitive spirit and new competition-and-integration-oriented policies, some jurisdictions have broadened their Shari'ah boards as they provide more flexibility for the operation of Islamic financial markets.[13]

2.3 Islamic Finance Sources

It is believed *Shari'ah* is the backbone of the religion of Islam and Islamic finance as its principles are the foundations of structure and performance of the industry. However, since the establishment and the operation of Islamic financial markets are based on conventional laws, a broad approach in our examination of sources is required. In this regard, there are two main sources: *Shari'ah* and international soft law.

2.3.1 *Shari'ah*

Shari'ah is defined as Islamic law asserted its system proceeded mainly from a high divine sources embodying God's will.[14] This narrow definition is based on the revealed sources of *Shari'ah* namely the *Quran* and the *Sunnah*. According to this approach 'there is no scope for any doctrine of natural law, or for human positive law in any significant sense.'[15] The

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http://www.strategyand.pwc.com/media/file/Competing-Successfull-Islamic-Banking.pdf> accessed 4 Januarys 2013; Rima Turk Ariss,' Competitive Conditions in Islamic and Conventional Banking: A Global Perspective' (2010) 19 Review of Financial Economics 101 < www.elsevier.com/locate/rfe > accessed 5 January 2013.

[13] For instance, some members of Shari'ah boards of Malaysian banks are now Arab scholars from the Middle East. See 'CIMB group Appoints Industry Leading Experts to Shari'ah Committee' (18 Jun 2007) http://www.cimb.com/index.php?ch=g2_mc&pg=g2_mc_news&ac=314&tpt=> accessed 5 January 2013.

[14] Majid Khadduri, 'Nature and Sources of Islamic Law' (1953) 22 the George Washington Law Review 3, 5; Ian Edge, *Islamic Law and Legal Theory* (Dartmouth publishing company 1996); A. Ibrahim, *Sources and Development of Muslim Law* (Malaya law journal Ltd 1965).

[15] J. N. D. Anderson, 'Law as a Social Force in Islamic Culture and History' in Ian Edge (n 14) 15.

non-revealed sources of *Shari'ah* are, essentially, a series of legal reasoning methods[16], such as *Qiyas* (analogy), *Ijma* (consensus of *Ulama*) and *Hadith*. In this regard, a more comprehensive definition encompasses the human quality of *Shari'ah* as well. When Muslims endeavour to understand the divine revelation and implement their understanding to meet the dynamic and diverse requirements of society, their finding become personal interpretation of *Shari'ah*, namely *fiqh.* In other words, '*Shari'ah* is not a codified body of law, but a principle-based legal system that is capable of development and subject to interpretation'[17]. Law in the context of *Shari'ah* encompasses all aspects of life, namely temporal and non-temporal, and as a consequence it conveys an inclusive concept for legal system that its aim is to provide believers with the right path.[18] Further, since the enforcement of this law, in its modern sense, does not necessarily question the validity of *Shari'ah,* believers are bound to observe it.[19]

Theoretically, it is assumed that, this is not society which shapes the *Shari'ah*, but the *Shari'ah* forms society and its requirements.[20] Despite the existence of this ideal tendency, the ever-changing needs of society and the adverse impacts of static laws, have led to the application of a functional Scholarship in the interpretation of *Shari'ah*. In this regard, the process of extracting legal rules from the sources of *Shari'ah* for the purpose of discovering God's law is termed *ijtihad.*[21] This strong juristic characteristic of *Shari'ah*, with due concern for the expedients of time and place, formed an intense legal pluralism in Islamic law and as it helped

[16] Richard Tredgett and others, 'Cross-Currency Swap' (Jun 2008) derivatives week 7 < www.derivativesweek.com/pdf/DW061608.pdf> accessed 5 January 2013.
[17] ibid.
[18] The connection between the generic and literal meanings of Shari'ah (the path a watering place) implies its inherent flexibility. See Chibli Mallat, *the renewal of Islamic law* (CUP 1993) 3.
[19] Khadduri (n 14) 6.
[20] Anderson (n 15) 17.

the emergence of different schools of thought.[22] This plurality is due to three reasons: firstly, different views of *Sunni* and *Shia* Schools of thought over the sources of *Shari'ah*, mainly on non-revealed sources[23]; secondly, dissimilarities in Legal Methodologies (*usul al-fiqh*) and Legal Maxims (*qawa'id fiqhiyya*);[24]Thirdly, diverse customs (*urf*).[25]

In this regard, there are four main *Sunni* schools of thought in Islam: the *Hanafi*, the *Maliki*, the *Shafie* and the *Hanbali* Schools of law; and one *Shi'a* School: Twelver (Athnā'ashariyyah). The *Hanafi* School is one of the oldest and the most widespread School was developed in *Kufah*. The founder of the School is Imam *Nu'man bin Thabit*, known as *Abu Hanifa*. This school has a reputation for wider usage of reason, logic, opinion (*ray*), *qiyas* (analogy) and juristic equity (*istihsan*) in the process of *ijtihad* as they deal better with practical issues and allow wider discretion in interpretation of the *Quran* and the *Sunnah*.[26]

The *Maliki* School is founded by *Imam Malik bin Anas* in *Madinah*. He is well known for his book *Muwatta*, a collection of *hadith* and narrations regarding the practice of the people of *Medina*, as a distinctive source in this school. This school tends to emphasis the authenticity of *hadith* and as a consequence its method of teaching is primarily based on the meaning of *hadith* in the context of actual problems.

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[21] See Mohammad Hashim Kamali, *Principles of Islamic Jurisprudence* (planduk publications, 1989); Sherman A. Jackson, *Islamic Law and the State* (Brill 1996); Bernard Weiss,' Interpretation in Islamic Law: the Theory of Ijtihad' (1978) 26 (2) the American Journal of Comparative Law 199.

[22] Baudoin Dupret, Maurits Berger and Laila al-Zwaini, *Legal Pluralism in the Arab World* (Brill 1999); Ihsan Yilmaz, *Muslim Laws, Politics and Society in Modern Nation States (*Ashgate 2005).

[23] Although jurists are agreed on *qiyas* (analogy) and *ijma* (consensus) as the two main non-revealed sources of Shari'ah, they differ widely on the definition and application of them. See Jamal Nasir, *The Islamic Law of Personal Statutes* (2nd edn, Graham & Trotman 1990) 7.

[24] While legal Methodology teaches how to derive legal rulings from the *Shari'ah* sources, legal Maxims explore the underlying structure of the rulings derived from the *Shari'ah* sources.

[25] The impact of different views of *madahib* on shaping the modern Islamic finance and the role of custom in commerce and finance is discussed in the next sections.

[26] Brannon M. Wheeler, *Applying the Cannon in Islam* (SUNY Press 1996).

The *Shafei* School is founded by *Imam Muhammad bin Idris al Syafi* who opened a new phase of development in Islamic *fiqh*. In his book *al-Risalah* he expounded the methodology of *Shari'ah* ruling. It mainly gives a special and different place for *qiyas* to bring about uniformity in the decisions. He also had a controversial disagreement with the *Maliki* and the *Hanafi* Schools about the concept of *Sunnah*.[27] The last *Sunni* school is *Hanbali* School founded by *Imam Ahmad bin Hanbal al Shaibani* and is considered the most conservative School due to its strict view on literal interpretation of the *Quran* and *Sunnah*.[28]

The *Shi'a* (Twelver) or *Ja'fari* School is the largest branch of *Shi'a* Islam. Its foundation is associated with *Imam Ja'far al-Sadegh* and is more hierarchical as is ruled by *Shi'ah Imams*. This school is more flexible as it insists more on intellect than analogy and a jurist has more power to alter a decision according to his reasoning.[29]

This intense pluralism in the interpretation of *Shari'ah* has had a deep impact on the structure of Islamic finance industry in terms of divergent juristic opinions over the structure and the operation of Shari'ah compliant products. In fact, the strong juristic characteristic of *Shari'ah* in the industry manifests itself through varied legal opinions issued by Islamic institutions' Shari'ah boards and International standard setting organizations such as the AAOIFI. This fact implies the lack of an agreed definition for *Shari'ah* as its concept and implications are contingent upon Shari'ah Jurists' interpretations.

[27] Ahmad Hasan, 'Al-Shafi's Role in the Development of Islamic Jurisprudence' (1966) 5 (3) Islamic Studies 239.
[28] Abdul Hakim I. Al-Matroudi, *The Hanbali School of Law and Ibn Taymyyah*: *Conflict or Conciliation* (Taylor & Francis 2006).
[29] Seyyed Hossein Nasr, Hamid Dabashi and Seyyed Vali Reza Nasr (eds), *Shi'ism Doctrines, Thought and Spirituality* (State University of New York Press 1988).

2.3.2 International Soft Law

The Post-Bretton woods financial system led international financial policy to a drastic change. Liberalised markets have created more opportunities for profits, and at the same time have introduced several new levels of risks to financial systems. In fact, the new risks are the results of adopting innovative and complex financial instruments for better diversification of profits and also to hedge against increasing credit and market risks that impact the systemic stability of international financial system.[30] In this regard, financial globalization led to the rise of multifunctional financial intermediaries, more interdependent financial networks, and consequently more exposure to systemic risk and at the same time necessitated more strength, coherence and effectiveness in international financial regulation.[31] In fact, the increasing frequency of global and regional financial crisis is the manifestation of deficiency in establishing international regulatory norms in a due institutional framework of standards required for promoting the efficient pricing of financial risk and consequently reducing occurrence and levels of systemic risk.[32] In this context, the main functions of international financial regulation, namely normative intervention, supervision and sanction,[33] are usually focused on crisis prevention and the maintenance of financial stability.[34]Particularly, after the recent financial

[30] Alexander (n 4) 14.
[31] ibid.
[32] ibid 15-24.
[33] Rolf H. Weber,'Multilayered Governance in International Financial Regulation and Supervision' (2010) 13 (3) Journal of International Economic Law 683, 685; Rolfh Weber 'Mapping and Structuring International Financial Regulation–A Theoretical Approach' (2009) 20 (5) European Banking Law Review 651, 652.
[34] Rolf H. Weber and Douglas Arner, 'Toward a New Design for International Financial Regulation' (2007) 29 University of Pennsylvania Journal of International Law 391, 417.

meltdown the supervisory function has got a macro-prudential feature to enhance systemic stability in the global financial networks.[35]

An optimal global governance of financial systems requires standards and rules resulted from an optimal international regulatory structure since they provide economic growth and stability as the public good.[36] International rules and standards for financial regulation bear an inherent soft characteristics which mostly are legally nonbinding.[37] These widely accepted standards are good practices which imply a common intent among international actors. Further, these standards lack the *opinio juris* as an important element of customary international law, and as the result, they present a soft power in the governance of international financial intermediation. In this context, the non-obligatory character of soft law is the predominant source of international financial regulation as it provides more flexibility in proper functioning of financial intermediaries.[38] These standards are mainly accepted as good practices and may be set out by public and private international financial institutions (IFIs) such as the Basel committee, International Organization of Securities Commissions (IOSCO) and International Swaps and Derivatives Association (ISDA).

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[35] Christian Tietje and Matthias Lehmann, 'The Role and Prospects of International Law in Financial Regulation and Supervision' (2010) 13 (3) Journal of International Economic Law 663, 672.

[36] Global governance of financial systems can be defined as the formal and informal process and institutions regulating collective problems in the international financial system, mainly financial stability and systemic risk. See Alexander (n 4) 17-18; John Kirton, Marina Larionova and Paolo Savona (eds), *Making Global Economic Governance Effective (*Ashgate 2010).

[37] The relations between international actors is based on power, and it accordingly forms the foundation of international financial regulation too. As a consequence, it provides more flexibility in commitments as power and governance require resilience. See Chris Brummer, 'Why Soft Law Dominates International Finance-and Not Trade' (2010) 13 (3) Journal of International Economic Law 623, 630.

[38] Mario Giovanoli, 'Reflections on International Financial Standards as Soft Law' (2002) the London Institute of International Banking, Finance and Development Law Ltd, Essays in International Financial & Economic Law No. 37, 6 < http://www.ucl.ac.uk/laws/clge/wp-series/ucl_clge_008_10.pdf> accessed 7 January 2013; J. Gold, Developments in the International Monetary System: the International Monetary Fund and International Monetary Law Since 1971 (1982) Collected Courses of the Hague Academy of International Law 107.

In this regard, Islamic financial industry as a hybrid system emerged in the mid-1970s and accordingly its regulatory issues have not been apart from conventional financial system. The internationalization of financial markets and responses to financial scandals have increasingly necessitated coordinated global trends to issues related to global financial stability through standard setting and rule making. In banking industry, the Basel Committee on Banking Regulation and Supervision is the leading international standard-setting body with persuasive influence over banking regulation and economic growth. The Basel committee was established in 1974 by the central bank governors of the Group of 10 countries (G10). The Basel Committee works informally and extends its network with banking regulators outside the G10 through establishing various consultation groups such as the Core Principles Liaison Group (CPLG).[39] By G7 communique in 1997 the Basel committee has got an authority to devise the core principles of prudential regulation for all countries with international banking activities.[40] Although, in a legal sense, the Committee's decisions are soft law and nonbinding, some market measures have made the Committee's standards sanctionable.[41] For example the International Monetary Fund (IMF) and the World Bank have a monitoring role in controlling member-states adherence to the standards and also they consider the level of standards 'compliance as a criterion for funding and lending programs'.[42]

Despite the existence of major differences between Islamic and conventional banks in terms of assets and the liabilities, the increasing need for foreign investment necessities more

[39] Alexander (n 4) 37; the CPLG was originally established to monitor the application of the Basel's Committee core principles for effective banking supervision, but has evolved into a forum for more general issues.
[40] The Basil Committee on Banking Supervision, 'Strengthening Banking Supervision Worldwide' (June 1997) submission for the G-7 heads of government at the Denver Summit http://www.bis.org/publ/bcbs28b.pdf> accessed 6 January 2012.
[41] Giovanoli (n 38).

competition between Islamic banks. Further, as the result of common financial risks in international banking system, Islamic banks are required to comply with international standards as well. Even though international banking standards, such as Basel Accords have never been intended for the Islamic financial industry,[43] global economy pressure and international organizations mandates have forced Islamic banks to meet those standards. For instance, Commercial banks in OECD[44] countries should implement Basel II capital adequacy standards.[45] In this regard, both the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) and the Islamic Financial Services Board (IFSB) tried to develop capital adequacy ratio (CAR) guidelines based on Basel II standards.[46] This implies that, since capital adequacy is the cornerstone of international banking regulation, Islamic banks are required to follow the international standards as they enhance their creditability and growth.[47]

Further, international response to global financial stability encompasses financial securities regulation as well.[48] The globalization of securities markets and the desire of regulatory authorities in emerging economics, particularly in the Gulf Cooperation Council (GCC) to attract

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[42] Alexander (n 4)143.
[43] M. Kabir Hassan and Ebid Smolo, 'Capital Adequacy Requirements for Islamic Financial Institutions: Key Issues' in QFINANCE: The Ultimate Resource (Bloomsbury 2011) 127.
[44] The Organization for Economic Co-operation and Development.
[45] Basil II is founded on three pillars: 1-Minimum capital requirements; 2-Supervisory review of Capital; 3-Public disclosure.
[46] Kabir Hassan (n 43); AAOIFI, 'Statement on the Purpose and Calculation of the Capital Adequacy Ratio for Islamic Banks' (1999); IFSB, 'Capital Adequacy Standard for Institutions (other than insurance institutions) Offering Only Islamic Financial Services' Standard' (Dec. 2005) IFSB-2; Central Bank of the United Arab Emirates in 2009 announced its compliance with Basel II, and accordingly from 2013 Islamic banks in the UAE are required, under a rule introduced by the UAE central bank to comply with Basel III standards. See Lilian Gheyath Al din Salih Tahir, 'The Impact of Basel Accord Standards on the Assessment of Capital Adequacy Ratio in Islamic Banks of UAE' (World Business and economics research conference Dec.2012) <http://ssrn.com/abstract=2185629> accessed 10 January 2012.
[47] Rima Turk Ariss and Yolla Sarieddine, 'Challenges in Implementing Capital Adequacy Guidelines to Islamic Banks' (2007) 9 (1) Journal of Banking Regulation 46, 47.
[48] Lu'ayy Minwer Al-Rimawi, *Raising Capital on Arab Equity Markets* (Kluwer Law international 2012) 88.

foreign investment paved the way for more harmonized regulatory approaches through following international regulatory standards, such as the IOSCO objective and principles securities regulation and IOSCO Multilateral Memoranda of Understanding.[49] In this context, regarding the compatibility of IOSCO's principles with Islamic finance products and practices, IOSCO's report in 2008 'has not identified any concerns in respect to the compatibility of the IOSCO core principles with the Islamic securities markets'.[50]

Also, in promoting the operational soundness and efficiency in Islamic financial industry, the World Bank and the International Monetary Fund's Financial Sector Assessment Program (FSAP) has been implemented internationally including by the Islamic Development Bank and the IFSB member countries.[51] Further, in assessing the improvement of the prudential regulatory framework, financial Sector Assessment Program for Islamic Financial System (iFSAP) looks upon regulatory standards established by international organizations such as BIS and IOSCO.[52]

2.4 Islamic Jurisprudence and Islamic Finance Development

It is assumed that each legal system is based on a set of high objectives rationalising the emergence and the development of new ideas as extensions, reactions to or substitute for earlier

[49] ibid 90-92.; the International Monetary Fund and the World Bank assess the securities sector of a given jurisdiction on the basis of IOSCO core principles. See IOSCO, 'Analysis of Application of IOSCO's Objectives and Principles of Securities Regulation for Islamic Securities Products' (Sep 2008) 14.
[50] IOSCO 4.
[51] Dadang Muljawan, 'Financial Sector Assessment Program for Islamic Financial System (iFSAP)' (the 8th International Conference on Islamic Economics and Finance' http://conference.qfis.edu.qa/app/media/231> accessed 10 January 2012; the World Bank, 'Financial Sector Assessment: A Handbook' (2005) < http://documents.worldbank.org/curated/en/2005/09/6338229/financial-sector-assessment-handbook> accessed 1 August 2015.
[52] Muliawan 1-7.

one.[53] However, the high objectives shall be reached through an efficient legal system, and adopting dynamic and just rules. In this regard, financial development is the outcome of a progressive legal system. Further, in the context of the modern economic system, financial and commercial laws are concerned with facilitating transactions in terms of the availability of products for trade and fostering the capacity of intermediaries and promoting stability.[54] In other words, the existence and the structure of markets and intermediaries are mainly the result of economic and political realities, and accordingly law functions as a facilitative means to promote efficiency and confidence.[55] Thus, adaptability of laws in terms of ability to evolve in response to the changing socioeconomic conditions receives a great attention.[56]

Modern finance is about how to manage money and includes transactions, services and operations needed for funding. Modern Islamic finance shares the same function but through the complying with Shari'ah principles. In other words, although the development of Islamic financial industry in the context of modern socioeconomic environment shares a common path with the conventional system, its operation is based on Shari'ah compliant techniques.

In this regard, Islamic finance industry is based on Islamic jurisprudence known as *Fiqh al-Mu'amalaat*, which includes all human interactions with regard to high objectives (*Maqasid al-Shari'ah*) originated from the perspective of the wealth in Islam.[57] The crucial place of Justice in the process and the result of Islamic financial transactions reveals the ultimate objective of the

[53] Ayman Shabana, *Custom in Islamic Law and Legal Theory* (Palgrave Macmillan 2010) 111.
[54] Barry A. K. Rider, 'Legal Aspects of Islamic Asset Securitisation' in *Strategies for the Development of Islamic Capital Markets: Infrastructures and Legal Aspects of Islamic Asset Securitization* (Islamic Financial Services Board 2011) 47.
[55] ibid 62.
[56] Beck Thorsten, Asli Demirgüç-Kunt and Ross Levine, 'Law and Firms Access to Finance' (2004) World Bank Policy Research Working Paper3194, 3.
[57] Abu Umar Faruq Ahmad, *Theory and Practice of Modern Islamic Finance, the Case Analysis From Australia* (Brown Walker Press 2010) 85.

Shari'ah, namely achieving people's benefits (*maslahah*) not only in this world, but also in the hereafter.[58] 'Say: my lord has commanded justice…'[59] and 'we sent our messengers with the clear signs and sent down the book and the balance with them so that mankind might establish justice…'[60] Accordingly, it is important that Islamic jurists, particularly in commerce and finance, endeavour to adopt a more objective-oriented approach within Islamic legal theory.[61]

In this regard, the absence of legislative canonical texts led to the establishment of some process of juristic inference (*ijtihad*).[62] *Ijtihad* is the main instrument for achieving and maintaining the harmony between revealed and non-revealed sources of *Shari'ah*.[63] *Ijtihad* acknowledges the distinction between law and its sources in Islamic jurisprudence, and 'this distinction assumes that the Holy Law, as the aggregate of divinely-ordained rules, is not entirely self-evident from the sacred text. If it were, the sacred texts would not be the sources of the law, but rather the law itself; they would constitute a divinely given code of law.'[64] Its literal meaning, doing one's highest endeavour has affinity to its actual process to deduce the divine law from the *Shari'ah* resources. In other words, the Law is the product of juristic interpretation of sources, a process of elucidating which is present but yet is not self-evident.[65]

Further, the inherent distinction between commercial and non-commercial issues reveals the significance role of sources used in the process of *ijtihad*. That is to say, the dynamic nature of

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[58] There are three fundamental categories of objectives: necessities, needs and embellishments. *Maslahah* belongs to the class of necessities (*daruriayyat*) as they preserve the essential objectives, namely: faith, life, Lineage, property, and intellect. See M. Ayub, *Understanding Islamic Finance* (John Wiley & sons 2007).
[59] Al-A'raf 29.
[60] Al-Hadid 25.
[61] Shabana (n 53) 126.
[62] Mahmoud A. El-Gamal, *Islamic Finance* (CPU 2006) 28.
[63] Hashim Kamali (n 21) 468.
[64] Bernard Weiss (n 21) 199.
[65] ibid 200.

commerce requires a flexible, responsive and predictable legal system to meet the ever-changing exigencies of time. Different approaches in Islamic jurisprudence, traditionalist or rationalist, have led to applying different methods and sources of *ijtihad*. For example, although all *Sunni* Schools of thought are agreed on the importance of reasoning through analogy (*qiyas*), they contradict over its method and the extent of use.

The economic understanding of the best classical jurists shows their cognizance of reason on benefit analyses, and the importance of rationally justifiable rules in *Muamalaat* issues.[66] For instance, in *Hanafi* School reason takes the form of *qiyas, ijtihad bi al-ray* and *Istihsan* (juristic preference),[67] and in *Maliki* School rulings should be compatible with customary practice and should prevent significant harm. Also to meet public welfare, *istislah* (public interest) takes the primary place in reasoning.[68] The rational reasoning in *muamalaat*, requires a consistency between rational rules and revealed rules. In fact, the consistency between reason and revealed law, 'led to the theory of the five "universals" which revelation aimed to protect: religion, life, reason, progeny and property.'[69]

Another aspect of the development of Islamic Finance is the scope of Individualism in Islamic law. Individualism and permissibility in Islamic contract law reveal the inherent duality of *fiqh al-muamalaat*. in order to establish balance in contractual relationships, Unlike the exchange-oriented English common law, individualism in Islamic law in concluding financial

[66] El Gamal (n 62) 28; In Sadr's view, Islamic economics is not a science, rather a conflation of social goals and economic reality. Thus, there is a great place for human experience and reason. See Chibli Mallat (n 18)117-118.
[67] Murtada Mutahhari, 'The Role of Reason in Ijtihad' (Mahliqa Qara'i (tr))<http://www.al-islam.org/printpdf/book/export/html/22962 > accessed 1 August 2015.
[68] El Gamal (n 62).
[69] Mohammad H. Fadel, 'Riba, Efficiency, and Prudential Regulation: Preliminary Thoughts' (2007-2008) 25 (4) Wisconsin International Law Journal 655, 669.

contracts is restricted by distributive-orientated rules and principles such as equilibrium or the balance of values and the certainty of contractual obligations.[70] Further, due to the lack of general theory of contract in *Fiqh al-muamalat*, sale (*bay*) represents the model of financing, and accordingly led to the doctrine of nominated contracts (*uqud al mu'ayyana*) in Islamic finance.[71] Despite of the great emphasis of contemporary jurists on nominate contracts with centrality of tangible subjects; the legal history of Islamic law acknowledges the importance of credit in some Islamic legal formulations such as *hawalah* and *suftajah.*[72] However, as the consequence of dominance of the rigid sale-based model of financing, the sale-based financial investment policy with a great emphasis on the role of real economy activity got priority in Islamic *fiqh*.

In this regard, one of the beneficial legal devices for providing flexibility and adoptability in Islamic financial transactions is legal maxim. Legal maxims (*Qawa'id al-Fiah*) are part of Islamic jurisprudence and have a significant role in the development of Islamic finance. They are theoretical abstractions and the expressive of *Shari'ah* objectives. They are generally defined as the 'statements of principles that are derived from the detailed reading of the rules of the *Fiqh* on various themes.'[73] Although they are broad guidelines, they smooth scholars' path to a better

[70] P. S. Atiyah and Stephen Alexander Smith, *Atiyah's Introduction to the Law of Contracts* (Clarendon press 2005); Valentino Cattelan, 'From the Concept of *haqq* to the Prohibition of *riba*, *gharar* and *maysir* in Islamic finance' (2009) 2 (3-4) International Journal of Monetary Economics and finance 384.

[71] Khaled Benjelayel, 'Contract Law' (2012) Institute of Advanced Legal Studies, 4 http://ssrn.com/abstract=2019550 accessed 1 August 2015; while the Islamic financial transactions are basically exchange contracts (*al Muawadat*), that entail the exchange of goods or services for a consideration, the conventional finance and banking is mainly lending-based. Ibid 5.

[72] Nicholas Dylan Ray, 'The Medieval Islamic System of Credit and Banking: Legal and Historical Considerations' (1997) 12 (1) Arab law quarterly 43, 50; Some scholars use the nominate contracts in Islamic finance by reasoning based on analogy and case study in *Fiqh*. Accordingly they explain the success of Islamic finance in the GCC countries as a result of their history of British rules of common law as they are similar to Analogy in *Fiqh*. See El Gamal (n 62) 15-17 and 64.

[73] Mohammad Hashim Kamali, 'Qawa'id Al-Fiqh: The Legal Maxims of Islamic Law' (1998) the Association of Muslim Lawyers 1 <file:///C:/Users/Sara/Downloads/Qawaid_al_Fiqh.pdf> accessed 1 August 2015; Subhi Mahmassani, *Falsafat at-Tashri' fil-Islam: The Philosophy of Jurisprudence in Islam* (Farhat I. Ziadeh (tr), Brill 1961).

comprehension of the *Shari'ah*. As a consequence, *mujtahids* consider them as persuasive and conducive evidence in *ijtihad*.[74] The development of Legal maxims is part of the history of *Fiqh*, and generally involves three main stages: rudimentary beginning, incremental growth and full-blown development.[75] The first stage started from the time of the Prophet until the end of the third Islamic century, and includes the main maxims derived from the *Quran* or the *Ahadith*.[76] The second stage of development is in the era of imitation (*taqlid*) of the Islamic jurisprudence, focused on abstracting the implicit principles used by early jurists to relate the substantive details to a few general principles that can be applied in different legal issues.[77] The third stage is identified by the composition of the *Majallah al-Ahkam al-Adliyyah* in 1870 by the Ottoman Empire, to update *Shari'ah* law according to conventional codes and custom (*urf*).[78] In this regard, all Islamic schools of thought (*Madahib*) have agreed upon five normative legal maxims: 1- Acts are judged by the intention (*al-umur bi maqasidiha*); 2-the elimination of harm (*al-darar yuzal*); 3-Certainty is not overruled by doubt (*al-yaqin la yazul bi l-shakk*); 4-hardship begets facility (*al-mashaqqah tajlib al-taysir*); 5-custom is the basis of judgment (*al-addah muhakkamah*).[79]

Regarding the legal effect of the first maxims over commercial and financial contracts,[80] generally it is believed that intention in *muamalaat* is an assumed element, because it brings a

[74] Hashim Kamali (n 73); Mahmassani (n 73) 152.
[75] Ayman Shabana (n 53) 112.
[76] ibid.
[77] ibid 113; M. Hashim kamali (n 73); This method is known as *takhrij* (extraction).
[78] ibid 111-112.
[79] ibid.
[80] The legality of these maxims is derived from a *Hadith* from the Prophet: "*Actions are judged according to intentions*." Hashim Kamali (n 73).

religious evaluation in ordinary life.[81] The maxim extent of application is a matter of disagreement between Islamic Schools of thought. While *Hanbali* and *Maliki* Schools consider the real intention in a contract, *Hanafi* and *Shafei* scholars give effect to words and forms as well.[82] This raises the issue of *hiyal* (legal stratagems) and its implications for the design of some financial transactions with the element of *riba*. *Hila* is defined as the use of acumen by Muslim jurists to avoid legal responsibility.[83] Although, *Hanbali* and *Maliki* schools consider *hiyal* as legal ruse violating the sprit of law, some scholars regard its legality as a procedural device to avoid clashes with the law and not to avoid the law.[84] in other words, since the alleviation of financial predicaments is the main reason for using *hiyal* in transactions, they have been widely exercised by Islamic financial institutions. For instance, Al-*Inah* sale, termed *tawarruq,* and buy-back-based mark-up operations in the NIB system in Pakistan have been used to achieve the development goals.[85] In this regard, some parameters are defined for *hiyal,* but the most important among them are the incentive of legally responsible individual and the objective of lawgiver, which should not contravene the great objectives of *Shari'ah* such as essentials (*daruriat*).[86] For example, liquidity management purposes in banking are categorized as

[81] Paul R. Powers, *Intent in Islamic Law: Motive and Meaning in Medieval Sunni Fiqh* (Brill 2006) 97-98.
[82] Oussama Arabi, 'Intention and Method in Sanhuri's *Fiqh*: Cause as Ulterior Motive' (1997) 4 (2) Islamic law and society 200, 213.
[83] Walid Hegazy, 'Fatwas and the Fate of Islamic Finance: A Critique of the Practice of Fatwa in Contemporary Islamic Financial Markets' in S. Nazim Ali (ed) *Islamic Finance, Current Legal and Regulatory Issues* (Harvard law school 2005) 143.
[84] Arabi (n 82) 220; Mahmassani (n 73) 119-126; Joseph Schacht, *an Introduction to Islamic Law* (OUP 1964) 81-84 and 205-210.
[85] Ayub (n 58) 148.
[86] Mohamed Fairooz Abdul khir, 'Shari'ah Parameters of *Hiyal* in Islamic Finance' (2010) 2 (2) ISRA International Journal of Islamic Finance, 161-165, <http://www.isra.my/media-centre/downloads/finish/42-volume-2-december-2010/263-shariah-parameters-of-hiyal-in-islamic-finance/0.htm> accessed 28 January 2013; bringing commercial practice into conformity with the requirements of the Shari'ah by the *hiyal* accentuates the form-ove-substance issue in Islamic financial contracts. See M. Kabir Hassan and K. Mervyn Lewis, *Handbook of Islamic Banking* (Edwards Elgar Publishing 2007) 74-75.

essentials and in this context the best exemplified *hilah* is *sug al-sila*[87] in Malaysia Islamic banking as it facilitates overnight deposits and short term deposits.[88]

The elimination of harm and facility in financial transactions are critical parts of a benefit analysis in Islamic commercial law. For instance, home financing through *murabaha* and *Bay bi Thaman Ajil*, promotes social welfare and serve *maslahah*.[89] It is worth noting, although Sunni Schools differ in restricting general rulings based on beneficial analysis, the overruling of explicit canonical rulings is not allowed by all of them. On this subject, although classical *Hanafi* and *Maliki* jurists have more liberal views than *Hanbali* and *Shafei* jurists,[90] in practice some controversial transactions such as *tawarruq* in the GCC region, *bay al-inah* and *bay al-dayn* in Malaysia are only approved by the *Hanbali* and *Shafei* Schools.[91]

[87] Bursa Suq Al-Sila' is a commodity trading platform specifically dedicated to facilitate Islamic liquidity management and financing by Islamic banks. Initiated as a national project, Bursa Suq Al-Sila' exhibits the collaboration of Bank Negara Malaysia (BNM), the Securities Commission Malaysia (SC), Bursa Malaysia Berhad (Bursa Malaysia) and the industry players in support of the Malaysia International Islamic Financial Centre (MIFC) initiative. See http://www.bursamalaysia.com/market/islamic-markets/products/bursa-suq-al-sila/ accessed 28 July 2015.

[88] M. Fairooz Abdul Khir (n 86)162; Asyraf Wajdi Dusuki, 'Can Bursa Malaysia 's Suq Al-Sila (Commodity Murabaha House) Resolve the Controversy Over *Tawaruq*' (2010) ISRA research paper No. 10/2010 <https://islamicbankers.files.wordpress.com/2010/04/suq-al-sila-and-tawaruq-controversy.pdf> accessed 1 August 2015.

[89] Ahmad kameel, Mydin Meera and D. A. Razak, 'Islamic Home Financing through *Musharakah Mutanaqisah* and Al-Bay bi Thaman Ajil Contracts: A Comparative Analysis' (2009) 22 (1) J.KAU: Islamic Econ. 3, 121-143 <http://www.kau.edu.sa/Files/320/Researches/54963_25288.pdf> accessed 20 January 2013; Luqman Zakariah, 'Necessity as a Pretext for Violation of Islamic Commercial Law: A Scenario of Mortgage Contract in the UK' (2012) 8 (1) Journal of Islamic Economics, Banking and Finance 35, 42-45 < http://ssrn.com/abstract=2222351 > accessed 1 August 2015.

[90] El-Gamal (n 62) 29.

[91] Aleshaikh, Nourah Mohammad, 'Jurisprudence on *tawarrug*: Contextual Evaluation on Basis of Customs' Circumstances, Time and Place' (2011) (Master thesis, Durham university 2011) 29-48 <http://etheses.dur.ac.uk/3188/> accessed 20 January 2013; Saiful Azhar Rosly and Mahmood Sanusi, 'Some Issues of *Bay'al-Inah* in Malaysian Islamic financial markets' (2001) 16 (3) Arab law quarterly 263.

In fact, the economic essence in *fiqh al-muamalaat* requires a rational inference for the maximization of benefits and the minimization of harm.[92] This trend in the modern Islamic finance that paved the way for a rational and functional approach in *ijtihad* can be traced back to Ottomans' codification of the *Hanafi* legal rules in 1876. In this regard, the adherence to *maslahah* in the ijtihad of contemporary international organizations is an expression of functionalism. For instance, the sale of *arbun*[93] was not accepted by all Islamic schools, except by the *Hanbali*, but Islamic *Fiqh* Academy ruled *urbun* to be a permissible transactions.[94]

In this regard, adherence to custom (*urf*) has been another effective device in commercial rulings.[95] The authority of *urf*, both as a source of law and as a device for extracting rules from sources, is derived from the *Shari'ah* texts. For example in the *Quran* verse 7:199, God enjoins three things among which is *urf* (literally translated good). However, some well-known jurists have admitted *urf* as an important legal consideration. For instance, Al-Sarakhsi in Al-Mabsut regards customary rights and rules as akin to canonical texts.[96] Further, reasoning behind the most important credit transactions in the medieval Islamic system, such as *Murabaha* and *ijara*, was based on *urf* and practice.[97] Regarding the importance of *urf* in Islamic law, it should be evaluated based on resulting benefits. In this context, there is a close connection between reason

[92] El-Gamal (n 62); El-Gamal, 'Incoherence of Contract-Based Islamic Financial Jurisprudence in the Age of Financial Engineering' (2008) 25 (4) Wisconsin international law journal 605,609.
[93] *Arbun* is a down payment with revocation option akin to a call option. However the contract is about a sale of a good for which the down payment is part of the price.
[94] The International Islamic *Fiqh* Academy Resolution No.72/3/8.
[95] There have been many definitions for *urf*, but technically is defined as '*what is established in life from reason and acceptable by sound natural disposition*'. Luqman Zakariah, 'Legal Maxims and Islamic Financial Transactions: A Case Study of Mortgage Contracts and the Dilemma for Muslims in Britain' (2012) 26 (3) Arab law Quarterly 255, 280.
[96] El- Gamal (n 62) 30.
[97] Dylan Ray (n 72); El Gamal (n 62).

and *urf.*[98] In other words, reasonableness is the criterion for a beneficial *urf* in financial transactions. Similarly, in English common law legal system, custom is regarded as a source of law when is reasonable and not repugnant to the common law.[99]

Islamic finance industry is flourishing mainly in countries with *Sunni* jurisprudence, thus the process of juristic inference (*ijtihad*) is restricted in *Sunni* schools. In this regard, since *qiyas* (analogical reasoning) is the predominant form of *ijtihad;*[100] jurists' endeavour has been for alternatives to conventional financial products by searching classical jurisprudence sources.[101] This mode of analysis is not unique to Islamic finance. In fact, common law legal analysis based on case studies and applying analogy reflects similarities between two legal systems methodologies.[102]

2.4.1 Juristic Ruling (*Fatwa*) and Islamic Finance

The emergence and the development of Islamic jurisprudence have been essentially based on the institution of *Fatwa* (Juristic ruling). *Fatwa* in Islamic finance has a crucial role in regulating markets through producing Islamic rules and Shari'ah standards.[103] The birth of Islamic finance is the result of a series of juristic rulings in the 1970s. In this regard, the *fatwa* at the first conference of Islamic banks in Dubai in 1979 concerning *murabaha lil-amir b-il-shira*

[98] Ayman Shabana (n 53) 114-115; as Sadr Al Din al-Shirazi says: '*Law conforms with reason'*; in the *Shia'h* School *urf* is known as bana al-uqala (building on the knowledge of wise). Chibli Mallat, *Introduction to Middle Eastern Law* (OUP 2007) 1.
[99] Catherin Elliot, *English legal system Source book* (Pearson Education 2006) 48-50; the House of Lords in one case rejected custom. See *Wolstanton Ltd and Duchy of Lancaster v Newcastle-under-Lyme Corporation* [1940] AC 860, [1940] 3 All ER 101.
[100] El-Gamal (n 62) 17-18; mainly based on *Shafei* legal theory.
[101] ibid.
[102] ibid 16-17; Richard Posner, *The Problems of Jurisprudence* (Harvard university press 1990) 86-100.

legal issues instigated the modern[104] Fatwa-based Islamic finance as its emphasis was on the legal opinions of jurists as the main source of regulation for Shari'ah compliance aspects of Islamic financial institutions' operation.

In this regard, the term law is about regulating human conduct. Law is used in many senses, but jurisprudentially refers to the body of rules, which can be formed in various ways such as status, judgements or juristic decisions.[105] In the context of Islamic finance a *fatwa* can be regarded as law. *Fatwas* are legal opinions provided by jurist consults or *muftis*, with extremely moral figures, who traditionally have been concerned with the private questions about the permissibility of different acts.[106] This process of question-and-answer is accomplished by unconstrained jurists with varying degree of dependence on classical schools of thoughts (*madahib*).[107] Historically, *fatwa* is considered as a personal or private legal relation between a questioner and a jurist over legal and non-legal issues. In this context, regarding the importance of legitimacy (or Shari'ah compliance) of the financial operation of Islamic financial institutions, the emergence of modern Islamic finance has given a significant place to the institution of *fatwa*.[108]

The development of the modern Islamic finance in terms of the renewal of authoritative interpretations in *fiqh al-muamallat* reflects its well-established relation to the notions of Collective *ijtihad* and *Fatwas*. After the fall of the Ottoman Empire, the *Majallat al-Ahkam al-adliyya* became outdated, and accordingly new movements for modernizing legal systems

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[103] Mughees Shaukati, 'General Perception of Fatwa and Its Role in Islamic Finance' (INCEIF university 2009) p 17.
[104] El-Gamal (n 62) 32-33.
[105] Habib Ahmed, 'Islamic Law, Adaptability and Financial Development' (2006) 13 (2) Islamic Economic Studies 79. 80.
[106] Hegazy (n 83) 140.
[107] El-Gamal (n 62) 31.
[108] Hegazy (n 83) 134.

through collective and liberal *ijtihad* started.[109] In the context of Islamic finance, collective *ijtihad* is considered as an applicable solution for the crisis of jurists' thoughts.[110] In this regard, modern financial *fatwas* have three forms: 1-international; 2-national; and 3-private.

International Islamic organizations, such as the *Fiqh* Academy of the Organization of Islamic Conference and the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) are the main international fatwa-ruling centres. The rationale behind the establishment of those organizations is to avoid fragmentation in opinions and achieve harmonization in the Islamic finance industry.[111] At national level, some Islamic countries such as Malaysia has appointed Shari'ah jurists at central banks and national Shari'ah boards. In this regard, the national *fatwas* enhance the integrity of the given jurisdiction's market in terms of predictable and sustainable development. The last category is concerned about private collective fatwas issued by Shari'ah boards of Islamic financial institutions. They have been individualized legal solutions provided by Shari'ah jurists who function in the form of a board and decide about the Shari'ah compliance desighn of financial products and the operation of Islamic financial institutions.[112] In fact, issued *fatwas* are the proof of Islamicity and the legitimacy of Islamic finance.[113] Although, in a legal sense, an issued *fatwa* by one Islamic financial institution's Shari'ah board has no legal bearing on other Islamic financial institutions, the reputation of Shari'ah board's members or the Institution may give rise to a wide recognition of the *fatwa* by other Islamic financial institutions.[114] This is particularly true in the case of interpretation over

[109] El Gamal (n 62).
[110] Nadirsiyah Hosen, 'Nahdlatul Ulama and Collective Ijtihad' (Jun 2004) 6 (1) New Zealand Journal of Asian Studies 5, 6.
[111] Warde (n 5) 236-237.
[112] Hegazy (n 83)134.
[113] El Gamal (n 62) 7.
[114] Hegazy (n 83).

the permissibility of controversial transactions, such as organized *tawarruq* or *murabaha lil-amir bi-al-shira*. [115]

As discussed before, since the issuance of a *fatwa* has been based on a private legal relation between a questioner and a jurist, consequently the nature of *fatwa* depends on the nature and the objective of the question.[116] In this regard, the application of traditional notion of *fatwa* in the context of modern financial system may result in anomalies in the governance of Islamic financial institutions. For instance, the practice of paying fees to Shari'ah jurists casts doubt on their independency. In other words, since their discharge of duties (issuing fatwa and regulating *Shari'ah* issues) to Islamic financial institutions conflicts with their own interest, the quality of the issued *fatwa* may be affected.[117]

It is crucial for understanding the framework of a legal institution to comprehend its social aspect through the examination of its macro and micro functions. In this regard, a chain of functions is created between law and economy as the economy influences legal reasoning and in turn, the law influences economic outcome. [118] Further, an efficient transaction enhances economic efficiency, and accordingly results in progress and development. In conventional finance, the economic efficiency of transactions is evaluated based on the rationality of parties.[119] In other words, parties' financial and legal preferences in the form of mutual consent in a contract guide market movements. In the context of Islamic law, although mutual consent and individual rationality in economic transactions are necessary, they are not sufficient. [120]

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[115] ibid.
[116] ibid 142.
[117] Hegazy (n 83) 135.
[118] Samuel L. Buffoed, 'International Rule of Law and the Market Economy-An Outline' (2006) 12 Sw. J.L. & Trade Am. 303.
[119] Nien-He Hsieh, 'Efficiency and Rationality' in John R. Boatright *Finance Ethics, Critical Issues in Theory and Practice* (WIELY 2010) 63.
[120] El-Gamal (n 62) 9.

Financial rationality in Islamic financial transactions is circumscribed by injunctions against certain financial transactions, such as interest-bearing loans.[121] This prohibition-driven[122] feature of Islamic finance manifests itself in issued individual and collective *fatwas*. For instance, *fatwas* against organized *tawarruq* in Islamic finance by individual scholars, such as Taqi Usmani[123], *fatwa* by Islamic organizations, like OIC Fiqh academy in 2009,[124] and jurists' denouncements against the 2002 *fatwa* issued by Rector of *Al-Azhar*, Dr. Tantawi over the depositor-bank relationship and legitimized collection of a fixed profit percentage.[125]

Despite the prohibition-driven feature of Islamic finance, intense development and competition policies in global economy have necessitated the influence of markets over tradition and doctrine.[126] In fact, concerns over economic growth (as a *darura*) established the basis of the hidden cause (*illah*) for modern market-driven *fatwas* and accordingly paved the way for a relaxed-approach in *fatwa* ruling through the use of exceptional legal rules such as *rukhas* (exemptions) and *talfiq* (patching) in the case of necessity.[127] For instance, the necessity of economic growth has been invoked in the controversial Egyptian *fatwas* over the permissibility of interest in banking.[128]

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[121] ibid.
[122] ibid.
[123] M. Taghi Usmani, 'Applications and Rules of Banking *tawarruq*' (the Islamic *Fiqh* Council, Dec 2003) 57.
[124] The OIC *Fiqh* Academy Resolution (2008) (19/5) 179.
[125] M. El Gamal,' Interest and the Paradox of Contemporary Islamic Law and Finance' (2003) 27 (1) Fordham International Law Journal 108.
[126] Warde (n 5) 41-42.
[127] Hegazy (n 83) 140; the basis of *rukhsa* is hardship. Hardship differs in intensity according to circumstances. Hegazy (n 83); *talfiq* is an adaptive mechanism in Islamic law, and authorizes jurists to choose an interpretation from other schools of jurisprudence. This eclectic approach is a procedure to select or '*privileging dissenting opinions (ikhtilaf*)'. Ibrahim Warde, 'Status of the Global Islamic Industry' in Craig R. Nethercott and David M. Eisenberg (eds) *Islamic Finance, Law and Practice* (OUP 2012) 8; David M. Eisenberg, 'Sources and Principles of Islamic Law' in ibid. 34-35.
[128] Warde (n 5) 41; for instance, Mufti Muhammad Abduh's Fatwa in 1904 on Egyptian Savings Fund (*Sanduq al-Tawfeer*), and a fatwa issued by Mufti Muhammad Sayyed Atiyya Tantawi in 1989 about

The development-oriented *fatwa* ruling bears different forms. For instance, in the GCC, privatized *fatwas* are issued by Islamic financial institutions' shari'ah boards and governments have no involvement in the process of *fatwa* issuing and they only prepare a proper ground for flourishing financial markets through legislation.[129] By contrast, some jurisdictions such as Malaysia established a central *fatwa* issuing authority by which all Islamic financial institutions' Shari'ah boards are required to follow a compatible approach in their fatwa-ruling with the issued *fatwas* by the central Shari'ah council. However, despite the positive implications of development-oriented *fatwas* for competition in the industry and the acceleration of financial development, they mainly disregard and abate Islamic law Principles (*qawa'id*).[130] In other words, macro-economic considerations play crucial role in issuing relaxed and adaptable *fatwas* in the industry.

2.5 Islamic Finance Principles

As we explained before, although permissibility (*ibahah*) is the basic idea in *fiqh al-muamallat*, law in the context of Islamic financial transactions is not based on unbounded human preferences, rather is defined vis-à-vis a bundle of principles, concerning high economic and moral objectives. The sanctity of human wealth in Islamic law revolves around the concepts

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legitimizing Capitalization certificates (*shahadat al-istithmar*) see: Chibli Mallat, 'the Debate on Riba and Interest in Twentieth Century Egypt*'* in C. Mallat (ed) *Islamic Law and Finance* (Graham and Trotman 1988) 69-88; Chibli Mllat, 'Tantawi on Banking' in M. Khalid Masud (ed) *Islamic Legal Interpretation: Muftis and Their Fatwas* (Harvard university press 1996) 286-296.

[129] Rodney Wilson, 'The Development of Islamic Finance in the GCC' (2009) Working Paper, Kuwait Programme on Development, Governance and Globalization in the Gulf States, 8-9 < http://www.lse.ac.uk/middleEastCentre/kuwait/documents/Wilson.pdf> accessed 2 August 2015.

[130] Hegazy (n 83) 140; In the GCC, Islamic financial institutions rather than governments have the prominent role in developing Islamic finance markets, and Shari'ah boards have been constructive and willing to approve new products. Wilson (n 129) 7-8.

of fairness and efficiency. In other words, the function of financial contracts should be explained in terms of distributive justice and fair wealth distribution. In the context of Islamic law, the prohibitions of *riba*, *gharar* and *maisir* are the manifestations of distributive function of contract.[131] While financial regulators limit the scope of credit and risk trading to prevent systemic failures, the prohibition of *riba* and *gharar* are Islamic forms of prudential regulation aim to protect individuals from their own greed.[132] However, the interpretation of these principles is the matter of considerable diversity, which can be attributed to the different premises of *madahib* in *ijtihad* and accordingly the interpretation of the generic prohibitions in the *Quran* and *Hdith*.[133]

2.5.1 The Prohibition of *Riba*

'Riba' literally refers to increase and 'wrongful devouring of property'.[134] Its technical meaning varies according to the source, and is not necessarily about interest.[135] It refers to any unlawful or undeserved gain derived from the quantitative inequality of the counter values in transactions.[136] The juristic meaning of *Riba* is commonly translated as Usury, a term that refers

[131] Benjelayel (n 71) 7; Duncan Kennedy, 'From the Substance in Private Law Adjudication' (1976) 89 Harvard law review 1685.
[132] El Gamal, *Islamic Finance* (n 62) 48; M. El Gamal, 'Mutuality as an Antidote to Rent-Seeking Shari'ah Arbitrage in Islamic Finance' (2005) www.ruf.rice.edu/~elgamal/files/Mutuality.pdf accessed 2 August 2015.
[133] Al-Rimawi (n 48) 118.
[134] Frank Vogel and Samuel Hayes, *Islamic Law and Finance: Religion, Risk, and Return* (Kluwer Law International 1998) 62.
[135] Ibrahim F. I. Shihata, 'Some Observations on the Question of RIBA and the Challenges Facing Islamic Banking' (2000-20001) 5 Y.B. Int'l Fin. & Econ. L. 23, 26.
[136] Nabil A. Saleh, *Unlawful Gain and Legitimate Profit in Islamic Law: riba, gharar and Islamic Banking* (2nd edn, Graham & Trotman 1992) 16.

to interest on loan.[137]However, interest or usury is only one form of *riba*. For instance, the imposition of late fees is an example of non-interest *riba*.[138] In fact, this is not an agreed meaning for *riba* in Jurisprudence and since 'the distinction between legitimate compensation and forbidden riba is the most fundamental distinguishing feature of Islamic finance',[139] this diversity in the meaning of *riba* impeded engineering new contracts, particularly in derivatives markets.[140]

The notion of *riba* and its implications may vary according to transactions' operation. Generally, there are two main types of *riba: riba al-nasi'a* and *riba al-fadl. Riba-al fadl* or *riba al-sunna*[141] refers to unlawful increase resulting from the simultaneous exchange of goods of the same type (*jins*), which are governed by the same efficient cause (*illa*),[142] and *riba al-nasi'a* refers to *riba al-quruth,*[143] is an increase in an amount of debt as a result of a delay or deferment in the payment of the debt.[144] These kinds of *riba* are *ex-ante* restrictions on the formation of spot and credit contracts, and are based on a set of statements attributed to the Prophet.[145]

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[137] Shihata (n 135) 26.
[138] Warde, *Islamic Finance in the Global Economy* (n 5) 52.
[139] El Gamal, *Islamic Finance* (n 62).
[140] The Islamic law pronouncements about *riba* can be categorized in three level, which are often contradictory: 1-National, for instance, the Malaysian Islamic banking laws allow for trading in debt; 2-juristics opinions. For instance, while modernist jurists, like Abduh and Rashid Rida, justify *riba* in the concept of *maslaha*, other jurists, mostly from the GCC and Pakistan have more restricted opinions; 3-international organizations, such as AAOIFI Shari'ah Standards Shari'ah Standard on Debit, Charge and Credit Cards in 1998. See David M. Eisenberg (n 127) 41-48; El Gamal, 'Interest and the Paradox of Contemporary of Islamic Law and Finance' (n 125) 114.
[141] El Gamal, *Islamic Finance* (n 62) 50.
[142] Shihata (n 135) 26; Nabil Saleh (n 136); this kind of riba is based on the Prophet tradition: Gold for gold, silver for silver, wheat for wheat, barley for barley, dates for dates, and salt for salt, like for like, hand to hand, and any increase is riba. See S Madi, 'the Concept of Unlawful Gain and Legitimate Profit in Islamic Law' (PhD thesis, University of London 1989) 96.
[143] 'Islamic Capital Market Fact Finding Report' (Report of the Islamic Capital Market Task Force of the International Organization of Securities Commissions July 2004).
[144] Shihata (n 135); Mahmoud Fadeel, 'Legal Aspects of Islamic Finance' in Simon Archer and Rifaat Ahmed Abdel Karim (eds) *Islamic Finance: Innovation and Growth* (Euromoney Books 2002) 91.

Riba al-jahiliya is a kind of *riba al-nasi'ah* (practiced in pre-Islam era), is the *ex-post* restriction on settlement of monetary obligations in debt contracts[146]and refers to doubling the principle in exchange for more time.[147] Three reasons have been introduced for expanding the framework of *riba al-nasi'ah*: 1- preventing the exploitation of poor debtor; 2-monetary uncertainty resulted from trading money; 3- trading foodstuffs for larger amounts of future foodstuff would lead to shortage in spot markets.[148] In other words, legitimate return in Islamic finance derives from real economy activities and responsibility not from sale of credit.[149] Further, the charitable nature of loan in Islam, as a way to help needy people, explains the prohibition of *riba* in credit transactions.[150]

The scope of *riba al-fadl* has been subject to different legal opinions over the *illa* (cause) that governs the species and the class of articles.[151] Excessive *gharar* resulting from parties' lack of knowledge about the result of the trade is considered the main reason for the prohibition of this kind of *riba*.[152] In this regard, it is argued that the prohibition of *riba al-fadl* in such exchanges is for fairness and the 'elimination of practices where unjust enrichment may occur'.[153] The controversy over *illah* in *ribawi* items is more perplexed in currency exchanges (*Sarf*). For instance, *Zahiri* School in contrast to the other *Sunni* schools, rejects analogy (*qiyas*) in determining the law. It

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[145] Mohammad H. Fadel (n 69) 66o.
[146] ibid 658.
[147] warde (n 5) 53; the Quran 3:129.
[148] El Gamal, *Islamic Finance* (n 62) 50.
[149] S. Cox, 'Retail and Private Client Services' in Simon Archer and Rifaat Ahmed Abdel Karim (n 144) 131.
[150] El Gamal (n 62) 57.
[151] N. Saleh (n 136).
[152] El Gamal (n 62) 51.
[153] Shihata (n 135) 30; in fact, the importance of economic rationality in addressing *riba* is admitted by Ibn Rushd. He found the precise *illah* (cause) for the prohibition of *riba-al fadl* in the exchange of goods of the same type for attaining fairness of exchanges. Accordingly 'as for fungible goods measured by volume or weight, equity requires equality, since they are relatively homogenous, and thus have similar benefits, since it is not necessary for a person owning one of those goods to exchange it for goods of the

assumes that the prohibition of *riba* in the *hadith* applies only to the six articles. Consequently, since paper money would not have the characteristics of gold and silver, is exchangeable with gold and silver on a deferred basis.[154] International Association of Islamic Banks in response to the request of the Dubai Islamic Bank has adopted a similar interpretation.[155] However, the Shari'ah board of the Kuwaiti Finance house strongly opposed the fatwa.[156]

2.5.2 The Prohibition of *Gharar*

Generally, legal rules and principles are the reflections of the prevailing economic philosophy in a system. In the context of commercial and financial transactions, efficient rules and principles provide more stability and flexibility for society. In this regard, the law of contracts and contractual relationships shape the form of property rights. Accordingly, since the proper operation of modern economy depends on contractual obligations and property rights, providing efficient legal framework for contracts is fundamental.

The concept of *gharar* in Islamic law may carry different meanings in relation to different contracts. Generally, *gharar* 'encompasses some forms of incomplete information and/or deception'[157], as well as uncertainty in the elements of contracts, which creates risks in transactions and consequently, dislocates resources and property rights unfairly.[158]

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same type, justice in this case is achieved by equating volume or weight, since the benefits are very similar.' El Gamal (n 62) 52-53.

[154] Muhammad Al-Bashir and Muhammad Al-Amin, *Risk Management in Islamic Finance: An Analysis of Derivatives Instruments in Commodity Markets* (BRILL 2008) 84.

[155] ibid 75-84.

[156] ibid.

[157] El Gamal (n 62) 58.

[158] Vogel and Hays (n 134) 64.

The normative justice of contract in Islamic law is based on welfare maximization and distribution with emphasis on the rights of parties and society. In other words, prohibitive principles in contractual relationships, such as *gharar* aim to establish balance in contractual relationships by stressing on the subject of contract in terms of the specificity of existence, price, quality, quantity and delivery.[159] In this regard, it is argued that the most cases of *gharar* are resulted from sale contracts.[160] The correlation between *gharar*, as a state of uncertainty, and bilateral contracts is acknowledged by the AAOIFI as well.[161] Accordingly, it is argued since the unlawful acquisition of wealth does not occur in a donation, there would be no loss.[162] This view is used in designing *takaful* (Islamic insurance), which is mainly based on *tabarru* (non-commutative and voluntary contribution) and *wakala* (agency).

Regarding the inherent incompleteness of commercial transactions, we can see the existence of some degree of uncertainty.[163] In this regard, accordingly jurists have distinguished between major *gharar* which vitiates the contract, minor *gharar* which is tolerable and average *gharar* (*al*

[159] Valenttino Cattelan, 'From the Concept of *haqq* to the Prohibition of *riba*, *ghara*r and *maysir* in Islamic Finance' (2009) 2 International Monetary Economic and Finance 384; Mahmood Bagheri, 'Conflict of Laws, Economic Regulations and Corrective/Distributive Justice' (2007) 28 (1) University of Pennsylvania Journal of International Economic Law 113.
[160] N. Saleh (n 136) 63.
[161] AAOIFI, 'Shari'ah Standard No (31) Control on Gharar in Financial Transactions' (September 2007).
[162] David M. Eisenberg (n 127) 45; Professor Al-Dhareer shares the same view, and considers *gharar* only in commutative financial contracts. *Maliki*, *Ibadi* and *Ja'fari* Schools have the same view.; M. S. Al-Ameen Al-Dhareer, 'Al Gharar in Contracts and its Effects on Contemporary Transactions' (1997) Islamic Research and Training Institute, Eminent Scholars' lecture series, no. 16) < http://ierc.sbu.ac.ir/File/Book/Al%20Gharar%20in%20Contracts%20and%20Its%20Effect%20on%20Contemporary%20Transaction_46904.pdf> accessed 2 August 2015.
[163] It is important to differ between exploiting uncertainties in contracts which could result in unilateral gains and non-exploiting uncertainties. See Vogel and Hayes (n 134) 72.

gharar al mutawwasit).[164] In contrast to minor and average gharar, the major *gharar* (*bay al-gharar*) is about 'unbundle and unnecessary sale of risk'[165] and is regarded as the main subject of prohibition in contractual arrangements.

As mentioned before, sale is the model contract in Islamic jurisprudence, thus Shari'ah jurists analyse the concept of *gharar* and its legal implications in the light of essential elements of sale contract. Further, since the variability of *gharar* in different contracts have not been clarified in *fiqh*, its evaluation has been subject to different juristic opinions. In this regard, the level of *gharar* has been evaluated in light of custom (*urf*) and the interpretations of public good or *maslaha* by jurists.[166] For instance, regarding the importance of *maslaha* in the interpretation of *gharar* and its legal consequences, the contract in question should not be the subject of public need (*hajat al-nas*),[167] as the removal of hardship (*raf al haraj*) is of great significance by virtue of legal maxim.[168] Concerning this issue, for instance, *salam* (advance purchase) and *istisna* (manufacture contract) are legal contracts regardless of *gharar* elements.[169] In this regard, while classical *fiqh* often equates *gharar* with ignorance and the lack of information *(jahl*), contemporary jurists mainly examine *gharar* with regard to uncertain and hidden

[164] M. Hashim Kamaliel, 'Uncertainty and Risk-Taking (*gharar*) in Islamic Law' (1999) IIUM law Journal 199, 203 < http://www.lib.iium.edu.my/mom2/cm/content/view/view.jsp?key=28jgiAlQX4cY5enzlLbpUTFOXTMAZNiT20080603092144671> accessed 2August 2015; AAOIFI (n 161) 2/2; El Gamal (n 62); average gharar is more susceptible to being differently evaluated. El Gamal (n 62).
[165] El Gamal (n 62) 60.
[166] Hashim Kamali (n 164) 204; David M. Eisenberg (n 127) 47; AAOIFI (n 161) 4/2/1.
[167] Hashim Kamali (n 164) 201.
[168] ibid.
[169] ibid.

consequences.[170] In other words, *gharar* is more comprehensive than *jahl*, and refers to everything unknown.[171]

Gharar may occur from the form of a contract when two sale contracts are combined into one (*bay'atayn fi bay'a*) or the completion of the contract is built upon a random selection of the subject matter to be sold (*bay al-hasat*).[172]In this regard, Islamic *fiqh* characterises sale contract as a legal tool for transferring the ownership of a property *in rem* or corpus (*ayn*) for a consideration (*thaman*).[173] In Islamic law *ayn* is considered as the objects of contract, and to avoid *gharar*, must observe three main interrelated conditions: 1-existence; 2-ownership of the object; 3- possession.[174] Accordingly failure to observe them will void the contract.[175] This proposition is in contrast to jurists' view on the meaning of *gharar* as uncertainty in the completion or the result of a contract.[176]

It is worth noting that, the prohibited uncertainty in commercial transactions is the result of the uncertainty of the main elements of contracts, and not from the outcome of contracts.[177]The mentioned requirements are the fundamental parts of arguments against conventional forward

[170] ibid; such as Dr Wahbah al-Zuhayli; Eisenberg (n 127) 46.
[171] Eisenberg (n 127); AAOIFI (n 161) Appendix C.
[172] Eisenberg (n 127) 47; AAOIFI (n 161) 5/1/1; Joseph Schacht, *An Introduction to Islamic Law* Clarendon Press (OUP 1982) 78.
[173] A. H. B. Buang, 'the Prohibition of Gharar in the Islamic Law of Contracts' (PhD Thesis, University of London 1995) 20.
[174] Priya Uberoi and Ali Rod Khadem, 'Islamic Derivatives: Past, Present, and Future' in Kabir Hassan and Michael Mahlknecht *Islamic Capital Markets: Products and Strategies* (WIELY 2011) 148.

[175] Buang (n 173) 221; There are other conditions. For example, the subject matter should be beneficial and pure. Buang (n 173).
[176] ibid; the meaning and scope of *gharar* is subject to different views. Generally, there are two trends in modern jurisprudence: traditional and modernist. The modernist trend considers *gharar* with regard to current financial circumstances, and in this regard Sanhuri presented a new interpretation of *gharar* which does not establish linkage between the existence of object and *gharar*. The traditional trend based on traditionalist scholars' view like Khafif, Zarqa and Zuhayli on the other hand, follows the classical *fiqh* views on *gharar*, and emphasises the existence and determination of object and its related contractual obligations. Buang (n 173) 345-349.

and future contracts. In this regard, the purchase of non-existent object of contract, selling object prior to holding property title (i.e. short selling), and reselling the object of contract prior to actual delivery or receipt are the main objections against conventional forwards and futures.[178] Further, the *Fiqh* Academy of the Organization of the Islamic Conference ruled that *Shari'ah* allows the deferment of payment or delivery, but not both together in a contract.[179] In other words, immediate and absolute sale is the only true form of contract, which requires 'the object of a bona fide trade or exchange must exist with identifiable characteristics.[180]However, Islamic *fiqh* provides two exceptions, *Salam* (forward investment) and *Istisna* (manufacturing) based on the necessity and the *darura* of the time. Regarding the presence of *gharar* in the purchase of non-existent object (*bay al madum*) in futures commodity contracts, clearing procedure by clearing houses such as Malaysian Derivatives Clearing-House (MDCH), tend to preclude any uncertainty over the existence and the delivery of subject matter.[181] Since, clearinghouses serve as counterparties and guaranty the performance of the contract,[182]the level of *gharar* in future commodities transactions is subject of doubt in modern jurists' opinions.[183]

Another example concerning the element of *gharar* is option. Option contract is defined as 'a contract between two parties in which one party (the buyer) has the right, but not the obligation, to buy or sell a specified asset at a specified price, at or before a specified date, from the other party (the seller). Thus an option conveys the right to buy or sell an underlying commodity at a

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[177] N. Saleh (n 136) 145.
[178] Uberoi and Khadem (n 174).
[179] M.A. Elgari, 'Islamic Equity Investment' in Simon Archer and Rifaat Ahmed Abdel Karim (eds) (n 144) 155.
[180] Andreas A. Jobst and Juan Sole, 'Operative Principles of Islamic Derivatives-Towards a Coherent Theory' (2012) International Monetary Fund working paper WP/12/63, 9 < https://www.imf.org/external/pubs/ft/wp/2012/wp1263.pdf> accessed 2 August 2015.
[181] Hashim Kamali (n 164) 209; AL Bashir (n 154) 139.
[182] Al Bashir (n 154) 140.

specified price within a specified period of time'.[184] In this regard, since a valid subject of contract under Islamic law theory must be characterized as a tangible property (*mal*), a usufruct (*manfaa'ah*), or a pecuniary right (*haqq mali*),[185] options cannot be regarded as property as they are pure rights, and fall into none of these categories.[186] As such, options cannot be considered independent goods, and consequently the subject of contract.[187]

In compare to the *Shari'ah*, uncertainty in common law carries a narrower concept. As mentioned earlier, contract in a positivist legal system such as common law is established based on liberalism and voluntary exchange, and accordingly parties have wide autonomy in arranging contracts' terms. In this regard, economy, competition and innovative financial instruments have exerted influence over the functions of contract, and shifted it to 'as the organizing mechanism for cutting-edge innovation'.[188] In this regard, although excessive uncertainty in the fundamental elements of a contract may result in failure,[189] courts in commercial cases try to define the construction of contracts by looking into commercial and financial standard mentioned or assumed by custom in a certain field.[190]

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[183] Hashim Kamali (n 164) 209-210.
[184] Hans R. Stoll and Robert E. Whaley, *Futures and Options Theory and Applications* (South-Western Publishing 1993) 6.
[185] Uberoi and Khadem (n 174) 150.
[186] ibid.
[187] ibid.
[188] Ronald J. Gilson, Charles F. Sabel and Robert E. Scott, 'Contract, Uncertainty and Innovation' (2010) Columbia University law school, Law & economics research paper series No. 385, Stanford Law and Economics Online Working Paper No. 403, 2 http://dx.doi.org/10.2139/ssrn.1711435> accessed 2 August 2015.
[189] *Fry v. Barnes* [1953] 2 DLR 817 (BCSC)
[190] *Hillas and Co. Ltd. v. Arcos Ltd*. [1932] 147 LT 503; *Whitlock v. Brew* [1968] 118 CLR 445; *Three Rivers Trading Co., Ltd. v. Gwinear & District Farmers Ltd.* [1967] 111 Sol. J. 831

2.5.3 The Prohibition of *Maisir*

The rationale behind the prohibition of *maisir* (gambling) is in the Islamic doctrine of investment. Money should be earned by real economic activities and productive occupation, not by gambling, as 'an activity that involves an arrangement between two or more parties, each of whom undertakes the risk of a loss for one means a gain for the other'.[191] In this regard, the *Quran* and *Sunnah* forbid gains made from the games of chance (*Qimar*).[192]The term speculation as profit seeking in markets through engaging in risky transactions,[193] is regarded as the main reason for unbounded innovative policies in the modern finance and accordingly the creation of systemic risk. In other words, the object of a gambling is risk,[194] and the aim of financial regulation is to prevent and control individuals' self-interested decisions in order to ensure public interest and financial stability[195].

Gambling, as a kind of speculation, conflicts with the goals of regulation since it results in unfair distribution of wealth and market failure.[196] Some conventional derivatives, particularly Over-The-Counter, have been used as gambling tools in financial markets and consequently their failures led to systemic risk and financial crisis. In this regard, Islamic law prohibits conventional options in indices as they are based on neither commodity, nor stocks, and nor anything else as underlying assets.[197] Speculation is the reason for the prohibition of conventional future

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[191] 'Islamic Capital Market Fact Finding Report' (n 143) 8.
[192] Abu Umar Faruq Ahmad (n 57) 99.
[193] ibid 100.
[194] M. Al Bashir (n 154) 212.
[195] Stephen A. Lumpkin, 'Regulatory Issues Related to Financial Innovation' (2009) 2 OECD Journal: Financial Market Trends < http://www.oecd.org/finance/financial-markets/44362117.pdf> accessed 2 August 2015.
[196] ibid.
[197] Al Bashir (n 154) 213; Debate over options is controversial. The best arguments and counter arguments are illustrated in the Islamic *Fiqh* Academy (OTC) forum on issue of options, See (1990) 1 *Majallat Majma' al-Fiqh al-Islami* 568 cited in Al Bashir (n 154).

contracts too. Although, we should distinguish between speculation unrelated to any activity and speculation as part of some real activity which helps to shift risks,[198] it is argued, since future is a bet on which way prices will move, is prohibited.[199]

2.6 Islamic Financial Institutions

In every economy, financial institutions as financial intermediaries serve two fundamental functions: the reallocation of surplus funds and providing financial solutions for market failures. Financial intermediaries reallocate surplus funds to economic units with funding needs (borrowers).[200] In this regard, savers and borrowers have different preferences in financial markets. While, savers have a preference for future consumption with inclination to have easy access to their savings, borrowers would rather invest resources in projects for higher returns in future.[201] Accordingly, 'Reconciling the different desires of savers and borrowers in terms of maturity and returns' is the main intermediaries' function.[202] Financial intermediaries also provide financial solutions for market failures, such as information asymmetry and high transaction costs.[203] In this context, the functions of intermediaries due to globalization and

[198] ibid.
[199] Y. T. Delorenzo, 'The Religious Foundations of Islamic Finance' in Simon Archer and Rifaat Ahmed Abdel Karim (eds) (n 144) 22-23.
[200] Franklin Allen and Anthony M. Santomero, 'What Do Financial Intermediaries Do?' (2001) 25 Journal of Banking and Finance 271, 272 < http://finance.wharton.upenn.edu/~allenf/download/Vita/intermed.pdf> accessed 2 August 2015.
[201] 'The Interplay of Financial Intermediaries and Its Impact on Monetary Analysis' (2012) European Central Bank Monthly Bulletin 59 < https://www.ecb.europa.eu/pub/pdf/other/art1_mb201201en_pp59-73en.pdf> accessed 2 August 2015.
[202] ibid.
[203] El Gamal (n 62) 135.

competitive impulses have been changed and the intermediation process shifted from more straightforward credit intermediation to risk intermediation.[204]

Islamic and conventional financial intermediaries perform aforementioned tasks according to different economic philosophy. In contrast to conventional system by which profit maximization constitutes the primary concern in transactions, Islamic financial intermediation aims to enhance fairness in transactions and accordingly place equal emphasis on the ethical and social dimensions.[205] As such, interest-bearing transactions are prohibited and intermediaries should perform their tasks with strict adherence to *Shari'ah* principles. In this regard, since money does not have time-value, Islamic financial institutions embrace the principle of profit and loss sharing. [206] Further, as Islamic economic doctrine is based on entrepreneurship and production, financial intermediation must allocate and mobilize funds to Shari'ah-compliant industries. Islamic finance industry like conventional industry presents three main institutions: Islamic banking, Islamic capital markets and *takaful* (insurance).

2.6.1 Islamic Banks

The basic investment concept in Islamic banking is the prohibition of making money's time value in any loan with predetermined value.[207] Although Islamic banks have different business

[204] Stephen A. Lumpkin (n 195).
[205] Zamir Iqbal, 'Islamic Financial Systems' (June 1997) 34 (2) Finance and Development 42 < http://www.imf.org/external/pubs/ft/fandd/1997/06/pdf/iqbal.pdf> accessed 2 August 2015.
[206] Andrew Henderson, 'Islamic Financial Institutions' in Craig Nethercott and David Eisenberg (n 127) 54-55.
[207] Abu Umar Farug Ahmad and M. Kabir Hassan, 'The Time Value of Money in Islamic Finance' (2006) 23 (1) The American Journal of Islamic Social Sciences 66; *Shari'ah* does not reject 'any increment in a loan given to cover the price of a commodity in any sale contract to be paid at a future date'. ibid.

mechanisms and their operation is based on the principle of profit and loss sharing, they share common characteristics with conventional banks. For instance, in the UK banking system Islamic law is not the only functional part of Islamic banks.[208] In the formation phase, Islamic and conventional banks in the UK take two legal forms: partnership; or company.[209] Alongside company law requirements, they should fulfil banking and financial regulations, for instance banks in Europe are required to consider EU Directives over banking and financial issues. However, the structure of Islamic banking includes an extra element, a Shari'ah supervisory board, comprised of Shari'ah law and economics experts.[210] This is for ensuring that banks activities in the mobilization and the allocation of funds are in line with the *Shari'ah*.[211]

The contemporary and the majority view of Shari'ah jurists against conventional banking is elucidated in the conclusions of the fourteenth session of Majlis Majma' Al-Fiqh Al-Islami in 2003:[212]

- Conventional banks' operation is based on creating credit through lending deposited funds with interest;
- The relationship between banks and depositors is based on loan not agency;

[208] Abdul Karim Aldohni, *The Legal and Regulatory Aspects of Islamic Banking* (Routledge 2011) 78; According to Directive 2007/64 EC (OJEC of the 5.12.2007) payment Institutions are authorised to provide payment services and also perform some limited monetary and credit functions similar to banks. However, based on the Directive rules they cannot use the funds stored, and accordingly are not entitled to pay interest. Thus, the issue of *riba* in the issue of *riba* would have no place in PIs transactions. Vittorio Santoro, 'The riba Prohibition and Payment Institutions' in M. Fahim Khan (ed) *Islamic Banking and Finance in the European Union: A Challenge* (Edward Elgar 2010) 222-225.
[209] ibid.
[210] ibid 80.
[211] Abdullah Saeed, *Islamic Banking and Interest* (BRILL 1999) 108; The operational side of Islamic banking is based on contractual relationships which are defined in Islamic jurisprudence (nominate). Also Islamic banks are required to purify their impure profits by *zakat* (alms). Brian Kettlell, *Case Studies in Islamic Banking and Finance* (WILEY Finance 2011) 82; IOSCO (n 143) 16.
[212] El Gamal (n 62) 144-145.

- Interest on deposits is kind of interest on loan, thus is riba and forbidden;
- Conventional banks' guarantee of principal capital in any form is not allowed.

The Islamic banking principle of profit and loss sharing is implemented through two main banking contracts categories: intermediation contracts and transaction contracts.[213] The main intermediation contract is *Mudaraba.*[214] *Mudaraba* or trust contract is a two-tier partnership agreement in which bank plays 'the middle-party' role.[215] Providers of funds are silent partners and bank acts an agent.[216] The rate of profit in two agreements is based on previously agreed percentage.[217] On the other hand, losses will be borne by: depositors, in the form of deduction in fund; by entrepreneurs in the form of not receiving any return; and by the bank by taking no fee. Also, the bank may lose its shareholders' money.[218] Regarding credit risk management in banking, Islamic banks should not ask collateral, and only may be requested to help to reduce moral hazard, for instance for preventing entrepreneur to break the agreement.[219] In this regard, it is argued that investing in debt instruments such as *murabaha*, *ijara* and *tawarruq* by banks may expose them to the same risks (credit risks, interest rate risk, liquidity risk and operational risk) as conventional banks.[220]

[213] Shelagh Heffernan, *Modern Banking* (John Wiley & Sons 2005) 324-329.
[214] Another intermediation contracts are *kafalah and Amanah*. In *Kafalah* banks act as guarantor for retail debtors. This contract is used to facilitate the issuance of letter of credit. *Amanah* contract is a demand deposit, and depositors share no profit. Shelagh Heffernan, (n 213); Aldohni (n 208) 94.
[215] Aldohni (n 208) 92.
[216] El Gamal (n 62) 138.
[217] Aldohni (n 208).
[218] ibid 92-93.
[219] Kassim Dakhlallah and Hela Miniaoui, 'Islamic Banks vs. Non Islamic: Ethical Dimensions' (2nd International Conference on Business and Economic Research (ICBER), Malaysia 2011) 2141, 2143 < http://ro.uow.edu.au/cgi/viewcontent.cgi?article=1269&context=dubaipapers> accessed 2 August 2015.
[220] El Gamal (n 62) 155.

Transaction contracts govern real economic activities including trade, exchange and finance.[221] The first type of transaction contracts is equity participation. *Musharaka* is a partnership contract, which is similar to a joint-venture agreement, by which capital owners (Islamic banks and depositors) enter into a partnership agreement to finance 'a joint commercial enterprise'.[222] Parties may contribute in capital in the form of physical or intangible assets, such as labour, share profits and losses at a predetermined ratio.[223]

The second category of transaction contracts encompasses asset-backed contracts. They are contracts with individual assets and subjects. Further, they are in contrast with conventional asset-backed contracts, as they are based on a claim against a pool of assets.[224] The first type of this category are securities for trade finance, such as *Murabaha*, a form of mark-up financing, by which banks purchase goods on behalf of clients, then resell to clients for a predetermined profit (mark-up)[225]and with differed payment.[226] In this context, risk management is a crucial issue for Islamic banks as they carry more risks such as deficiency and delivery with regard to the ownership of those assets.[227] The second type of the asset-backed transactions are collateral securities. *Ijara* is the main contract in this category, and similar to conventional lease, associated with a separate contract (*tamwyl*) that transfers ownership.[228] *Istisna* or commission to manufacture, is the other type in this category and refers to financing the production of non-existent items through paying the price in one or multiple instalments by buyer, and delivery

[221] Dahlia el-Hawary, Wafik Grais and Zamir Iqbal, 'Regulating Islamic Financial Institutions: The Nature of Regulated' (March 2004) World Bank Policy Research Working Paper 3227, 7 < http://elibrary.worldbank.org/doi/abs/10.1596/1813-9450-3227> accessed 2 August 2015.
[222] Aldohni (n 208).
[223] Dahlia El-Hawary (n 221) 8.
[224] ibid.
[225] Aldohni (n 208) 95.
[226] Hefernan (n 213).
[227] Aldohni (n 208).

of the object in future by seller.[229] This contract is commonly used with *ijara*, and creates a BOT (build, operate, transfer) structure to finance infrastructure development projects.[230]

The set of contracts discussed above also form the models of Islamic financial intermediations: 'two-tier *mudaraba*' and 'two-windows'.[231] In two-tier *mudaraba* both funds' mobilization and utilization are based on profit and loss sharing among the investor, the bank and the entrepreneur.[232] The first tier is between the depositor (*rabul mal*) and the bank (*mudarib*). This profit and loss sharing investment of deposits is a form of limited-term equity and capital is not guaranteed.[233] The second tier is between the bank as supplier and the entrepreneur. In this model banks would accept demand deposits as liabilities alongside investment deposits.[234] The function of this model is that by the integration of assets and liabilities sides of a bank's balance sheet, the active asset or liability management would be minimized, and accordingly provides stability in economic shocks.[235]

The two-windows model refers to bank's liabilities with two parts: demand and investment accounts. Investment windows are used for risk-bearing projects, and require banks to hold a zero present reserve.[236] Since demand deposits are liabilities in the strict sense, banks should hold a 100 present reserve.[237]

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[228] ibid.
[229] El Gamal (n 62) 90.
[230] ibid 91; Reinhard Klarmann, 'Construction and Lease Financing in Islamic Project Finance' (2004) 19 (3) Journal of International Banking Law and Regulation 61.
[231] El-Hawary (n 221) 10; Zamir Iqbal and Abbas Mirakhur, 'The Development of Islamic Financial Institutions and Future Challenges' in Simon Archer and Rifaat Ahmed Abdel Karim (eds) (n 144) 44.
[232] El-Hawary (n 221); Vogel and Hayes (n 134) 130-131.
[233] El-Hawary (n 221).
[234] ibid.
[235] ibid.
[236] ibid.
[237] ibid.

Theoretical expectations such as risk-sharing principle are neutralized by Islamic banks' rate of payments on investment accounts based on market competitive rates and regardless of their actual performance.[238]Also, practical issues, such as asset allocation and exposure to liquidity risk on the liabilities side require Islamic banks to follow a risk averse policy in the modes of financing, for example, through adopting *ijara* and *murabaha* instead of *mudaraba* and *musharaka* modes.[239] Further, another confusion concerns the safety of deposits with Islamic banks.[240] In this regard, while investment accounts are not guaranteed by the banks, guaranteed deposit accounts do not effectively protect the real purchasing power of deposits against inflation.[241]Thus, 'deposit protection emerges as a perfectly legitimate concern'.[242]

Moreover, it is argued that, since Islamic banks' direct entrance into trade and business is expensive, it is against the *maslehah* of society.[243] In this regard, the essence of financial intermediation is the transfer of funds from owners to users, and entering into trade through contractual arrangements such as *salam*, *istisna*, *ijara* and *bai bithaman al-ajal* (credit-sale), which are originally the forms of direct finance, and expose banks to all kinds of business risks, which ultimately will be carried by depositors of investment accounts.[244] However, the dominant culture in Islamic financial industry prefers a classical approach in financial intermediation.

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[238] ibid 17.
[239] ibid 17-18.
[240] Murat Cizakca, *Islamic Capitalism and Finance: Origins, Evolution and the Future* (Edward Elgar 2011) 241.
[241] ibid.
[242] ibid 243; *Hefz-al mal* (protection of property) as one of the pillars of *Maqasid al-Shari'ah* requires a more progressive approach in Islamic banking. Ibid.
[243] Muhammad Nejatullah Siddiqi, 'Islamic Banks, Concept, Precept and Prospects' in Amer Al-Roubaie and Shafiq Alvi Routledge (eds) *Islamic Banking and finance, Critical Concepts in Economics* (Vol. IV 2010) 38.
[244] ibid 38-44.

2.6.2 Islamic Capital Markets

Capital markets play crucial economic roles in risk allocation, supplying capital for those need them, and liquidity management.[245] Islamic capital markets are part of international capital markets and accordingly, Islamic financial instruments tend to be listed on the same exchanges and being subject to the same set of regulatory rules as conventional financial instruments.[246]

The permissibility of shares' transactions in stock exchanges has been subject to different opinions among Muslim scholars. The legal nature of a 'share' in common law has evolved alongside the evolution of corporation legal nature. It changed from a pro rata ownership of the assets of the company to a bundle of rights, or in other words, chose in action.[247] In contrast to common law, a share in Islamic finance is regarded as the proof of a shareholder's right to the company's wealth.[248] While there are several types of stocks, such as common (based on principle of profit and loss sharing), preferred (based on profit at a pre-fixed rate) and loan (based on profit at a fixed rate of interest), only common stock is regarded permissible by the majority of jurists.[249] However, the affirmative decision of *fiqh* academy of the OIC over transactions of shares accelerated the development of Islamic equity markets.[250]

As said earlier, the transactions of shares and securities in Islamic equity markets are based on the principles of *Shari'ah* which are subject to various interpretations. Generally, all Islamic

[245] John Board, 'Development of Islamic Capital Markets' in *Strategies for the Development of Islamic Capital Markets: Infrastructures and Legal Aspects of Islamic Asset Securitization* (n 54) 7.
[246] ibid 8.
[247] *Borland's Trustee v Steel Bros & Co Ltd* [1901] 1 Ch. 279 Ch D; *Macaura v Northern Assurance Co Ltd* [1925] A.C. 619 HL; Eva Micheler, *Property in Securities* (CUP 2007).
[248] Seif El-Din I. Taj El-Din, 'Towards an Islamic Model of Stock Market' (2002) 14 J.KAU: Islamic Econ. 3.
[249] ibid 8.

equity markets are agreed on: a) prohibition on trading in the shares of companies in impermissible activities, such as alcohol and gambling; b) prohibition on equity investment in companies involved in *riba* and debt financing, except on: 1- if the capital structure of the company is mainly equity based (the total debt of the company is less than thirty three percent of its market capital); 2- receivables are less than fifty present of the company asset.[251]

The development of Islamic financial products is substantially the result of Shari'ah advice and methodological framework utilized by Shari'ah advisors in *fatwa* ruling.[252] In this regard, structuring of Islamic securities requires a precise analysis concerning the nature of the securities, whether debt-based (like *murabaha*), asset-based (*ijarah*) or equity-based (*musharakah*).[253]However, it is argued that the analysis of instruments should be in accordance with the development objectives. For instance, regarding the national development program of Malaysia, Shari'ah advisors are required to propose structures in line with the Securities Commission and regulators' preferences, and carrying out research for further development of Islamic capital market.[254]In this regard, for instance, Malaysia innovations in the securitization of cash flow receivables portfolios by using *mudarabah sukuk*, paved the way for a flourished debt market.[255]

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[250] M. A. Elgari, 'Islamic Equity Investment' in Simon Archer and Rifaat Ahmed Abdel Karim (eds) (n 144) 151-152.

[251] Elgari ibid 153-156; the Securities Commission of Malaysia, *Islamic Equity Markets* (LexisNexis 2009) 7-9.

[252] Aznan Hasan, 'The Role of Shari'ah Advisors in the Development and Enhancement of Islamic Securities' in Aly Khorshid (ed) *Euromoney Encyclopedia of Islamic Finance* (Euromoney Institutional Investor PLC 2009) 49.

[253] ibid 51-52.

[254] Securities Commission, 'Guidelines on the Offering of Islamic Securities' (July 2004).

[255] Aznan Hassan (n 252) 60-64; the interpretation of *riba* and *qharar* in financial products is a critical element in differences between *madahib*. The *Shafei* School (predominant in Malaysia) has taken more innovative approach than *Hanfi*, *Maliki* and *Hanbali* Schools (predominant in the GCC). However,

Despite the common regulatory challenges, such as transparency, liquidity, and monitoring in all securities markets, Shari'ah-compliance requirements are further barriers for the development of Islamic capital markets.[256] Further, the existence of intense divergence in Shari'ah rulings impedes the integration of Islamic capital markets. In this regard, since religious approval for each issue, particularly for *sukuk*, requires extensive knowledge on legal and economic structures, there is considerable demands on the availability and expertise of Shari'ah scholars. In other words, the dearth of Shari'ah expertise and the availability of Shari'ah scholars act 'as an impediment to the wider acceptance of the Islamic finance'.[257]

2.6.3 Islamic Insurance (*Takaful*)

The emphasise of *takaful* or Islamic insurance like other Islamic finance institutions is on welfare and wealth maximization too.[258] Its operation is in a collective endeavour which aims for risk elimination whiting a given social group.[259] In this regard, conventional insurance has been prohibited in the ninth declaration at the second session of the Fiqh Academy of the OIC.[260]The main objections against the conventional insurance are: first, the presence of chance (*gharar*) taken by the insurance company; the second, the presence of *maisir* (if the risk does not materialize the insured loses the premium, but if the risk materialized he will get much more than

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initiation of application of new financial products in the GCC countries, such as *tawarruq* is manifestation of shifts from classical approaches to the modern ones.

[256] John Board (n 245).

[257] ibid 11.

[258] Vogel and Hayes (n 134) 26.

[259] Tom Baker, 'Risk, Insurance, and the Social Construction of Responsibility' in Tom Baker and Jonathan Simon (eds) *Embracing Risk: the Changing Culture of Insurance and Responsibility* (the University of Chicago Press 2002) 37-38.

[260] El Gamal (n 62) 147.

the premium); the third, the presence of *riba*. Further, it is argued that the funds accumulated in insurance companies are invested mainly in interest-based instruments.[261]

takaful is based on the concepts of *ta'awun* (mutual assistance and compensation) and *tabarru* (donation). The modern forms of *takaful* are: *mudaraba* and *wakala* (agency). But, *wakala* is the dominant form. This is probably due to the Shari'ah Committee of the Islamic Development Bank's opinion against taking undertaking surplus by *takaful* operator, because an underwriting surplus is not a profit and the operator is not permitted to take on underwriting risk.[262]In *wakala* or agency model, the operator acts as an agent and does not share any risk borne by *takaful* fund.[263] And also the operator is not liable for any deficit of the fund.[264] Regarding responsibilities of the operator, the IFSB has warned against the lack of a clear mechanism for controlling the *takaful* operator, and also agency problems resulting from the segregation of ownership and control.[265]

2.7 Conclusion

This chapter examined the development of Islamic finance industry with regard to the implications of the principles of *Shari'ah* for the development of Islamic finance industry. It explained that the concept of *Shari'ah* as the main source of Islamic finance may be different in different Islamic Schools of thoughts. In other words, its concept and scope depend on human

[261] Cizakca (n 240) 197; arguments against conventional insurance has been rejected by some jurists, such as Mustafa Al-Zarqa. He argues that parties in an insurance transaction are joined in a cooperative manner against future loss. Mohd Masum Billah, *Applied Takaful and Modern Insurance: Law and Practice* (3rd edition, Sweet & Maxwell 2007) 74-77.
[262] Cizakca (n 240) 200.
[263] ibid.
[264] ibid.
[265] ibid 201-202.

quality involved in the interpretation of revealed sources, namely the *Quran* and *Sunnah*. In fact, *ijtihad* as a process of extracting God's will from the *Quran* and *Sunnah* by Shari'ah jurists bears an individualized or personal character.

In this regard, although the pluralism in Islamic finance reflects the richness of classical *fiqh*, as the result of the intense juristic divergence in the industry, it has generated difficulty for Islamic financial institutions to achieve *Shari'ah* objectives (economic well-being and wealth protection). The plurality of legal opinions has seemingly produced contradictory implications for the Islamic financial industry. In this regard, it led to an adaptable legal system to survive the test of time, but at the same time endangers the stability and the development of the system by Shari'ah risk. In fact, endeavours by international standard setting bodies, such as the IFSB and the AAOIFI in the harmonization of Islamic financial industry practices require more national supports. However, since Islamic financial industry shares the same characteristics with conventional financial system in terms of structure and governance, it must follow the same regulatory path established by national and international authorities. In other words, international regulations serve as soft laws and bear soft power in shaping the operation of Islamic financial institutions and also in the harmonisation of Shari'ah rulings in the industry. In fact, although *Shari'ah* is the main source of Islamic finance, it is not the only one as international financial regulation has deep effect on the operation of the industry.

Chapter Three

The Significance of Shari'ah Boards in the Context of Islamic Finance

3.1 Introduction

Control is an essential concept in the good governance of financial institutions. It may take various forms such as legal and ethical. In this regard, the design and implementation of a control system addresses the goals of the financial institution and supports its governance in pursuing its economic or non-economic purposes according to the assumed principles. The operation of Islamic finance industry is based on conventional precepts, thus it shares common goals with conventional financial system. However, the religious feature of Islamic finance led to intense differences in terms of product engineering and the operation of Islamic financial institutions. In this regard, Shari'ah boards are considered as Shari'ah compliance gatekeepers as they provide the industry with legitimacy in the eyes of stakeholders. This chapter examines the significance of Shari'ah boards in the context of Islamic finance industry in terms of the development of the industry. In this regard, its approach is mainly doctrinal and addresses the implications of Shari'ah boards and Shari'ah jurists' divergence of opinions on the industry integration. The first part reviews the historical development of Shari'ah boards, then explains how different

regulatory systems may affect their functions. At the end, financial innovation is explained in terms of diversity in the opinions of Shari'ah boards.

3.2 The Historical Development of Shari'ah Boards

The development of Shari'ah boards is rooted in the economics' views of Islamic scholars. In the early of the twentieth century Islamic economics was perceived as an antidote to socialism and capitalism. Its emphasis was on justice and freedom from colonial exploitation by a return to Islamic ideals such as elimination of poverty, decrease of inequalities and distribution of wealth.[266] Despite the existence of prevailing Islamic movements, there were few references to the *Shari'ah* as a set of codified laws at a particular time and place (*fiqh*).[267] In other words, objectives or *maqasid al shari'ah* were the main concerns, and there were no fundamental role for Shari'ah scholars.[268]

The issue of riba-free banking and finance can be traced back to the mid-twentieth century. In this regard, the first writings on interest-free banking were presented in the 1940s by Muslim economists, not by *Shari'ah* jurists trained in traditional Islamic schools.[269] The flood of technical writings by Shari'ah scholars over the subject started in the mid-1970s.[270]

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[266] Mohammad Nejatollah Siddiqi, 'Shariah, Economics and the Progress of Islamic Finance: The Role of Shariah Experts' (Paper presented at the workshop on select ethical and methodological issues in Sharia'-compliant finance, Seventh Harvard Forum on Islamic Finance, Cambridge, Massachusetts, USA 2006).
[267] ibid.
[268] ibid.
[269] Mohammad Nejatollah Siddiqi, '*Muslim Economic Thinking: A Survey of Contemporary Literature'* (the Islamic Foundation 1981); for instance, Islam and theory of interest by Ouishi, al riba by Maududi and social justice in Islam by Sayyed Qutb.
[270] Siddiqi (n 266).

Alongside informal endeavours in establishing Islamic finance institutions from the early 1950s to the late 1960s[271] the first two actual Islamic banks were founded in the mid-1960s in Dubai by Sheikh Saeed bin Luthah and in the early 1970s by the government of Egypt.[272] Contrary to the religious form and approach of the mentioned banks, there is no record of a formal effort to institutionalize a Shari'ah body for developing the riba-free banking and finance according to Islamic law.[273] The first formal phase of alliance between Islamic finance industry and Shari'ah scholars traced back to the mid-1970s and the early 1980s. The sudden increase in oil revenues and the formal establishment of large-scale banking institutions such as the Dubai Islamic Bank, Kuwait Finance House, Dar Al-Maal Al Islami and Dallah Al-Baraka Group, necessitated searching for financial and legal cods based on *Shari'ah*.[274] In this regard, Shari'ah experts mainly served as private advisors and most of their early *fatwas* discuss fundamental profit-and-loss sharing contracts like *Mudarabah* or *Musharakah* and accordingly there was no systemic effort to engineer Islamic financial products as substitutions for conventional products.[275] However, need for credibility and legitimacy led newly established Islamic banks to form a formal Shari'ah body in their governance structure. The Faisal Islamic Bank of Egypt in 1976 established the first Shari'ah board and accordingly this tradition was continued by the Jordan Islamic Bank and the Faisal Islamic Bank of Sudan.[276] In this regard, the establishment of Shari'ah boards in corporate governance of Islamic financial institutions in some countries

[271] The first experience was Tabung Hajji as a government-sponsored-and-supervised financial institution established in the 1950s by Malaysia and the second one was Mit Ghamr established in Egypt in 1963.
[272] The Nasser social bank.
[273] Monzer Kahf, 'Islamic Banks: the Rise of a New Power Alliance of Wealth and Shari'a Scholarship' in Clement M. Henry and Rodney Wilso (eds) *The Politics of Islamic Finance* (Edinburgh University Press 2004) 17-36; Yahia Abdul-Rahman, '*the Art of Islamic Banking and Finance'* (Wiley 2010) 75.
[274] Yahia Abdul-Rahman (n 273).
[275] Siddiqi (n 266).
[276] Kahf (n 273) 21-23.

such as Malaysia, Jordan and Egypt got statutory mandate and in other jurisdictions it reflects a customary tradition.

Further, globalization and technology advances in the 1990s accelerated the growth of Islamic finance industry. As a consequence, competition in the market encouraged the managers of new international Islamic investment funds to get Shari'ah scholars on board to gain more acceptance from potential clients.[277] Further, the new mandate in Islamic institutions also brought *Shari'ah* governance to international Islamic standards setting bodies' attention and acknowledged some departures from the early practices in Shari'ah advisory role.[278]

3.3 The Function of Shari'ah Boards

The authoritative interpretation of the principles of *Shari'ah* in the context of commerce and finance is a multi-dimensional issue. In this regard, an efficient and effective *ijtihad* by Shari'ah scholars considers religion, economic, political and cultural facts together.[279] It should regard the context of the given issue and rule according to expertise. In this regard, generally there has been no clear definition for Islamic financial institution, and in the case of Islamic banking, laws of jurisdictions with Islamic banking systems also present no definite concept.[280] For example, Malaysia with a dual banking system in which Islamic financial institutions operate alongside conventional financial institutions, Islamic banking is defined as: 'banking business whose aims

[277] ibid.
[278] AAOIFI, 'Governance Standards for Islamic Financial Institutions No 1, Shari'ah Supervisory Board: Appointment, Composition and Report', accounting, Bahrain 2010); IFSB, 'Guiding Principles on Shari'ah Governance Systems for Institutions Offering Islamic Financial Services' (Malaysia 2009).
[279] Warde (n 5) 234.
[280] Mohd Daud Bakar, 'The Shari'a supervisory board and issues of Shari'a rulings and their harmonisation in Islamic banking and finance' in Simon Archer and Karim Rifaat (eds) (n 144).

and operations do not involve any element which is not approved by the Religion of Islam.'[281] Also, other jurisdictions such as Iran with complete Islamic banking system, banking laws[282]do not present a clear-cut definition for Islamic banking.[283]

The legal nature of Islamic banking and finance operation shares the same characteristics and qualities with conventional finance. However, adherence to Islamic standards and mechanisms is the distinctive feature of the Islamic finance industry. In fact, Shari'ah certification is the most important distinction between conventional and Islamic financial industry.[284] Although, Shari'ah boards are responsible to supervise the Shari'ah compliant operation of Islamic financial institutions, there is no standard definition for the Shari'ah supervision task,[285]and accordingly no standard definition for Shari'ah governance. However, it is generally defined as a process of review, investigation and analysis of the Islamic financial institution operation to ensure its compliance with *Shari'ah*.[286] In this regard, Shari'ah certification reveals the main objective of Shari'ah supervision, namely ensuring that all activities of an Islamic financial institution are align with *Shari'ah* principles.[287]Further, Shari'ah boards play a crucial role in the development of Islamic finance industry. Shari'ah supervision is aimed at improving the efficiency of Islamic financial products and the enhancement of Islamic financial markets' depth and breadth. In other

[281] Malaysia Islamic Banking Act 1983, s 2.
[282] Iran has a complete Islamic financial system.
[283] The Law for usury-free banking (1983) defines objectives and duties of Islamic banking in Iran.
[284] Yusuf Talal DeLorenzo, 'Shari'ah Supervision in Modern Islamic Finance' <https://www.guidanceresidential.com/blog/wp-content/uploads/2015/05/shariah_supervision_in_modern_islamic_finance.pdf> accessed 6 August 2015.
[285] Samy Nathan Garas and Chris Pierce, 'Shari'a Supervision of Islamic Financial Institutions' (2010) 18 (4) Journal of Financial Regulation and Compliance 386.
[286] Abu Ghudda, 'Shari'a Supervisory Boards: Establishment, Objectives, and Reality' (Proceedings of the First Annual Conference of AAOIFI, Bahrain 2001) 1-24; Hussein Shehata, 'Organizational Management, Administration and Responsibilities of the Shari'a Supervisory Board in Islamic Financial Institutions' (1991) 116 Islamic Economic Journal 41-8; the role of Shari'ah boards in the governance of the Islamic financial institutions is discussed in the following chapters.
[287] AAOIFI (n 278).

words, efficient Shari'ah supervision assists Islamic financial institutions in engineering Shari'ah compliant products through efficient *ijtihad* and supervision. As a consequence, it enhances profitability of Islamic financial institutions[288] and accordingly results in development and integration of markets.

The role of Shari'ah supervision in Shari'ah certification and the development of Islamic financial markets reflect the nature of Shari'ah boards as legitimate control bodies[289] in the governance of Islamic financial institutions. They carry consultative and supervisory responsibilities to ensure conformity of Islamic financial institutions' internal and external operations with *Shari'ah*. In this regard, Shari'ah scholars exercise *ex ante* and *ex post* religious audits by reviewing financial products' structure and operations.[290] According to the IFSB:

'The mechanism for obtaining ruling from Shari'ah scholars, applying fatwa and monitoring Shari'ah compliance shall cover:

- Both ex ante and ex post aspects of all financial transactions carried out by IIFs-that is, to ensure Shari'ah compliance of the contracts, and later the performance of obligations under the contract; and
- Operations of the IIFS, including aspects such as Shari'ah compliance review, investment policies, disposal of non-Shariah-compliant income, charitable activities, etc.'[291]

[288] R. El-Khelaifi, 'Shari'a Supervision: Its Importance and Impact on the Profitability of Financial Institutions' (the Second Annual Conference of AAOIFI, Bahrain 2002) 1-10.
[289] Warde (n 5).
[290] Siti Faridah Abdul Jabbar, 'Investor Protection in the Islamic Financial Services Industry' (PhD Thesis, Institute of Advanced Legal Studies, University of London 2010) 135.
[291] IFSB (n 278) 11.

In this regard, *ex ante* and *ex post* advisory and controlling functions of Shari'ah boards include:

- Issuing fatwa according to enquiries submitted by board of directors or any other Interested party;
- Reviewing and revising all the institution transactions;
- Working with advisors in preparing contracts;
- Participating in researches related to Shari'ah issues such as directing *zakat* (alms) resources and determining its rate or percentage;
- Reviewing the institution's operations.[292]

Further, Shari'ah boards control Islamic financial institutions' operations and if they find any *haram* activity, Islamic financial institutions should purify generated revenue by donation to charity.[293] With respect to Islamic financial institutions' *haram* activities and financial crimes, theoretically, it is held that, since one of the responsibilities of Shari'ah boards is to ensure that Islamic financial institutions are not involved in any *haram* activity, thus prevention and control of financial crimes falls within the scope of their duties. In this regard, they discharge this responsibility as *Amin* through reviewing decisions and operations of the board of directors.[294] Watching others' property as an *Amin* in Islam refers to: 'namely a person or governance body that occupies a position of trust', and accordingly since Shari'ah boards should examine the rightfulness of decisions and operations of Islamic financial institution, they are considered *Amin*

[292] Abdelgadir Banaga, Graham Ray and Cyril Tomkins, *External Audit and Corporate Governance in Islamic Banks* (Avebury 1994); Nathan Garas (n 285) 7-8.
[293] Simon Archer and Rifaat Ahmed Abdel Karim, 'Introduction to Islamic Finance' in Archer and Karim (eds) (n 144) 6.

in the industry.[295] However, in practice, identifying and combating financial crimes require profound expertise and knowledge.[296] Further, in line with the provision of the legal maxim, 'Adjudication of a case is an offshoot of its conception' and concerning the formal responsibilities mentioned earlier for Shari'ah boards, it is hard to regard them responsible in this issue.[297] In other words, the main function of Shari'ah boards should be considered in terms of Shari'ah compliance and Shari'ah supervision since their function is part of the internal Shari'ah control and is done by assistance of internal Shari'ah department (audit) as an internal committee and integral part of the institution governance.[298]

As discussed earlier, historically, the involvement of Shari'ah scholars in legal and non-legal issues has been through *ijtihad* and fatwa issuing. In this regard, their involvement in Islamic finance in the form of Shari'ah board's membership or individual jurist still reflects the same techniques. However, it is worth noting that their functions now may be influenced by various factors such as financial regulations and politics. Particularly, at individual level their fatwas are mainly limited to specific financial institutions and more subject to regional variations.[299]At international level, Shari'ah boards' engagement in Islamic finance takes a broader scope as they

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[294] Siti Faridah Abdul Jabbar, 'Financial Crimes: Prohibition in Islam and Prevention by the Sharia Supervisory Board of Islamic Financial Institutions' (2010) 17 (3) Journal of Financial Crime 2.

[295] Ibid.

[296] ibid 3.

[297] Abdul-Razzaq A. Alaro, 'Sharia Supervision as a Challenge for Islamic Banking in Nigeria' in Oloyede I.O. (ed.), *Al-Adl (The Just): Essays on Islam, Islamic Law and Jurisprudence*' (Ibadan, 2009) 53-72. http://unilorin.edu.ng/publications/Sharia%20supervision%20in%20Islamic%20Banks.pdf accessed 2 March 2013.

[298] Internal Shari'ah audit operates under the established policies of the Islamic financial institution. It should have a charter consistent with Shari'ah rules and approved by the Shari'ah supervisory board. Mufti Aziz Ur Rehman, 'The Role of the Shari'ah Auditor' Newhorizon <http://www.newhorizon-islamicbanking.com/index.cfm?action=view&id=11420&section=features> accessed 1 July 2012.

[299] Anne-Sophie Gintzburger, 'An Analysis of Global Trends and Regional Pockets in the Application Islamic Financial Contracts in Malaysia and the Gulf Cooperation Council' in Kabir Hassan and Michael Mahlknecht, *Islamic Capital Markets* (Wiley 2011) 311.

involve in standard-setting in organizations such as AAOIFI and the International Islamic *Fiqh* Academy (IIFA). In this regard, adherence to the fatwas of these international organizations is voluntary and accordingly they only carry customary status through which Islamic financial institutions in different jurisdictions can achieve harmonization in Shari'ah boards' responsibilities.[300] Further, although the fatwa-issuing function of these influential organizations is in collective form, some members Shari'ah trends have more influence on the process and result of *ijtihad*. In other words, although these fatwa bodies endeavour to harmonize Shari'ah authority through consensus-building, some *madahib* are considered more prominent than the others. For instance, the International Islamic *Fiqh* Academy as an influential international organization is regarded a multi-Islamic legal school, in which opinions are supposed coming from all the *Sunni* and *Shia* schools of thought (*Hanafi*, *Maliki*, *Hanbali*, *Shafei*, *Jafari*, *Zaydi* and *Zahiri*). However, in practice opinions from the *Hanafi, Maliki* and *Hanbali* are more pronounced in discussions of the organization.[301] Although, this fact acknowledges the existence of different interpretive approaches in Islamic *fiqh,* the prominent place of some Schools hinders intellectual development of Islamic *fiqh*.

In this regard, the legalistic approach tries to review Islamic finance issues from the classical *fiqh* point of view and accordingly aims to implement classical *fiqh al-muama'lat*. In the other hand, the economic approach relies more on efficiency of the products and not full implementation of classical *fiqh*. It seeks to provide the industry with efficient interpretation for prohibition of *riba*, *gharar* and *maisir*. In the IIFA example, to discover sound opinion and also

[300] Laurent L. Jacque, 'Financial Innovations and the Dynamics of Emerging Capital Markets' in Laurent L. Jacque and Paul M. Vaaler (eds) *Financial Innovations and the Welfare of Nations* (Kluwer Academic Publishers 2001) 35.
[301] Jean-Mathieu Potvin, 'Shaping Interpretive Communities by Debating Irregular Opinions' (Feb.2013) 3 (1) ISFIRE 20, 20-21.

to eschew diversity of opinions, the Academy employs a conservative and hanbali-oriented practice through which irregular opinions have no legal effect.[302] An irregular opinion is regarded 'contrary to definitive and certain texts and those that have been subject to consensus'.[303] This fact demonstrates the isolated status of innovative reasoning or 'irregular' opinions in the Academy resolutions.[304] For instance, on interpretation of *gharar* and injunctions banning conventional commercial insurance, Mustafa al-Zarqa one of the founding members of the Academy, had been defending commercial insurance by presenting innovative interpretation over *gharar* and risk taking. In his view, insurance contracts as an institution minimize *gharar* and uncertainty. His opinion was rejected by the Academy members such as Wahab Zuhayli and regarded as positive lawyers approach.[305]

In this regard, the prevailing approach in the industry is also clear in definitions and requirements of Shari'ah boards' membership provided by international standard-setting organizations. For instance, AAOIFI governance standards for Islamic financial institutions No 1 on Appointment, composition and report of Shari'ah boards gives the following definition:[306] 'A Shari'a supervisory board is an independent body of specialised jurists in *fiqh al-mu'amalat* (Islamic commercial jurisprudence). However, the Shari'ah supervisory board may include a member other than those specialised in *fiqh al-mu'amalat* but who should be an expert in the field of Islamic financial institutions and with knowledge of *fiqh al-mu'amalat*. The Shari'ah supervisory board is entrusted with the duty of directing, reviewing and supervising the activities

[302] ibid.
[303] The International Fiqh Academy (Resolution No 153).
[304] Potvin (n 301).
[305] ibid 22; also Shaykh Sayyid Tantawi innovative fatwa over permissibility of collection of interest on conventional bank deposits based on profit and investment argument has been opposed by the Academy as well.
[306] AAOIFI (n 278).

of the Islamic financial institution that they are in compliance with Islamic Shari'ah rules and principles. The fatwas and rulings of the Board shall be binding on the Islamic financial institution.' In this regard, the International Association of Islamic Banks describes general characteristics of the Shari'ah Board as follows: '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 legitimate Control Body has the same means and jurisdictions as the auditors of accounts.'[307]

The provided definitions reveal common and the most fundamental characteristic of Shari'ah scholars, namely their knowledge in *fiqh al-muamalat* or Islamic commercial Jurisprudence. This is held mainly due to commercial nature of financial and banking issues.[308] However, interpretation and application of *Shari'ah* principles by Shari'ah boards in the context of Islamic finance is an ethical task and not legal.[309] In other words, applying *Shari'ah* principles as legal rules in the form of modern state-enacted law requires codification.[310] Legal validity of human acts in *Shari'ah* is categorized from valid (*sahih*) to null (*batil*). When *Shari'ah* principles are enacted as state law, they fall into this category and accordingly are regarded as law.[311] In countries like Iran which legal system is Islamic (Following 1979 Islamic revolution) and

[307] Hmed El-Nagar 'and others, *One Hundred Questions & One Hundred Answers Concerning Islamic Banks* (Islamic Banks International Association 1980) 20.
[308] Bakar (n 280) 76.
[309] Kilian Balz, 'Sharia Risk? How Islamic Finance Has Transformed Islamic Contract Law?' (Islamic Legal Studies, Harvard Law School 2008) 7.
[310] ibid.
[311] ibid 12.

conventional laws in banking business have been changed and new Islamic codes are enacted, *Shari'ah* principles carry legal status as the result of state enactment and not based on individual interpretation of Shari'ah scholars. This fact could be the reason for non-existence of Shari'ah boards in Iran financial institutions.

The other category encompasses religious assessment, ranging from obligatory (*wajib*) to forbidden (*haram*). *Shari'ah* principles in the context of Islamic finance are only employed to discover permissibility or religious place of the transactions.[312] In other words, 'Islamic finance has the effect of reducing Islamic law to business ethics'[313] and accordingly it has deep effect on divergence of opinions over permissibility of financial products. In this regard, further to plurality of Islamic schools of thought, cultural identity and local needs led to diversity of *ijtihad* in Islamic finance too. Despite the acceptance of the principle of permissibility (*ibahah*) in *muma'mallat* by all *madahibin*, Shari'ah scholars have dissimilar opinions about its conceptual scope.

3.4 The Regulation of Shari'ah Boards

The lawfulness of financial activities and products is a pre-requisite for sound operation of markets in both secular and religious sense.[314] In the context of Islamic financial industry, *Shari'ah* is the crucial criterion for lawfulness and its implementation and assessment is done by Shari'ah boards of Islamic financial institutions. In other words, lawfulness in the Islamic finance industry carries a dual quality determined by religious and conventional institutions. In

[312] ibid 13.
[313] ibid.
[314] Barry Rider, 'Legal Aspects of Asset Securitization' (n 54) 50.

addition, the religious role of Shari'ah scholars and Shari'ah boards (as guardians of ethics in the industry), their power, structure and function are derived from variety of sources such as national and international regulatory laws and standards[315], the constitution and the internal policy of the Islamic financial institution and religious education of Shari'ah scholars.[316] In this regard, *Shari'ah* framework in each jurisdiction is subject to the existence of Shari'ah supervision. Also, the form of regulatory collaboration between national authorities and individual Islamic financial institutions over Shari'ah supervision affects the Shari'ah framework.

As discussed before, since many Contemporary financial products have not been addressed in *fiqh* and the revealed sources of *Shari'ah*, the necessity of *ijtihad* is acknowledged in Islamic finance by all market players.[317] In jurisdictions with national regulatory authority with responsibility to lead and control the framework of *ijtihad*, Islamic finance industry has more harmonised structure. However, in comparison with decentralized regulatory approach, centralized regulation demonstrates a slow model in product development.[318] For instance, due to lack of a centralized regulatory authority in the GCC region, Shari'ah boards can follow a market-based approach in product engineering, hence being faster in adopting new products.

3.4.1 Shari'ah Boards in Malaysia

[315] For instance, Jordan Banking Law 2000; Malaysia Central Bank Act 1958 and its amendment in 2003; Kuwait Islamic Banking Act 2003.
[316] Garas (n 285) 3; Gintzburger (n 299) 313.
[317] Gintzburger (n 299).
[318] ibid 316.

Shari'ah governance system in Malaysia follows a centralized and pro-active regulatory approach.[319] Pursuing its development goals, Shari'ah governance pattern in Malaysia seeks to integrate and harmonize innovation in Islamic financial market. In this regard, there are two central Shari'ah Boards, one for securities commission (SC) and one for the Bank Negara Malaysia (SAC).[320] the Shari'ah Advisory Council of the central bank is established under the Central Bank of Malaysia Act 1958 (amended in 2003 and the new one in 2009) to decide on *Shari'ah* matters relating to banking and financial business.[321] The SAC and SC have presented resolutions and standards over Shari'ah compliance and governance issues which must be considered in operations of respective Islamic financial institutions. In this regard, regulatory authorities have power to monitor the operation of Islamic financial institutions and assess their adherence to standards. For instance, the appointment of Shari'ah boards' members must be approved by SAC.[322] Further, regarding Shari'ah boards responsibility in issuing fatwa over Shari'ah compliance aspects, SAC is responsible to validate Islamic financial products to ensure their Shari'ah compliance. This fact reflects the regulatory influence of SAC and SC standards on Shari'ah boards' functions.[323] In other words, Shari'ah boards in Malaysia have complementary role[324] and endeavour to adapt their decisions to established regulatory

[319] Zulkifli Hasan, 'Regulatory Framework of Shari'ah Governance System in Malaysia, GCC Countries and the UK' (2010) 3-2 Kyoto Bulletin of Islamic Area Studies 82, 84. http://www.asafas.kyoto-u.ac.jp/kias/1st_period/contents/pdf/kb3_2/07zulkifli.pdf accessed 6 August 2015.
[320] Bank Negara Malaysia, Shari'ah Resolutions in Islamic Finance (2nded 2010); Suruhanjays Sekuriti, Resolutions of the Securities Commission Shari'ah Advisory Council (2nded 2007).
[321] Hamid Ibrahim, 'Islamic Banking Act 1983 (Act 276)' in Hamid Ibrahim and Nasser Hamid (eds) *Islamic Banking and Finance* (Gavel Publications 2007) 253.
[322] Gintzburger (n 299).
[323] ibid 315.
[324] Hjh Siti Faridah Abd Jabbar, ' The Governance of Shari'ah Advisors of Islamic Financial Institutions: The Practice in Malaysia' (2009) 30 (10) Company Lawyer 10 (2009) 312.

standards.[325] Although, this approach slows down the process of product development, provides more stability, harmonization and security for innovative products, thus contributes to an effective and conductive Shari'ah framework for development of the Islamic finance industry.[326]

3.4.2 Shari'ah Boards in the GCC

The most of the GCC countries (with the exception of Oman and Saudi Arabia) follow a minimalist regulatory approach[327] since regulatory authorities do not intervene in regulation of Shari'ah boards, and Islamic financial institutions individually are free to decide on Shari'ah compliance aspects of their operation. In this sense, each Shari'ah board has authority to dictate and follow particular *fatwas* and *Shari'ah* rules.[328] This approach indicates the influence of some Shari'ah boards (generally more from the *Hanbali* School) such as Kuwait Finance House on engineering and operation of some products. For instance, since sell of debt is not permitted by most of Islamic schools of thought such as the *Hanafi*, *Maleki* and *Hanbali*, products based on *bay al-inah* are not accepted by Shari'ah boards in the GCC. In this regard, some scholars have the power to influence the market.[329] For instance, the *fatwa* of Taqi Usmani, president of AAOIFI, in 2007 against *Sukuk*, launched a shockwave in the Middle East and caused a noticeable decline in *Sukuk* issuance. The contentious fatwa demonstrates the extra-economic power of religious and financial authority in Islamic finance and also non-financial incentives

[325] ibid.
[326] ibid.
[327] Hasan (n 319).
[328] Gintzburger (n 299) 316.
[329] ibid.

driving investors in the Middle East.[330] Although this approach helps the quick progress in development of products[331], diversity of opinions, lack of harmonization, risk of non-recognition of products in other markets and high risk of fatwa shopping have exposed the industry to a non-uniform shape.

3.5 Divergence in the Interpretation of Shari'ah and Islamic Finance Products

Financial innovation is the cornerstone of financial industry development. The history of finance is a chronicle of innovations.[332] Financial innovation is defined as any new development in a financial system to enhance the *allocational efficiency* of the financial intermediation process and also to improve the *operational efficiency* by reducing cost and risk of transactions.[333] However, the term 'new' is not congruent with the innovation.[334] In other words, it is important to separate the 'the plain improvement' from the true innovation.[335] In this regard, a qualitative assessment is required to differentiate between a purely different (adaptive) and a truly innovative product or process.[336] while true innovative products or processes reconfigure the relevant opportunity set to achieve new objectives and hence improve

[330] David Bassens, Ben Derudder and Frank Witlox, 'Setting Shari'a Standards: On the Role, Power and Spatialities of Interlocking Shari'a Boards in Islamic Financial Services' (2011) 42 Geoforum 94. http://isiarticles.com/bundles/Article/pre/pdf/12063.pdf accessed 6 August 2015.
[331] ibid.
[332] Mark D. Flood, 'Two Faces of Financial Innovation' (Sep/Oct 1992) 74 (5) Federal Reserve Bank of St. Louis Review 3, <http://research.stlouisfed.org/publications/review/article/2563> accessed 28 May2013.
[333] Laurent L. Jacque, 'Financial Innovations and the Dynamics of Emerging Capital Markets' in Laurent L. Jacque and Paul M. Vaaler (eds.) (n 300) 2.
[334] Charles R.P. Pouncy, 'Contemporary Financial Innovation: Orthodoxy and Alternatives' (1997-98) 51 SMU Law Review 505, 515-516.
[335] Pouncy (n 334).
[336] ibid 516.

profitability (model innovation), adaptive innovations are incremental ways of 'bundling' and unbundling the existing instruments and methods to achieve desired objectives in a more efficient way (process innovation).[337]

Islamic banking and finance provides an example of process innovation as endeavours to actualize the economic effects of conventional financial products by different mechanics.[338] For instance, in banking *salam* has been developed into parallel *salam* to facilitate the financing of commodities, and accordingly is regarded as a potential contract in the future markets in the Bursa Malaysia.[339] Another example is *Musharakah* contract has been developed to a new product (*musharakah mutanaqisah*) used in home financing.[340] In this regard, as Dar says: 'Islamic financial innovation, the way it has been practiced, can be defined as the process of utilising Islamic legal contracts in new ways to develop financial products that are in compliance with *Shari'ah* and at the same time have the ability to replicate the economic effects of conventional financial products.'[341] In other words, although financial innovation in Islamic finance should be understood within *Shari'ah* framework, it follows the same economic purposes supposed for conventional financial innovation.

337 Humayon Dar, 'Islamic Financial Innovation: Tools and Trends' (2012) <http://www.edbizconsulting.com/articles/2012_07_11_Islamic_financial.pdf> access 12 Jun 2012; Jurg Niehans, 'Financial Innovation, Multinational Banking and monetary policy' (1983) 7 (4) Journal of Banking & Finance 537, 538; Pouncy (n 334) 516-517.

338 Dar (n 337); Yusuf Talal Delorenzo,'Shariah Boards and Modern Islamic Finance: From the Jurisprudence of Revival and Recovery to the Jurisprudence of Transformation and Adaptation' (IFSB Conference Presentation, London May 2004).

339 Ahcene Lahsasna and M. Kabir Hassan, 'The Shariah Process in Product Development and Approval in ICM' in Kabir M. Hassan (n 299) 25.

340 ibid.

341 Dar (n 337) 7.

Shari'ah compliant is the distinguishing feature of Islamic financial engineering,[342] and its conception is contingent upon the practice of individual or collective *ijtihad* resulted from a multitude of individual Shari'ah opinions. This practice of *ijtihad* has demonstrated a genuine adaptability quality in its applications to regional circumstances in terms of permissibility or non-permissibility of some Islamic financial contracts.[343] In other words, Islamic finance is the manifestation of the unresolved relationship between traditional Islamic schools of thought and changing social and cultural practices. As Lawrence Rosen stresses on the influence of locality upon *Shari'ah* (*Fiqh):* 'Islamic law, deferring to the local version of what facts mean to people's relationships, allows facts to speak to their consequences through local custom, personnel and standards.'[344]

Although, locality is the sign of flexibility, might be viewed as the result of non-existence of a central legislative authority to regulate different groups of people with widely disparate backgrounds.[345] It is of note here that, the practice of accommodating *Shari'ah* to fit social usage has been tempered by the doctrine of *Taqlid* (Imitation).[346] However, in practice, the need for the coordination of the ideal of immutable *Shari'ah* with the social changes led to a legal system consisted of underground doctrines such as *hiyal*, *maslaha* and *Istihsan*.[347] In this regard, the application of different methodologies in *ijtihad* in the context of different cultures and regions resulted in variations in opinions of Shari'ah boards over innovative financial products. In principle, the lack of harmonized approaches in interpretation of *Shari'ah* and also the

[342] In fact, Shari'ah compliance is the rationale behind the willingness to pay higher price for Islamic financial products known as Shari'ah premium by Shari'ah sensitive investors.
[343] Gintzburger (n 299) 307.
[344] Lawrence Rosen, *Law as Culture: an Invitation* (Princeton University Press 2006) 176.
[345] John Hursh, 'The Role of Culture in the Creation of Islamic Law' (2009) 84 (4) Indian Law Journal 1417.
[346] S.E. Rayner, *the Theory of Contracts in Islamic Law* (Kluwer Law International 1991) 23.

absence of firmly established market practices led to divergent trends in application of Shari'ah compliant products in Middle Eastern and South-east Asian markets.[348] Variations in opinions are particularly more evident in permissibility or non-permissibility of some innovative Islamic financial products such as some types of derivatives (options and forwards) in currency exchanges. However, Islamic finance has gone beyond those regions in which Islam is the predominant religion.[349] Initiatives in opening Islamic branches by conventional banks in the Europe and other regions, the existence of the Dow Jones Islamic Market Index, FTSE Global Islamic Index Series (GIIS), and also globalization of business practices have a strong influence on Shari'ah boards opinions and accordingly on structure of Shari'ah compliant products.

3.5.1 Shari'ah Framework and financial innovation

Before embarking on the topic of Shari'ah framework in the context of Islamic finance, it is prerequisite to ponder on the role of interpretation and *ijtihad*. Contract law is the cornerstone of financial operations.[350]The principles of contracts are expression of normative concept in any legal system, and this concept might take various forms in the context of which is implemented. In the context of Islamic finance, it is generally asserted that Islamic *fiqh* knows no theory of contract,[351] and the system of Islamic contracts is developed by Shari'ah Jurists.[352] *Fiqh al'muamalay* presents a non-systemised and non-codified legal order of contracts in which mutual consent is restricted by general principles of *Shari'ah* (prohibition of *riba*, *gharar* and

[347] ibid 22-23.
[348] Balz (n 309) 18-19.
[349] ibid.
[350] Rayner (n 346) 86.
[351] ibid.
[352] ibid.

maiysir) in the form of classes of nominate contracts with distinctive rules.[353] Thus, the doctrine of freedom of contract presents a narrow concept in *fiqh al'muammalat* contrary to what is perceived in the common law.

In this regard, the lack of a general theory of contract acknowledges the inevitability of interpretation. However, employing the variety of interpretive methods by different Islamic schools of thought on categorization and permissibility of contracts in the pre-modern juridical framework brought some implications for design and development of Islamic financial products. In other words, adherence to the classical approach in interpretation of Islamic contract law in the context of modern financial system led to a quasi-adaptive *ijtihad*. In Vogel words: 'Islamic finance insists, on the one hand, on the application of classical law, but also, on the other hand, seeks to become a thoroughly modern industry meeting all the modern needs its participants.'[354]

The quasi-adaptive approach endeavours to reach objectives of law by employing a restricted and pre-defined category of contractual framework. Contrary to this approach, a constructive interpretation imposes objectives on financial practices to reach an integrative *ijtihad* which incorporates both underlying moral principles and social needs.[355] The notion of *ijtihad* has a dynamic essence, and accordingly contradicts pre-existing classical interpretations. It expresses a plurality feature in which there is no pre-determined status before the intervention of *faqih* (Shari'ah jurist).[356] In this regard, the reason for existence of plurality and variation in opinions

[353] ibid 86-91.
[354] Frank E. Vogel, 'Ijtihad in Islamic Finance' (Proceedings of the Fifth Harvard University Forum on Islamic Finance, Cambridge, Massachusetts 2000) 121.
[355] Anver M. Emon, 'To Most Likely Know the Law: Objectivity, Authority, and Interpretation in Islamic Law' (2009) Hebraic Political Studies, forthcoming <SSRN: http://ssrn.com/abstract=1474746> accessed 6 August 2015; Ronald Dworkin, *Law's Empire* (1st ed, Harvard University Press 1986) 225.
[356] Bakar (n 280) 84.

in Islamic law is 'the revealed law is itself often undetermined and relative.'[357] In other words, changing socioeconomic situations affect the object of *ijtihad*, hence make disagreement in *ijtihad* inevitable and the formulation of *Shari'ah* as toil.[358]

Uncertainty in the interpretation of *Shari'ah* 'probable formulations of the law were expressions of jurists' fallible opinions, and opinion could vary from one jurist to another, giving pluralism in the law.'[359] Regarding relativism in Islamic *fiqh* and diversity of schools of thought, it is important to note, the authority of Shari'ah jurists in the context of Islamic finance is relative too. In principle, *Ijtihad* in Islamic finance is a product of intellectual effort of *faqih* bounded by rules and traditions of one of the schools of thought throough which presents its own interpretive approach. In other words, since *faqih* does not have a direct approach to interpretation of text (the *Quran*) and *Sunnah* (main sources of *Shari'ah*), his authority is relative.[360] As a consequence, the devotion for old classical *fiqh* and applying the conservative approach in interpretation of current rules and also in devising new rules has restricted innovation in financial products.[361]

The function of *ijtihad* in the context of Islamic finance is deeply influenced by regional diversity. Regarding geographical spread of Islam, main *Sunni* (*Hannafi*, *Maliki*, *Shafei* and *Hanbali*) and *Shi'ah* (*Jafari*) schools of thought are established in South East Asia and the Middle East. With such a variety in the contexts which Islamic finance is practicing, Shari'ah

[357] ibid.
[358] ibid; Bernard G. Weiss, *The Spirit of Islamic Law* (University of Georgia Press 1998) 89.
[359] Weiss (n 358) 88.
[360] ibid 113-133.
[361] Vogel (n 354) 122-123.

Boards of institutions offering Islamic financial products show a diverse pattern in permissibility over the use of Islamic contracts.[362]

Diversity in the interpretation of *Shari'ah* has been a privileged quality and part of legal culture of Islamic *fiqh*. However, in the context of globalized financial markets aiming for more integration, it raises doubts about its functionality. In this regard, although Shari'ah jurists have been resistant to state regulation and defended autonomy of the *madhhab* strongly,[363] the dematerialized and ever-changing international financial order necessitated the institutionalization of interpretations through collective *ijtihad* at national or transnational level. However, this task has not been done properly and Islamic finance industry developed separately in Southeast Asia and the Middle East[364] and accordingly despite having common *Shari'ah* sources, Shari'ah scholars have presented divergent interpretations over Islamic financial products.[365] For instance, whereas Islamic finance practice in Malaysia follows Mahathir's call for innovative *ijtihad*, in the Middle East it has demonstrated a legalistic approach to *ijtihad*.

Generally, there are two ranges of products in Islamic finance: Shari'ah-based and Shari'ah-compliant. Shari'ah-based products are those products have been addressed and introduced in Islamic *fiqh* based on rules of primary or secondary sources of *Shari'ah*. Shari'ah-compliant products are conventionally based products with specific structures which are imported and converted into Islamic products.[366] Concerning disagreements between Islamic schools of thought over the range and type of secondary sources, in practice all Shari'ah-based

[362] Gintzburger (n 299) 310.
[363] Muhammad Qasim Zaman, *Modern Islamic Thought in a Radical Age: Religious Authority and Internal Criticism* (CPU 2012) 92.
[364] Gintzburger (n 299) 313.
[365] ibid.
[366] Ahcene Lahsasna and M. Kabir Hassan (n 339) 37-39.

contracts and products such as *mudarabah*, *musharakah*, *bai bi thamin ajil*, *salam* and *istisna* are not accepted by all Shari'ah scholars. In this regard, rules and conditions of each contract are clarified in books of Islamic *fiqhs* based on each *madhab* practice. Accordingly, development of some of those contracts will not change their nature and the same rules apply to the developed contracts.[367] For example, all basic rules of *salam* govern parallel *salam* too.[368] Generally, Shari'ah-based accepted contracts in Islamic finance are: *mudarabah*, *musharakah*, *musharaka mutanaghisa*, *murabaha* and *istisna*. However, even though these are universally accepted Shari'ah-based contracts, their application may be divergent. For instance, while *mudarabah* contract is broadly accepted across different markets for project financing, in the GCC it is especially applied to deposit accounts, and in Malaysia *Wadiah* contract has a corresponding function.[369] Among Shari'ah-based contracts, *bai'al dayn* and *bai al ina*[370] are only applicable in Malaysia. Generally, Malaysia market encompasses all Shari'ah contracts approved by AAOIFI, Fiqh Academy and those applied in the GCC market.

Despite of diversity in the practice of Islamic finance, the development policies in the two regions have embarked some interactions between financial institutions. Pursuing development policy by Islamic financial hubs required the harmonization of *fatwas* and innovative trends. In this respect, despite the belief that standardization of *fatwas* would go against the dynamic nature of *Shari'ah* as it requires precedence of one school of thought,[371] the increasing need for foreign direct investment revealed the necessity of consistency in fatwas, standardization and

[367] ibid 37.
[368] ibid.
[369] Gintzburger (n 299) 318.
[370] *bai al ina* is applicable in cash financing in banking and also as the basis for *bai bithaminajil.*
[371] Jamal Abbas Zaidi, 'Shari'a Harmonization, Regulation and Supervision' (AAOIFI-World Bank, Islamic Banking and Finance Conference, Bahrain 2008).

harmonization of *ijtihad* at national and international level.[372] However, the consistency of opinions depends on the area of activity and aspect of the industry. For instance, risk management suffers from deep divergent opinions over permissibility of risk management products such as derivatives. Next sections examines the implications of divergent Shari'ah frameworks for Islamic finance industry with regard to derivatives instruments and money markets.

3.5.1.1 *Shari'ah* and Product Development

Product development is defined as: 'creating business, suggesting means to it, keeping in mind the realities and business prospects for the future.'[373] Product development in the context of Islamic finance refers to the process of developing assets in the form of products and services within the parameters of *Shari'ah*.[374] Further, highly competitive financial markets require products in line with customers' needs and at the same time adhering to respective national and international laws. In this regard, also ever-changing international financial markets bring necessity of engineering new products to the fore. For instance, the current financial crisis revealed the exigency of poor liquidity risk management and the need for an effective liquidity risk management policy and products.

In practice, Islamic product development mainly includes re-engineering of conventional products in accordance with *Shari'ah* principles.[375] As mentioned before, Innovation in Islamic finance is an adaptive innovation and all development and innovative ideas must be introduced

[372] Gintzburger (n 299).
[373] Muhammad Ayub, *Understanding Islamic Finance* (John Wiley 2011) 358.
[374] ibid.

and applied within the scope of classical *fiqh al muammalat*. In this regard, the involvement of Shari'ah boards in the process of product development is regarded as one of the requirements.[376] In this regard, they are responsible for giving *fatwa* on the products with the underlying supporting evidences to the Islamic investors.[377]

Since *Shari'ah* provides limited and vague principles, Shari'ah scholars must elucidate them with regard to the custom and contingencies of time. In this sense, *Shari'ah* paradigm in product development is subject to *Shari'ah* sources and mechanisms such as analogy, *istishab* and *maslaha*[378] used by Shari'ah scholars within their relative school of thought to remove hardship and bring benefit to mankind. Further, as the concept of freedom of contract in the context of Islamic *fiqh* essentially is limited to the classical nominate contracts'[379]Shari'ah boards try to develop products by employing different techniques, such as modifying, amalgamation and enhancement of contracts.[380] However, the explanation of those techniques requires the examination of regulatory regimes and their impact on Shari'ah boards' approaches in product development. In this regard, it is perceived that jurisdictions with dual financial systems (where the conventional and Islamic banking systems coexist) provide more competitive markets for financial institutions and accordingly for engineering of sophisticated products.[381] For instance In Malaysia Shari'ah advisors beside their very advising role for product development, also are

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[375] ibid.

[376] Aznan Hasan, 'The Role of Shari'a Advisor in the Development and Enhancement of Islamic Securities' in Aly Khorshid (ed) *Euromoney Encyclopedia of Islamic Finance* (1st ed, Euromoney Institutional Investor 2009) 49.

[377] Muhamad Muda and Abdullah Jalil, 'Islamic Financial Product Development: Shariah Analysis' (IIUM International Conference on Islamic Banking and Finance (IIC*i*BF), 'Research and Development: The Bridge Between Ideals and Realities' 2007).

[378] ibid 53.

[379] As Amin explains about freedom of contract: 'a matter of legal policy stating that individuals are free to change their rights as they please' Islamic law allows Autonomie de la Volonte which is 'a juristic principle stating that the free will of the individuals produces changes in rights.' Rayner (n 349) 97.

[380] ibid 55-58.

responsible for development of Islamic capital markets by proposing structures in line with the SAC and SC preferences and also conducting research for further development of capital markets.[382] In the UK although there is no special enactment or explicit responsibility for Shari'ah boards in developing capital markets, the competitive market of UK urges adopting flexible Shari'ah approach in product development.

In the development of Islamic financial products, modification and amalgamation have been the most popular techniques. By the modification, the structure of some Islamic nominate contracts are modified as they meet better modern financial needs.[383] For instance, *musharakah* and *mudarabah* in classical *fiqh* are based on the concept of *sharikah* as an equity finance mode by which two or more parties in a project sharing the profit and loss of the joint venture.[384] *musharakah* is intended to be perpetual and there is no determination of ceiling profit rate.[385] However, in the context of Islamic finance industry, *musharakah* essentially is a bond under which shares of partners are to be redeemed at a particular of time and the entitlement of investors are kept to a certain rate.[386] In other words, due to risky nature of the contract, issuers try to give the impression to the investors that their investment is secured.[387]

Another Islamic mode of innovation is combination of two or more nominate contracts. For instance, *ijarah sukuk* is comprised of *ijarah* and sale contracts. *ijarah* in *fiqh* mainly refers to

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[381] Muhamad Muda (n 377) 2.
[382] Aznan Hasan (n 376) 50-51.
[383] ibid 55.
[384] Muhammad Ayub (n 373) 307; Hasan, ibid p 58; Muhammad al-Bashir Muhammad al-Amine, '*Global Sukuk and Islamic Securitization Market, Financial Engineering and Product Innovation',* BRILL (2012) p205
[385] Hasan (n 376).
[386] ibid.
[387] ibid.

transferring the usufruct of a property in exchange for rent[388] and in essence, in its modern form, is a lease-based bond by which the originator of the *Sukuk* will sell certain assets to the issuer and then lease it back from him for the duration of the *Sukuk*.[389]

The practice of combination of different contracts to form a particular mode of financing has been criticized for being incoherent as it emulates the substance of conventional financial products by using variations on contract forms that were approved by pre-modern Shari'ah scholars, and consequently increases transaction costs.[390] Furthermore, reductionism and form-based product development approach led to a kind of regulatory arbitrage, in which Shari'ah boards try to reengineer and endorse products applied in conventional markets.[391] In this regard, divergent interpretations and implementations of *Shari'ah* principles in the form of Shari'ah-based and Shari'ah-compliant products in different regions and also the lack of standardization led to a practice of 'fatwa shopping', particularly in the GCC region with decentralized regulatory system. This innovation and product development approach is an established practice in all areas of Islamic finance, including risk management and liquidity management.[392] In this regard, innovative derivatives are a crucial issue in the industry as Shari'ah boards must reconcile their conventional concepts to Shari'ah forms.

3.5.1.1.2 Derivatives in Islamic Finance

[388] al-Bashir (n 384) 145.
[389] ibid 146-147.
[390] Mahmoud A. El-Gamal, 'Incoherence of Contract-Based Islamic Financial Jurisprudence in the Age of Financial Engineering' (n 92) 3.
[391] El-Gamal, 'Limits and Danger of Shari'a Arbitrage, Islamic Finance: Current Legal and Regulatory Issues' (Islamic Finance Project, Harvard University, Cambridge 2005) 117-131.
[392] El-Gamal (n 92).

Derivatives are the ultimate innovation of market economy. Changes in financial theory along with globalization, deregulation and advances in technology increased the flow of capital, consequently generated demand for new financial products.[393] The competitive impulses of these innovative products have led to changes in function of financial intermediation, which expanded from more straightforward credit intermediation to risk intermediation.[394]

In this context, hedging and intermediation of risk in *Shari'ah* as a way of reducing any substantial losses are permissible tasks, but only through *Shari'ah* acceptable means.[395] In this regard, speculative practice as the way of using available information to anticipate future price movements of securities and accordingly benefiting from price differences is not an acceptable practice under *Shari'ah* since it seeks no real business.[396] As discussed before, regarding prohibition of *riba* and *gharar* in *Shari'ah*, the prohibited risk is a deliberate injection of avoidable uncertainty to material substances of the transaction, such as subject matter and price.[397] Although most Shari'ah scholars have approved the necessity of risk management in the context of modern financial transactions, their legal argument is mainly structured based on *maslaha* and *dharurah*. In other words, *fiqh al muammalat* considers risk management as an exception to the transactions. In this regard, despite the difference between uncertainty (*gharar* and gambling) and hedging, Shari'ah scholars consider a strong gambling tendency in

[393] Bernard Karol, 'An Overview of Derivatives as Risk Management Tool' (1995) 1 Stanford Journal of Law, Business and Finance 195, 197-198.
[394] Stephen A. Lumpkin, 'Regulatory Issues Related to Financial Innovation' (2009) 2 OECD Journal: Financial Markets Trends <http://www.oecd.org/finance/financial-markets/44362117.pdf> accessed 6 August 2015.
[395] Mohammad A. Elgari, 'Current Trends in Islamic Finance and the Development of Islamic Hedge Funds' 6 <http://www.elgari.com/english/wp-content/uploads/downloads/2011/08/IslamicHedgeFunds.pdf> accessed 5 June 2013.
[396] Ahmad Abdel Fattah El Ashkar, 'Towards an Islamic Stock Exchange in a Transitional Stage' (1995) 3 1 Islamic Economic Studies 79.

derivatives transactions.[398] Hence, the main challenge for Shari'ah scholars in risk management is to distinguish risk taking from *ghara*r and gambling like transactions.[399] In other word, the overarching requirements for sale under *fiqh al-muammalat*, (namely Existence of subject matter of contract, ownership of asset and delivery)[400] and their interpretations are subject to profound disagreement between Shari'ah scholars.

As discussed before, innovation and product development in Islamic finance is an adaptive practice by which products are engineered based on nominate contracts. The type and range of basic nominate contracts in *fiqh al-muamallat* is contingent on the particular Islamic school of thought. Among them, only *modarabah, musharakah*, *ijarah*, *murabaha* and *istisna* are universally accepted, and other nominate contracts such as *salam, tawarrugh, kafalah, Bay al' dayn* and *urbun* are not applicable in product engineering of all Islamic financial institutions. As a consequence of such a diverse interpretive atmosphere in the industry, product development in terms of derivatives has demonstrated an inflexible pattern.

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[397] Nabil A. Saleh, '*Unlawful Gain and Legitimate Profit in Islamic Commercial Law: Riba Gharar and Islamic Banking'* (CPU1986) 64.

[398] Muhammad Ayub, 'Use of *W'ad* and *Tawarrugh* for Swaps in the Framework of Islamic Finance' (8th International Conference on Islamic Economics and Finance, Centre for Islamic Economics and Finance, Qatar Faculty of Islamic Studies, Qatar Foundation 2011) 3.

[399] Sami Al-Suwailem, 'Hedging in Islamic finance' (Islamic Development Bank, Occasional Paper No. 10, May 2006) 57.

[400] financial derivatives may be compatible with Shari'ah if they: '(i)address genuine hedging demand associated with effective and intended ownership (*qabd*) in an identifiable asset or venture,(ii) guarantee certainty of payment obligations arising from contingent claims, (iii) disavow deferment of contractual obligations (*nasi'a*) from the actual and direct transfer of a physical asset as the object of an unconditional transaction, (iv) contain collateralized payment for the use of risk protection but role out provisions aimed at generating unilateral gains from interim price changes of the underlying asset beyond the original scope of risk sharing (*sharik*) among counterparties parties, (v) eschew all prohibited sinful activities, in particular those deemed similar to gambling and speculation....' Andreas A. Jobst and Juan Sole, 'Operative Principles of Islamic Derivatives-towards a Coherent Theory' (2012) IMF Working Paper WP/12/63, 13 https://www.imf.org/external/pubs/ft/wp/2012/wp1263.pdf accessed 6 August 2015.

In this regard, the structure of Islamic derivatives is the result of amalgamation of two or more nominate contracts with combination of promise (*wa'd*). In other words, Complexity of Islamic derivatives arises from two reasons: 1- diversity of opinions over the acceptability of components (nominate contracts) of the derivative contract; 2- contradictory and diverse opinions with regards to operational and technical issues. Regarding intense legal pluralism in Islamic law, regulatory system of the jurisdiction in which the Islamic financial institutions operate and local custom affect Shari'ah boards opinions over the permissibility of the derivatives. In this regard, Inflexibility and diversity of opinions adversely have affected competitiveness and integrity of the industry.

3.6 Conclusion

Shari'ah supervisory boards as Shari'ah compliance gatekeepers bear an influential role in the development of Islamic finance. In this regard, their approach in interpretation of *Shari'ah* (legalistic or economic oriented) reflects a continuing historical authority which forms the industry practice. This authority in the context of Islamic finance shows a rapid evolvement from pure endorsement to advisory and auditing as now Shari'ah board's members from various schools of thought function as a legitimate control body in ex ante and ex post Shari'ah compliance auditing. However, there has been no agreed definition for Shari'ah supervision and this has had some negative implications for the industry in terms of integrity and development of markets. Fatwa as a historic tradition in *fiqh* has been regarded efficient when could solve the given problem according to exigencies of time. In the context of Islamic finance, an efficient fatwa requires attention to economic facts by Shari'ah board. In this regard, the current practice in the Islamic finance industry at national and international levels reflects a legalistic or classical

approach in *ijtihad* as Shari'ah boards main concern is adherence to the legal forms provided by classical *fiqh.* Although, some jurisdictions regulatory systems such as Malaysia their national development have affected this legalistic approach and changed it to more flexible *Ijtihad*, the practice of international standard setting organization still follows a conservative perception of *Shari'ah*. This approach particularly at national and individual levels of Shari'ah supervision impeded efficient innovation in financial products such as derivatives necessary for risk management.

Chapter Four

The Legal Relation of Shari'ah Boards with Islamic Financial Institutions

4.1 Introduction

The Rapid development of modern financial markets, advances in technology and accordingly in financial engineering led to convoluted legal relationships. Despite the complexity in financial contracts and differences in common law and civil law legal systems, globalization encouraged them to evolve into similar legal institutions. In this context, the increasing need for development in all markets reflects the importance of 'welfare'. It bears an extensive concept as its ultimate support for individualism encourages freedom of contract, and accordingly supports sustainable development. Further, the modern notion of 'welfare', as an objective for the operation of corporates, persists on functions not persons. In this regard, since the ever-changing markets' exigencies and preferences define new functions, legal institutions and Company laws evolve to keep pace with those changes. In this context, it is assumed that directors, employees and any person responsible for managing investors' money is in the position of fiduciary and accordingly is required to be loyal and avoid any conflict situation. In the context of Islamic finance, although fiduciary duties established in common law and statutes cover directors and employees of Islamic financial institutions as well (as there is no legal difference between them

and other directors employed in conventional financial institutions), there have been no legal place for Shari'ah boards. This chapter examines Shari'ah boards' legal relation with Islamic financial institutions. The first part explains the modern corporate law objectives and compares them with Shari'ah objectives. The next part studies the fiduciary position of Shari'ah boards in the context of English common law and at the end addresses their fiduciary duties with regard to Islamic financial institutions and investors.

4.2 Corporate Objectives and Its Implications for the Legal Relations of Corporate

The operation of modern corporations reflects an economic perception of law. Corporation, as a legal entity is an economic instrument and organization acts as a nexus of contracts between individual suppliers of various input (principals) and managers (agents) to generate economic profit. This view portrays the primacy of internal (private) relations in corporate law and its aim to maximize welfare of shareholders.[401] The privatized view over corporation is mainly based on the freedom-of-contract as it supports individual economic innovations in market economy and accordingly reinforces primacy of shareholders' welfare.[402] In this regard, the aim of granting separate legal personality to a corporate is to maintain and improve efficiency. From an economic view point, efficiency is subject to shareholders' interests. In the context of the UK law, the concept of the 'interests of the company' has been commonly equated with shareholders'

[401] David Millon, 'Theories of the Corporation' (1990) Duke Law Journal 201.

[402] ibid 203; the new economic theory of corporation is grounded on neoclassical economics and its root can be traced back to Coas's article about the nature of the firm and other conventional legal theorists' views over corporate theory such as Ross, Jensen and Meckling. See Ronal H. Coase, 'The Nature of the Firm' (1937) 4 (16) Economica 386; Stephen A. Ross, 'The Economic Theory of Agency: The Principal's Problem' (1973) 63 (2) American Economic Review 134; Michael C. Jensen and William H. Meckling, 'Theory of the Firm: Managerial Behaviour: Agency Cost and Ownership Structure' (1976) 3 (4) Journal of Financial Economics 305.

wealth maximization.[403] As stated in *Brady v Brady*[404]: 'the interests of the company as an artificial person cannot be distinguished from the interests of the persons who are interested in it'.

The economic rationale and efficiency justification behind the predominance of shareholders' interests in the UK corporate law is that as they are residual risk bearers contracted for a promise to maximize the value of their stock, their interest is allied with the solvent company.[405] Further, as shareholders have the incentive to bear more risks so they are likely to foster economic efficiency.[406] In this regard, the economic objective has some implications for corporate legal relations as its contractarian nature persists on relations and functions, not on persons. Also, the individualism in the contractarian theory reveals its 'instrumental effect in justifying the prevalence of default rules in pursuit of the ultimate goal of shareholders wealth'.[407] In this context, English Law considers shareholders as contractual parties and entitles every member to observe and claim a right over company's articles.[408]

In line with contractarian, directors and persons entrusted with managing shareholders' money and regarded as trusted agents to maximize shareholders' value. Agency theory presupposes that agents are self-interested, thus divergence between their interests and the shareholders' results in

[403] T. Clarke, *International Corporate Governance: A Comparative Approach* (Routledge 2007) 281.
[404] *Brady v Brady* [1988] B.C.L.C. 20 CA (Civ Div) at 40, per Nourse L.J.)
[405] Frank H. Easterbrook and Daniel R. Fischel, *the Economic Structure of Corporate Law* (Harvard University Press 1991)36.
[406] Andrew Keay, 'Ascertaining the Corporate Objectives: An Entity Maximization and Sustainability' (2008)71 Modern Law Review 663.
[407] Shuangge Wen, 'Revisiting the Corporate Objective through the Economic Lens: the UK Perspective' (2013) 8 International Company and Commercial Law Review 302.
[408] *Salmon v Quin & Axtens Ltd* [1909] A.C. 442 HL; *Beattie v Beattie* [1938] Ch. 708 at 722, per Sir Wilfred Greene M.R; K. W. Wedderburn, 'Shareholders' Rights and the Rule in Foss v Harbottle' (1957) 15 (2) Cambridge Law Journal 194.

agency costs (as residual costs) and as a consequence impedes wealth maximization.[409] On this subject, the aim of corporate law is to provide mechanisms to reduce agency costs and to ensure an efficient alignment of agents and principles' interests.[410]

4.2.1 Shari'ah Objectives and Corporate Objectives: the Role of *maslahah*

As discussed earlier, the well-being of humanity is the ultimate objective of *Shari'ah*. The History of Islamic law acknowledges this fact as jurists have used different legal instruments to meet this objective. On this subject, *maslaha* has been considered as an instrument for legal reform to adjust and implement *Shari'ah* with regard to changes in human civilization. In other words, *maslahah* allows creativity and flexibility in terms of legal policies.[411] Further, *maslahah* through the underlying purposes establishes a balance between Islamic *fiqh* and objectives of *Shari'ah* when it (Islamic *fiqh*) does not present any legal solution for new legal incidents.

The concept of *maslahah* has evolved over the centuries as its definition has been under the influence of different social and political contexts. Literally, *maslahah* means benefit or interest, and in English is rendered as public interest. In this regard, *maslaha* is considered as the purpose of law. Al-Ghazali believed that *maslaha* is God's purpose in revealing the divine law to preserve essential elements of human mankind's well-being (religion, life, intellect, offspring and

[409] Juan Fontrodona and Alejo Jose G. Sison, 'the Nature of the Firm, Agency Theory and Shareholder Theory: A Critique from Philosophical Anthropology' (2006) 66 Journal of Business Ethics 33.
[410] ibid 8.
[411] Tawfique Al-mubarak and Noor Mohammad Osmani, 'Applications of Maqasid al-Shari'ah and Maslahah in Islamic Banking Practice: An Analysis' (International Seminar on Islamic Finance, India. October 2010) http://irep.iium.edu.my/4251/1/Applications_of_Maqasid_Shari%60ah.pdf accessed 20 October 2013.

property) and whatever protects these elements and averts harm is *maslaha*.[412] Al Ghazali theory of *maslahah* reconciled between rationalist objectivism of Muta'zil and theistic subjectivism of Ash'ari Schools of Islamic theology.[413] In this regard, *maslaha* is regarded as the means of legal change and guidance as jurists use in their decisions, particularly in *muamalat* issues which there has been no clear rule (*hokm*) for them. However, some jurists such as Ibn Tymiyya although considered *maslahah* as the purpose of law, they believe the priority of maslahah is absolute and should be applied over any text or interpretation of the law that goes against the purpose of *Shari'ah*.[414] In other words, the focus of *maslahah* here is on its role in guidance of decisions towards the objectives of *Shari'ah*.

Regarding the relation between the objectives of modern companies and *Shari'ah*, it is believed that *Shari'ah* presents a broader concept for corporate objectives as its ethical approach to social responsibility[415] holds the common good of society as the main ground for business activities. Accordingly, it establishes a common responsibility to create wealth for all in a fair way, and as a consequence assumes a collective religious obligation (*fard Kifayah*) for Muslims and Islamic financial institutions to follow its social-religious principles.[416] This approach is embedded in Islamic financial institutions articles of associations. In fact, the prohibitions of *riba, ghara* and *maisar* have a public good value which benefits capital providers and the society

[412] Muhammad al-Ghazali, *al-Mustasfa min 'ilm al-usl* (Vol. 2, Sharikat al-Madna al-Munawwara 1993) 481-2, 502-3.
[413] elicitas Opwis, 'Maslahah in Contemporary Islamic Legal Theory' (2005) 12 Islamic Law and Society 182, 188-189; the *Muta'zil* school believes in human intellect ability to know the value of acts without the aid of revelation and the *Asha'ri* school believse in inability of human intellect. Opwis, ibid.
[414] Felicitas Opwis, *Maslaha and the Purpose of the Law: Islamic Discourse on Legal Change from the 4th/10th to 8th/14th century* (Brill 2010) 2.
[415] Elizabet Garriage and Domenec Mele, 'Corporate social responsibility theories: mapping the territory' (2004) 53 Journal of business ethics 51.
[416] Sayd Farook, 'On Corporate Social Responsibility of Islamic Financial Institutions' (2007) 15 (1) Islamic Economic Studies 31, 32.

as a whole. However, in practice interpretation and operation of these principles have not presented an identical or comparable pattern. In the context of Islamic finance, the authoritative interpretation of *Shari'ah* is entrusted to Shari'ah boards. They act as a control body to ensure the compliance of the Islamic financial institutions with provided fatwas and accordingly assessing their operation with regard to corporate goals.

In this regard, it is discussed since in Islamic *fiqh* a *mufti* legal opinion based on *maslahah* is usually concerned about a single case, should not be regarded as public interest. It refers to public interest when the political authorities issue rulings within the sphere of *Shari'ah*.[417] Although the history of Islamic law acknowledges the individual-oriented feature (in the process of *ijtihad* and implementation) of fatwas, Shari'ah boards' fatwas in the context of international financial markets are not any more personal as they may have macro effects on their operation. Further, the modern corporation as an independent legal person has changed the perception over private property rights, and accordingly over the function of Shari'ah boards' fatwas as they are not absolute anymore. In this regard, in the context of Islamic finance, human wellbeing and sanctity of property take public feature as Shari'ah boards are required to deal with money of people in a public form. Thus, *maslaha* and Shari'ah objectives give a public feature to *fatwa* and legal opinions of Shari'ah boards.

4.3 Shari'ah Boards as Fiduciaries

The examination of Shari'ah boards' fiduciary relationship with Islamic financial institutions requires the clarification of what is meant by 'fiduciary' in English common law. The word

[417] Opwis (n 413)183.

'fiducia' is regarded as the Latin root of the word, akin to a modern trust.[418] However, this trust-like relationship does not have a universally accepted definition[419]and is profoundly subject to legal and social changes. Trust is defined as a reasonable belief that the other party will tell the truth and perform its promises.[420] This definition of trust implies the non-contractual nature of fiduciary law since the violation of trust carries a 'moral taint that is not appropriate to violation of contract.[421]

The Fiduciary position in the context of modern financial world is a form of power as it plays the significance role in promoting individual welfare and increasing efficiency of resource allocation.[422] Although frequent attempts have been made to define fiduciary relationship, the open-textured[423] nature of the relationship makes it difficult. In this regard, a distinction is drawn between status-based and fact-based approaches in identification of fiduciary relationships. The statute-based approach does not focus on the character of the fiduciary relationship and tries to determine sufficient similarities in the given relationship with trustee and beneficiary relationship (quasi-trust).[424] As Worthington explains: 'fiduciary Law evolved from Equity's regulation of the relationship between trustees and beneficiaries. Over time, these rules were extended, with minor modifications, to cover other situations that seemed analogous. Now it is accepted that relationships between directors and their companies, agents and their principals, solicitors and their clients, and partners and their co-partners are all fiduciary. These are all statute-based

[418] Andrew Stafford and Stuart Ritchie, *Fiduciary Duties: Directors and Employees* (Jordan 2008) 14.
[419] ibid 15.
[420] Tamar Frankel, *Fiduciary Law* (OUP 2011) xvi.
[421] ibid 238; Richard Holton, 'Fiduciary Relations and the Nature of Trust' (2011) 91 Boston University Law Review (2011) 991, 994.
[422] Tamar Frankel, 'Fiduciary Law' (1983) 71 (3) California Law Review 795, 803.
[423] J. Dennis Hynes, 'Freedom of Contract, Fiduciary Duties, and Partnership: The Bargain Principle and the Law of Agency' (1997) 54 Wash. & Lee. L. Rev. 439, 442.
[424] Paul B. Miller, 'A Theory of Fiduciary Liability' (2011) 56 (2) McGill Law Journal 235, 241.

fiduciary relationships. The status itself inevitably attracts fiduciary impositions.'[425]

However, the narrow view of statute-based approach does not include new categories of fiduciary relationship. In this regard, it is required to consider the certain characteristics of fiduciary relationships to determine the nature of the relationship.[426] in both *Lac Minerals Ltd v International Corona Resources Ltd*[427] and *Hospital Products Ltd v United States Surgical Corp*[428] it is recognized that the presence of certain factors in non-fiduciary relationships such as discretion or power given by beneficiary to the fiduciary, vulnerability of the beneficiary,[429] trust, ascendancy and confidence[430] would result in fiduciary obligations. Consequently, a fact-based approach is considered more effective for definition of fiduciary relationship. For instance, In Justice Finn words: 'fiduciary is someone who undertakes to act for or behalf of another in some particular matter or matters.'[431] This definition has been followed in many cases such as in *Bristol & West Building Society v Mothew*.[432] Based on this definition a fiduciary acts on behalf of a beneficiary and exercises discretion, whether in accordance or not, other's (the beneficiary) instruction for the benefit of the beneficiary.

Regarding the discretionary power of fiduciary, it is noteworthy that the exercise of discretion in financial companies (although established based on the common fiduciary characteristics) is different. The difference lies in the perception of property or 'critical resources'. Critical resources in the context of fiduciary relationships in financial corporations encompass a broader

[425] Sarah Worthington, *Equity* (OUP 2003) 129.
[426] Miller (n 424) 243.
[427] [1990] F.S.R. 441; [1989] 2 S.C.R. 574.)
[428] (1984) 156 C.L.R. 41, HCA.
[429] *Frame v Smith* [1987]
[430] *Lac Minerals* at 648, 656-66
[431] Paul Finn (ed) *Fiduciary Obligations* (Law Book Company 1977) 201.
[432] *Bristol & West Building Society v Mothew* [1998]

concept than ‘property’ as they cover not only tangible and intangible properties, also anything could be a potential for opportunism such as non-commercial confidential information[433]and the reputation of the enterprise. Further, the exercise of discretionary power by fiduciaries with respect to a critical resource ‘connotes the power to use or work with the critical resource in a manner that exposes the beneficiary to harm that cannot reasonably be evaded though self-help.’[434]

From the economic point of view, the contractarian nature of the firm and agency theory implies a broad discretionary power for fiduciaries with regard to controlling investors’ money. Accordingly in the context of Islamic finance, the discretionary power of Shari’ah boards implies a broader meaning as their *ex ante* and *ex post* functions are based on *Shari’ah*. In other words the discretionary power of Shari’ah boards reflects its unpredictability as it bears religious and conventional characteristics together.

In *Arklow Investments Ltd v Maclean* the Privy Council held that: ‘fiduciary encaptures a situation where one person is in a relationship with another which gives rise to a legitimate expectation, which equity will recognise that the fiduciary will not utilise his or her position in such a way which is adverse to the interests of the principal.’[435] Based on the aforementioned definitions, trust and confidence[436]are the main features of fiduciary relationships which require a self-denial[437]state from the fiduciary to manage property of principal efficiently. However, regarding the inevitable interrelation between an agent and information given by principal, the identification of another category of fiduciary relationship, namely the relationship of

[433] D. Gordon Smith, ‘The Critical Resource Theory of Fiduciary Duty’ (2002) 55 Vand. L. Rev. 1399.
[434] ibid 1449.
[435] [2000] 1WLR 594
[436] P. J. Millett, ‘Equity’s Place in the Law of Commerce’ (1998) Law Quarterly Review 214.

confidentiality is crucial. In this regard, Lord Millett identifies the relationship of confidentiality whenever information is imparted in confidence.[438] According to Hollander and Salzedo, the obligation to respect confidentiality 'may be contractual or equitable. It may arise from the circumstances in which the information was imparted, or from the obviously confidential nature of the information.'[439] The views of the Privy Council in *Arklow Investments Ltd v Maclean* over the relationship between confidentiality and fiduciary duties now must be the basis for Lord Millett's view.[440]

Based on the foregoing analysis, there is some kind of dependence and influence in a fiduciary relationship upon information and advice.[441] In this regard, however, it is discussed that the subject of advice should be 'a matter which our society considers to be of importance to the adviser's personal or financial well-being…'[442] Further, a fiduciary relationship appears when the principal does not make his own evaluation of the information or advice given and 'will not in consequence exercise an independent judgement in his own interests in the subject of decision…'[443]

However, fiduciary in the context of Angelo-American Law is an elusive concept and may take many forms in different circumstances. The lack of a clear concept for fiduciary relationship and the basis of fiduciary duties resulted in uncertainty and inconsistency in the authorities.[444] Accordingly, due to its applicability in a variety of contexts and situations, fiduciary law has

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[437] Stafford and Ritchie (n 418) 17.
[438] Millett (n 436); Charles Hollander and Simon Salzedo, *Conflict of Interest* (Sweet & Maxwell 2011) 17.
[439] Ibid.
[440] [2000] 1 W.L.R. 594. ; Hollander and Salzedo (n 438).
[441] Ibid.
[442] Finn, 'Fiduciary Law and the Modern Commercial World' in McKendrick (ed), *Commercial Aspects of Trusts and Fiduciary Obligations* (OUP 1992) 10-11.
[443] ibid 11.

developed through a jurisprudence of analogy rather than principle.[445] In this regard, the fiduciary relationship is described as a 'concept in search of a principle.'[446] Regarding the contagion effects of bad financial decision-makings, the word fiduciary in the context of financial markets bears an inclusive concept and enjoys a deep public dimension as it affects not only the principal interest, also society's as well. In this regard, the discretionary nature of the fiduciaries power over the others' property cannot be easily subject to detailed standards and 'they require educated judgment about uncertain and problematic issues. In addition such decisions frequently require the use of specialised financial or business information….because fiduciaries manage or have some control over very substantial property interests of others, they have the potential power to inflict great losses on those property owners.'[447]

Regarding the legal relation of Shari'ah boards with Islamic financial institutions, based on the established perception over the concept of fiduciary in the Anglo-American Law we can consider Shari'ah boards as fiduciaries. Their *ex ante* and *ex post* functions such as Financial product engineering, auditing and advising all imply the concepts of trust and confidence. Further, since the reliance of Islamic financial institutions and Shari'ah-sensitive investors (shareholders and debtors) on Shari'ah boards' instructions is faith-based, the concepts of trust and confidence bear a non-financial essence (although with financial implications). In other words, the religious nature of Shari'ah boards' functions may define a moral root for fiduciary duties. Further, in theory, as Islamic financial institutions follow a different economic and legal

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[444] Paul B. Miller (n 423) 237.
[445] Deborah A. Demott, 'Beyond Metaphor: An Analysis of Fiduciary Obligation' (1998) Duke Law Journal 879.
[446] Sir Anthony Mason, 'Themes and Prospects' in P. D. Finn *Essays in Equity* (Law Book Co of Australasia 1985) 246.
[447] A G Anderson, Conflict of Interest: Efficiency, Fairness and Corporate Structure (1977) 25 UCLA L. Rev. 738.

perception over financial investment[448], fiduciary duties get broader meaning. This issue is important due to the relations between the fiduciary duties of Shari'ah boards and directors' duty to promote the success of the company under the Companies Act 2006. In this regard, Shari'ah boards' fiduciary duties do not always increase company's financial interests as financial interests must be followed according to *Shari'ah* principles. In fact, Shari'ah scholars act as *Mujtahid*, and accordingly their fatwas, interpretations and views over the Shari'ah compliance aspects of financial products and operation affect the profitability of financial institutions and the integrity of markets. In this manner, Shari'ah scholars are responsible to align the interests of financial institutions and investors with *Shari'ah* principles in a moderate way.

4.3.1 Fiduciary Relationship in the Context of Modern Corporate Law

The economic-oriented perception towards corporate law has affected legal theories, and accordingly the concept of fiduciary relationships and duties. In this regard, since law is the result of the constant evolution of the economic and market circumstances, the concept and scope of fiduciary duties are not excepted. In the context of financial markets, although legal traditions seek to define the concept of fiduciary based on the reasonable behaviour, the economic tradition pull it to rational behaviour.[449] The emphasis of modern portfolio theory is on rational (self-interest) behaviour and accordingly its approach has deemphasized the conception of fiduciary based on prudence characterized by wisdom to regard effects of investment on

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[448] Asset-based or asset-backed.
[449] Steve Lydenberg, 'Reason, Rationality and Fiduciary Duty' (Feb. 2013) Journal of Business Ethics 1.

others.[450] While reasonableness requires respect for society's interest and avoiding speculation, rationality requires a utilitarian approach toward corporation. The former resembles the shareholders primacy theory and latter stakeholder theory of the modern corporation.

However, an efficient approach requires the combination of both theories, as rationale viewpoint helps in directing fiduciaries attention to the maximization of shareholders and keeps their decisions free from personal conflict of interests,[451] and accordingly reasonable view is concerned about the long-term effects of financial decisions on the society. In this regard, according to the Companies Act 2006, the primacy of shareholders' value and the responsibility of directors to act in the best interests of the company reflect a more inclusive approach to value since it regards long-term relationships and seeks to balance the different interests of stakeholders.[452] It establishes the concept of *Enlightened Shareholder Value* in s 172(1) with regard to the duty of directors to promote the success of the company for the benefit of its members as a whole.[453]

regarding the fiduciary duties of Shari'ah boards to Islamic financial institutions, since the UK financial system is based on market economy with no privilege for Islamic finance, its laws encompass no religious characteristic and accordingly principles of *Shari'ah* are regarded ethical not legal. However, the operation of Islamic financial institutions based on both conventional laws and *Shari'ah* principles has some implications for Shari'ah boards. In other words, despite the lack of statutory place for Shari'ah boards in the UK corporate law, since directors are

[450] ibid 2-3.
[451] ibid 17.
[452] The Company Law Review Steering Group, 'Modern Company Law for a Competitive Economy: Developing the Framework' (Department of Trade and Industry 2000) 15; Andrew Keay, Tackling the Issue of the Corporate Objectives: An Analysis of the United Kingdom's Enlightened Shareholder Value Approach (2007) 29 Sydney Law Review 577.

responsible for the ultimate direction and management of the corporate the fiduciary relation of Shari'ah boards with Islamic financial institutions should be analysed with regard to their fiduciary duties defined in the Companies Act 2006. Further, the Law Commission consultation paper No. 124 explains that when there is no status-based fiduciary relationship which it falls within an existing category such as trustee and beneficiary, the recognition of fiduciary relationship should be based on facts and the test is based on discretion to act for another and vulnerability.[454]

Vulnerability in the context of investment decisions arises when investors lack knowledge or expertise with regard to financial decisions. In other words, as professor kay says: 'vulnerability is closely associated with information asymmetry.'[455] Vulnerability in the context of Islamic finance encompasses a dual characteristic as it implies religious and conventional aspects together. Regarding implications of the UK corporate law for Shari'ah boards as fiduciaries, s. 172 contains the duty of directors to promote the success of the company and this 'core duty' is regarded as a successor to the duty to act bona fide in the best interest of the company which was the predominant duty before the codification of the duties.[456] In the case of *Aberdeen Railway Co v Blaikie Brothers,* Lord Cranworth said that: 'a corporate body can only act by agents, and it is of course the duty of those agents so to act as best to promote the interests of the corporation whose affairs they are conducting.'[457] Also in *Scottish Co-operative Wholesale Society Ltd v*

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[453] The Companies Act 2006 s 172(1).
[454] Law Commission, *Fiduciary Duties and Regulatory Rules* (Law Com No 124, 1992), para 2.4.3.6.
[455] John Kay, 'The Kay Review of UK Equity Markets and Long-Term Decision Making, Final Report' (July 2012) Pa.9.3.
[456] Andrew Keay, The Duty to Promote the Success of the Company: Is It Fit for Purpose? (2010) University of Leeds School of Law, 4 http://www.law.leeds.ac.uk/assets/files/research/events/directors-duties/keay-the-duty-to-promote-the-success.pdf. Accessed 17 August 2015.
[457] (1854) 1 Macq at 471, HL (Sc) per Lord Cranworth LC

Meyer, Lord Denning said the duty of directors 'was to do their best to promote its business..'[458]

In this regard, the fiduciary duties of Shari'ah boards, although religious and based on principles of *Shari'ah*, should be interpreted and carried out by reference to general objectives of Islamic financial institutions established based on the UK laws. On this subject, the consistency between *Shari'ah* and fiduciary duties of Shari'ah boards in Anglo-American Corporate Law system requires an enabling and inclusive interpretation of *Shari'ah*. This argument is concerned with *ex ante* and *ex post* issues such as product engineering (Shari'ah-compliant products) and auditing to assess the Shari'ah compliance of Islamic financial institutions operation. In this regard, as board of directors is the ultimate responsible body to shareholders, it is imperative to analyse the fiduciary duties of Shari'ah boards with regard to directors' duties. This argument in the context of post-financial crisis environment requires paying heed to macro-economic policies. In other words, micro-economic policies (accordingly, fiduciary relationships between director and financial institution, and Shari'ah board and the institution) must regard macro-economic concerns such as stability. This policy revolves around two aims: the first is to encourage long-term value creation over short-term profits; and the second is to restore trust and confidence in the investment chain.[459] Accordingly, Shari'ah boards as fiduciaries like directors should consider macro-economic goals in their rulings and reports. This implies a broad responsibility for Shari'ah boards to improve living standard and widening economic opportunity for the many by a flexible and inclusive interpretation of *Shari'ah*.[460]

[458] [1959] AC AT 367
[459] Law Commission, *Fiduciary duties of Investment Intermediaries* (Law Com, May 2013); John Kay (n 455).
[460] Susan C. Atherton, Mark S. Blodgett and Charles A. Atherton, 'Fiduciary Principles: Corporate Responsibilities to Stakeholders' (2011) 2 Journal of Religion and Business 1, 12.

4.3.2 The Fiduciary Obligations of Shari'ah Boards

The dominant legal approach in the analysis of fiduciary relationship follows a syllogistic examination and clarification form.[461] This syllogistic approach reveals diversity of fiduciary obligations[462] which definition of their scope is not a simple task.[463] Particularly, development in judicial concepts over the time led to significant changes in the modern content of fiduciary duties over the last decade.[464] For instance, in *Lac Minerals Ltd v. International Corona Resources Ltd*, La Forest stated that: 'not every legal claim arising out of a relationship with fiduciary incidents will give rise to a claim for breach of fiduciary duty'.[465] in this regard, Millett LJ in *Bristol & West Building Society v. Mothew* stated that: 'the expression 'fiduciary duty' is properly confined to those duties which are peculiar to fiduciaries and the breach of which attracts legal consequences differing from those consequent upon the breach of other duties. Unless the expression is so limited it is lacking in practical utility. In this sense it is obvious that not every breach of duty by a fiduciary is a breach of fiduciary duty.'[466] Further, 'the concern of the law in a fiduciary relationship is not negligence or breach of contract'[467], but loyalty.[468] Millett statement acknowledges the distinctive nature of fiduciary obligations as he says: 'distinguishing obligation of a fiduciary is the obligation of loyalty.'[469]

According to Oxford English dictionary, 'loyalty' refers to the quality of faithful adherence to

[461] Mathew Conaglen, *Fiduciary Loyalty, Protecting the Due Performance of Non-Fiduciary Duties* (Hart Publishing 2010) 7-8.
[462] Deane J. in *Chan v. Zacharia* (1984) 53 ALR 417
[463] Finn (n 431) 1.
[464] Conaglen (n 461) 16; Austin J. in *Aequitas v. AEFC* [2001] NSWSC 14 at [283])
[465] *Lac Minerals Ltd v. International Corona Resources Ltd* [1989] 2 SCR 647
[466] *Bristol & West Building Society v Mothew* [1998]16
[467] Dawson and Toohey JJ in *Breen v Williams* (1996) 186 CLR 93
[468] ibid.
[469] *Bristol & West Building Society v Mothew* [1998]

one's obligations.[470] Although, the dictionary definition reveals the essence of the concept of loyalty (faithful adherence to obligations), the examination of the real meaning is related to the functions of fiduciaries.[471] In other words, 'the fiduciary concept of loyalty is best explicated by reference to duties that are peculiar to fiduciaries.'[472] 'Loyalty' in the context of financial relations implies an economic feature. In other words, the duty of 'Loyalty' (although with undefined scope) as the cornerstone of other fiduciary obligations primarily is used to protect economic interests.[473] In this regard, loyalty implies the concept of stewardship based on trust and respect[474]which its promotion requires clarity in the concept and scope of the responsibilities of fiduciary.

Pursuing the 'economic interests' of beneficiary in the context of Islamic finance does not carry a straightforward content and accordingly techniques. Although, economic prosperity (*falah*) is one of the main objectives of *Shari'ah*, the existence of intense Legal pluralism in *fiqh al-muamalat* and accordingly different interpretations over the Shari'ah compliance structure and operation of Islamic financial institutions resulted in non-harmonized practice in the engineering and regulation of Islamic finance products. In this regard, the economic theme of 'loyalty' in the context of Shari'ah boards' religious functions due to divergent interpretations presents a vague connotation. For instance, the recognition and expenditure of non-Shari'ah compliant incomes of the Islamic financial institutions by Shari'ah board bears a discretionary feature as may lead to abuse of position. According to this argument, due to the existence of pluralism in the interpretations of *riba* and *gharar*, the definition and scope of 'loyalty' and accordingly

[470] J Simpson and E Weiner, Oxford English Dictionary (2nd ed, OUP 1989) vol. 9, 74.
[471] Conaglen (n 461) 59-61.
[472] Ibid 61.
[473] Dal Pont and Chalmers, *Equity and Trusts in Australia* (4th ed, Lawbook Co 2007) 93.
[474] Kay (n 455).

'economic interest' with regard to the non-fiduciary duties of Shari'ah boards suffers from ambiguity. This fact affects the prophylactic feature of 'loyalty' as it disturbs the object of fiduciary duties, namely protecting the fiduciary from 'influences that are likely to interfere with proper performance of the fiduciary's non-fiduciary duties.'[475]

In this regard, the protective nature of 'loyalty' implies other fiduciary duties which are mainly negative in nature. In other words, the core duty of 'loyalty' requires a set of duties which are proscriptive rather than prescriptive as they maintain fidelity to the principal[476]by removing temptations 'which have a tendency to sway the fiduciary away from proper performance of those non-fiduciary duties.'[477] In the context of Islamic finance markets, those duties enhance investors' confidence over structure and operation of Shari'ah compliant products as well. In this regard, two basic fiduciary duties, namely no conflict (interest and duty) and no profit rules have been recognized as the core proscriptive duties in all fiduciary relationships.[478] In other words, this argument reveals the function of fiduciary rules, namely controlling opportunism.[479] Opportunism generally, in the context of finance bears a strong pecuniary characteristic, and also implies a moral (or somehow reputational) aspect in the context of Islamic finance as Shari'ah scholars are highly regarded individuals and their conducts connote their actual level of adherence to Shari'ah moral principles such as honesty and integrity.

In this regard, as Johnson says: 'fiduciary principle is a principle of natural law that has been

[475] Conaglen (n 461) 61.
[476] P. D. Finn, 'the Fiduciary Principle' in TG Youdan (ed.) *Equity, Fiduciaries and Trusts* (Carswell 1989) 25 and 28-29.
[477] Conaglen (n 461) 202.
[478] The Law Commission summarised the basic fiduciary duty under the following four rules: no conflict, no profit, undivided loyalty and duty of confidentiality, see Law Commission, *Fiduciary Duties and Regulatory Rules* (Law Com No 236, 1995) Para 2.4.9.
[479] Robert Flannigan, 'The Economics of Fiduciary Accountability' (2007) 32 (2) Del. J. Corp. L. 393.

incorporated into the Anglo-American legal tradition',[480] and its natural law root is evident as 'many cultures repeatedly articulate the same rule.'[481] However, it is worth noting that there is a distinction between the western notion of natural law as an epistemological rationalism which is known 'as principles about nature that are logically unavoidable' and the God-given (divinely dictated) perception of natural law in Islam.[482] *Shari'ah* presents a *tawhidi* view over natural law and its emphasis is on God's will rather than the unavoidable nature of material reality in existence of natural law.[483] Further, although the Shi'a School and *Maturidi* branch of the *Hanafi* School recognize the capability of reason to discern the law, both believe that God binds nature.[484]

Islam as an obligation-orientated religion regards no contradiction between moral and legal obligations as they both are the essential parts of one system and accordingly the lack or deficiency of each of them results in adverse consequences for other one. Further, in Islam the main obligation is to God: 'I have not created mankind and jinn except to worship me'.[485] The *tawhidi* root of obligation is in the Quran gives the quality of sanctity to obligation as the primary responsibility is before God and he is the ultimate owner of the universe. Thus, human is only the trustee (fiduciary) and is obliged to serve his master properly.

In this regard, as explained before Shari'ah boards can be subject to the notion of *Amin* in Islamic law as they are entrusted with people property and their functions deal with advising

[480] Joseph F. Johnson Jr., 'Natural Law and the Fiduciary Duties of Business Managers' (Spr. 2005) 8 (1) Journal of Markets and Morality 27.
[481] Timothy L. Fort and James J. Noone, 'Challenges to Corporate Governance: Bundled Contracts, Mediating Institutions, and Corporate Governance: A Naturalist Analysis of Contractual Theories of the Firm' (1999) 62 *L. & Contemp. Probs.* 163.
[482] Imad-ad-Dean Ahmad, 'On natural law and shari'ah' (the IIIT Summer Institute 2009) 4 http://www.minaret.org/Natural%20Law%20and%20Shariah.pdf accessed 29 11November2013.
[483] ibid 6.
[484] Bernard G. Weiss, *the Spirit of Islamic Law* (University of Georgia Press 1998) 36.

financial institutions over the Shari'ah aspects of investors' money management. Regarding duties of *Amin* the *Surah Albagharah* says: '…then if one of you entrusts the other, let the one who is entrusted discharge his trust [faithfully] and let him be afraid of Allah, his Lord…'[486] However, the notion of trust or *Amanah* bears a general essence and its implications can be identified only in the particular aspects of legal relationships with the help of the modern notion of trust or fiduciary duties as they help to measure the strictness of liability and the enforceability of remedies and assess the degree of efficiency with regard to the breach of fiduciary duties.

In Islam, the breach of trust and confidence is regarded as *khianah* (betray of trust), which is the ultimate violation of right and justice. From the moral point of view, there have been strong condemnations for *khianah* as one of the greatest sins in Islam. As the *Quran* says: 'O you who believe! Betray not Allah and His Messenger (pbuh), nor betray knowingly your Amanat [the things entrusted to you]…'.[487] Also, with regard to the importance of trust and confidence the Quran says: 'Verily, Allah commands that you should render back the trusts to those, to whom they are due'.[488]

However, the modern legal system requires the specificity and the rigorous application of these commands.[489] An efficient legal system is effective in compensating the injured and deterring potential injurer.[490] The notion of 'liability' in Islamic jurisprudence is about prohibition or lawfulness of acts, as its aim alongside regulating people social relationships covers relationship between man and God. Thus, earthly and afterlife provisions in *Shari'ah*

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[485] Al-Dariat (51): 56.
[486] AL-Bagharah (2) 283.
[487] Al-Anfal (8): 27.
[488] Al-Nesa (4): 58.
[489] Rider (n 54).

reveals the distinction between legal and moral liabilities in Islam. However, since the Quran and Sunnah do not present any theory over liability, Islamic jurists too have not theorized their ideas over civil and criminal liabilities and study each type of liability separately. Before the codification of civil law of Islamic countries in the twentieth century, *Mejellah* was the only source of civil law and it did not present a complete ranges of liabilities same as common law.[491] Accordingly, from a common law jurist point of view Islamic *fiqh* in the context of Islamic finance lacks specificity and enforceability mechanisms over the breach of duties and accordingly over the legal liabilities.

4.3.2.1 No Conflict of Interest

No conflict rule is the inflexible rule of equity which does not allow a fiduciary 'to put himself in a position where his interest and duty conflict.'[492] Similarly, in *Aberdeen Railway Co v. Blaikie Brothers*,[493] Lord Cranworth L.C. said: '[a fiduciary will not be permitted] to enter into engagements in which he has, or can have, a personal interest conflicting, or which possibly may conflict, with the interests of those whom he is bound to protect.'[494] According to Pennington 'the underlying principle of equity is that a person who acts as representative of another is in a conflict of interest situation if, either at the time when he accepts appointment or subsequently while he acts as a representative, there is a material interest of his own… and the pursuit or protection of that interest would create a substantial risk that he might not act in the best way to

[490] Monzer Kahf, 'Economics of Liability: An Islamic View' (2000) 8 (2) IIUM Journal of Economics and Management 85, 86.
[491] http://www.biicl.org/files/777_introduction_to_islamic_law.pdf accessed: 5 December 2013.
[492] *Bray v. Ford* [1896] A. C. 44, at 51
[493] [1854] 1 Macq 461
[494] ibid 471.

pursue or protect the interest of the person he represents'.[495]

The foregoing accounts indicate the preventive objectives of conflicts of duty and interest: the first is to prevent the fiduciary from 'allowing any undisclosed personal interest to sway him from the proper performance of the undertaking'.[496] The second is to prevent the fiduciary from abusing his position to further his own interest.[497] In this regard, the conflict of interest occurs 'where a person willingly or otherwise, is placed in a position where the proper or, at least satisfactory discharge of a duty to another, he has assumed or been given, conflicts with his own interests, in terms of either his own self-advancement or in the protection of some interest'.[498] The word 'interest' in this context signifies a personal concern 'of possible significant pecuniary value'[499] which 'may take the form of an actual, prospective, or possible profit to be made in, or as a result of decision he takes or the transaction he effects. Or it may take the form of an actual, prospective, or possible saving, or a diminution of a personal liability.'[500]

In this regard, although this rule is critically based on human nature and not founded upon principles of morality[501], 'fiduciary' is regarded as a means by which law conveys its ethical essence to resolve human interactions[502]. Hence it establishes a moral essence for fiduciary duties such as the conflict rule as well. Further, the development of fiduciary principles reveals their moral root as fiduciary's functions associated with the roles of stewards in the history of

[495] R. R. Pennington, 'How Conflicts of Interest May Arise' in R.M. Goode (ed), *Conflicts of Interest in the Changing Financial World* (Financial World Publisher 1986) 2.
[496] Finn (n 431) 200.
[497] ibid.
[498] Chizu Nakajima, Conflicts of Interests and Duties: A Comparative Analysis in Anglo-J: A Comparative Analysis in Anglo-Japanese Law (Kluwer Law International 1999) 1.
[499] ibid 203.
[500] ibid 204.
[501] Lord Herschell's observation in *Bray v. Ford* [1896] A.C. 44, 51-52
[502] LI Rotman, *Fiduciary Law* (Thomson Carswell 2005) 2 and 153.

early religions and businesses.[503] Stewardship is described as moral agency or representative of God[504] and the King as God's representative was responsible for supervising people's accords 'and who must avoid preoccupation with the trappings of office while observing the law.'[505] In this context, the modern fiduciary rules are secularized religious traditions applied to commercial undertaking.[506] Thus, despite the lack of moral approach to modern fiduciary law, fiduciary duties require 'selflessness and a willingness to subordinate the fiduciary's interests to that of another.'[507] This argument is consistent with Islamic ethics simce loyalty and trust (*amanah*), with centrality of monotheism, are applicable principles to all aspects of human's life (*ebadiat and muamalat*).

In this regard, one category of conflict of interest and duty could be unauthorised remuneration within which a fiduciary obtains financial benefits beyond what is authorised.[508]as Lord Normand signified: 'some who are subject to the [fiduciary] duty are never entitled to remuneration; some are *ex lege* entitled to payment for their services; some are entitled to payment *ex conventione*, and some are entitled to payment if the settlor or testator so directs. The rule is the same for all: it is not that reward for services is repugnant to the fiduciary duty but that he who has the duty shall not take any secret remuneration or any financial benefit not authorised by the law, or by his contract, or by the trust deed under which he acts, as the case may be.'[509] Therefore, the purpose of the rule is to prevent unauthorised profits being made through bribes or

[503] Atherton (n 460) 9.
[504] Sarah Key, Toward a New Theory of the Firm: A Critique of Stakeholders "Theory", (1999)37 Management Decision 317.
[505] Atherton (n 460).
[506] Stephen B. Young, 'Fiduciary Duties as a Helpful Guide to Ethical Decision-Making in Business' (2007) 74 (1) Journal of Business ethics 1.
[507] Ibid 10.
[508] *Dale v IRC* [1954] AC 11 at 27; [1953] 2 All ER 671 at 674; Finn (n 431) 205.
[509] *Dale v. Inland Revenue Commissioners*, ibid.

secret commissions.

In the context of Islamic finance, the concern over the possibility of Shari'ah boards being influenced by financial inducement lacks a solid ground as their consultancy fees are irrelevant to the outcome of their decisions and payments to them by Islamic financial institutions are for their efforts in analysing financial documentation.[510] In this regard, it is possible that the interest of Shari'ah boards' members as shareholders in another competitor financial institution such as a bank conflicts with their duty. For example, their announcement on a new financial product may affect their interest in another financial institution where they are shareholders. However, this argument lacks a concrete ground for unauthorised remuneration as there is no possibility and record for bribing or getting secret commission by the relevant financial institution. Further, the nature of the relationship does not let Shari'ah scholars like a financial advisor or an agent to get unauthorised remuneration.[511] Thus, due to the lack of a 'real sensible possibility of conflict'[512], there is no room for further argument in this category with regard to Shari'ah boards' relationship with financial institutions.

As said before, the word 'fiduciary' in the context of Islamic finance bears a strong religious aspect as the main desire of Shari'ah sensitive investors is to gain *halal* earnings and financial services. In this context the conflict of interest may occur when Shari'ah boards do not discharge their duties impartially as they 'assist financial institutions in coming up with as many Shari'ah-compliant products and services as possible'[513] and ignore their non-Shari'ah compliant

[510] A statement by S.H.H. Hassan, a member of the Syariah Advisory Council of Labuan Offshore Financial Services Authority (LOFSA) in N.M.H.N. Hassan, 'The cry is for more Islamic bankers' in Abdul Jabbar (n 290) 140-141.
[511] Abdul Jabbar (n 290) 141.
[512] Law commission (n 454) para. 2.4.9 (i).
[513] Abdul Jabbar (n 290).

operations. In other words, although from the financial point of view they may regard the economic interest of investors properly, they may disregard Shari'ah (or religious) aspects of their interest. This argument particularly is worthy of attention as the current practice in the industry shows high payments to Shari'ah boards' members without any formal supervision from financial industry.

4.3.2.2 Conflict of Duties

Loyalty and integrity construct the moral root of fiduciary as they prevent any opportunistic behaviour and accordingly protect interests of the principal. This argument in the context of commercial relations reflects the aim of fiduciary rules to provide certainty and security in transactions. Same as the conflict of interest, the conflict of duties involves the breach of undivided loyalty as multiple fiduciary engagements prevent the adequate discharge of obligations without conflicting with another.[514] Similarly, Millett L.J. said: 'a fiduciary who acts for two principals with potentially conflicting interests…is in breach of the obligation of undivided loyalty; he puts himself in a position where his duty to one principal may conflict with his duty to the other…[515] Further, conflict of duties arises 'where a person finds himself in the position of owing duties to two or more persons, the satisfactory discharge or execution of which would neither fully account for, nor possibly satisfy the due expectations of one or, indeed, both.' [516] In *Fullwood v Hurley* the inconsistency of serving two or more masters is acknowledged by Scrutton L.J as he says: 'No agent who has accepted an employment from one principal can in law accept an engagement inconsistent with his duty to the first principal from a

[514] *Beach Petroleum v Kennedy* at 46; *Breen v Williams* at CLR 135
[515] *Bristol & West Building Society v Mothew*, [1998] at18
[516] Chizu Nakajima and Elizabeth Sheffield, *Conflicts of Interest and Chinese Walls* (LexisNexis 2002) 1.

second principal…'[517]

However, multiple employments are not offensive in itself and does not contribute to the breach of fiduciary duty.[518] The breach of duty arises where there is an actual or potential conflict or conflicts between duties owed in each relationship [519] which is reasonably foreseeable[520] and can be realized according to the relevant circumstances in each relationship. This subjective approach requires looking at specific characteristics of each client in each relationship to find 'a real conflict of duty and interest and not to some theoretical or rhetorical conflict.'[521] Regarding the multiple employments of Shari'ah scholars by financial institutions and the possibility of the breach of their duties related to their different fiduciary relationships, it is now clear that the mere multiple employments by various financial institutions cannot be considered the breach of conflict rule. However, the possibility of actual conflicts requires us to consider and examine the characteristics of Shari'ah scholars' duties.

As explained before, the function of Shari'ah scholars in the context of Islamic finance is mainly to advise[522]over Shari'ah issues and also audit the Shari'ah compliance operation of Islamic financial institutions. In this regard, Shari'ah boards do not advise like a financial advisor or solicitor about gain and loss of transactions.[523] Although their advisory function covers Shari'ah activities of financial institutions, it necessitates the study and analyse of several pages of financial reports and plans. Accordingly, this laborious duty requires a lot of time and efforts as Shari'ah scholars should be aware over each issue and give advice whenever is needed.

[517] [1928] 1 KB at 502
[518] Finn (n 431) 252.
[519] ibid 253.
[520] *Bristol & West Building Society v Mothew*, ibid, Ch. 1
[521] *Boulting v Association of Cinematograph, Television and Allied Technicians* [1963] 2 Q.B. at 638
[522] Abdul Jabbar (n 290) 144.

In this context, since the power of human in carrying out several tasks properly at the same time is restricted, it is hard to assume, Shari'ah scholars are able to come up with their functions properly according to their clients' interests as well. Another possibility of the conflict of duty in Shari'ah boards multiple functions and employments may arise when they get confidential information about new financial products from their competitor clients (financial institutions). As discussed before, the breach of confidence and trust in Islam is regarded as *khianah* (betray of the trust) as the ultimate violation of justice and right. As Ali ibn-Abitalib says: 'every person discloses a secret which was entrusted to him, definitely he has betrayed.'[524]

This issue is the context of competitive markets is more important as the confidentiality of information about the structure of new products are more crucial. The importance of confidentiality is acknowledged by the IFSB too. According to its principles: 'Shari`ah board members should ensure that internal information obtained in the course of their duties is kept confidential' and 'Where a member of the Shari'ah board or Shari'ah advisory firm serves several IIFS simultaneously, the issue arises as to how they handle confidential or commercially sensitive information obtained in the course of performing their duties. It is a key concern of professional ethics that confidential or sensitive information obtained by a member of the Shari`ah board or Shari`ah advisory firm while serving an IIFS should not be used by them in ways that could be detrimental to that IIFS, particularly in ways that might give a competitive advantage to its competitors.'[525] This approach by the IFSB is consistent with Loyalty and good faith as the ethical root of fiduciary law and accordingly implies the risk of liability for Shari'ah scholars in any conflicting situation in their fiduciary relationships. This issue may be more

[523] ibid.
[524] Jamalodin Khansari, *Sharhe Ghararol Hakam* (1st ed, Daneshgah Tehran 1366) 268.
[525] IFSB (n 278) part IV, par. 51.

convoluted when the obtained confidential information is relevant to subsequent matter and disclosure of it to the latter client is the breach of duty to the former and not to the latter client.[526] Particularly, it may arise when there is a contractual responsibility as the observance of confidentiality is in the terms of the contract for service of Shari'ah board. In this regard, IFSB principles says: 'to facilitate observance of confidentiality, an IIFS shall ensure that the terms of reference in the contract for service of the Shari`ah board or its members expressly set out that they shall preserve and secure the confidentiality and secrecy of business and market-sensitive information shared with them by the IIFS. An arrangement should be made to brief and/or clarify to the Shari`ah board or its members the importance of careful preservation of confidential and market-sensitive information. Every member of the Shari`ah board should sign a non-disclosure agreement or a letter of undertaking affirming their obligation to observe confidentiality and secrecy in respect of business and market-sensitive information shared with them by the IIFS.'[527]

However, by fiduciary law it is possible through complete disclosure about conflicts and getting consent of clients to avoid breaching this duty.[528] This requires disclosure about all facts that may affect the interest of clients.[529] In the context of Islamic finance, due to the existence of multiple employments and conflicting interests in Shari'ah boards' functions, the disclosure of conflicts could be impractical solution.[530] Further, the dearth of Shari'ah scholars[531] and the multiple employments of Shari'ah scholars imply a kind of consciousness and intention in the industry. In other words, practically financial institutions surrender their rights to Shari'ah

[526] Finn (n 442) 23, 30-31.

[527] IFSB (n 278) pa. 55.
[528] Millet L. J. in *Bristol & West Building Society v Mothew* [1998] Ch. 1.; Scrutton L.J. in *Fullwood v Hurley* [1928] 1 KB 498
[529] Hollander and Salzedo (n 438) 38.
[530] Nakajima and Sheffield (n 516) 8; Abdul Jabbar (n 290) 147.

boards.

4.3.2.2.1 No Profit Rule

The profit rule like the other fiduciary rules is based on moral concerns and aims to prevent the abuse of a fiduciary's position.[532] It 'prohibits a fiduciary from taking decisions with the principal purpose in mind of furthering his own interests.'[533] in this regard, numerous authorities treat the profit rule as the subset of conflict rule. for example Lord Upjohn in *Boardman v Phipps* says: 'the relevant rule for the decision of this case is the fundamental rule of equity that a person in a fiduciary capacity must not make a profit out of his trust which is part of the wider rule that a trustee must not place himself in a position where his duty and his interest may conflict.'[534] However, English case law considers these rules separate. Morritt LJ in *Don King Productions v Warren* says: 'it is appropriate to consider separately each of the standards'[535] and 'would be superfluous if analysis of one necessarily captured whatever results the other might reveal.'[536] the strict rule of no profit is acknowledged by Lord Russell of Killowen in *Regal (Hasting) Ltd. v Gulliver*: 'The rule of equity which insists on those, who by the use of a fiduciary position make a profit, being liable to account for that profit, in no way depends on fraud, or absence of bona fides; or upon such questions or considerations as whether the profit would or should otherwise have gone to the plaintiff, or whether the profiteer was under a duty to obtain the source of the profit for the

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[531] Abdul Jabbar (n 290).
[532] Conaglen (n 461) 120.
[533] Finn (n 431) 47.
[534] *Boardsman v Phipps* [1967] 2 AC 46, 123; see also *Bray v Ford*, ibid 51; *New Zealand Netherland Society 'Oranje' Inc v kuys* [1973] 1 WLR 1126; *Conway v Ratiu* [2005] EWCA Civ 1302; *Queensland Mines Ltd v Hudson* (1978) 52 ALJR 399
[535] *Don King Productions v Warren* [2000] Ch 291 at 42

plaintiff, or whether he took a risk or acted as he did for the benefit of the plaintiff, or whether the plaintiff has in fact been damaged or benefited by his action. The liability arises from the mere fact of the profit having, in the stated circumstances, been made. The profiteer, although, honest and well intentioned, cannot escape the risk of being called to account.'[537] In the context of Islamic finance, Shari'ah scholars are obliged to avoid using confidential information to accumulate wealth or following a self-dealing approach in doing their duties without the consent of financial institutions.

4.4 Confidentiality

The nature of fiduciary relationship carries a strict duty of good faith for the fiduciary as requires him to act in the best interest of the beneficiary. In this regard, one of the most crucial aspects of good faith in the context of financial relationships is confidentiality. According to Sir John Donaldson MR: 'there is an inherent public interest in individual citizens and the state having an enforceable right to the maintenance confidence.'[538] The importance of confidentiality rests on the idea of the protection of competitive power of a business over its rivals.[539] In fact, economic justifications and commercial ethics build the analytical basis of the law of confidence and accordingly remedies for the unauthorised disclosure of the information.[540] On this subject, although 'the relationship of the parties never extended beyond one created by and limited to the giving and receipt of confidential information'[541]and fiduciary duties has been kept distinct from

[536] Conaglen (n 461) 115.
[537] (1942) 1 All ER 378
[538] *Attorney General v Guardian Newspapers Ltd* (No 2) [1988] UKHL 6 (13 October 1988) 'Spycatcher' Case.
[539] John Hull, *Commercial Secrecy: Law and Practice* (Sweet & Maxwell 1998) 1.
[540] ibid 3-4.
[541] *Arklow Investments Limited v. Maclean* [2000] 1 WLR 594 at 600

the duty to respect confidentiality, the protection of confidential information is recognised as an integral part of a fiduciary relationship.[542]

In this regard, the importance of the protection of information in a confidential relationship reflects the juridical justification for a relation known as confidential. According to equity and contract law a confidential relation must have 'necessary quality of confidence.'[543] In this regard, the relationship between a Shari'ah board and an Islamic financial institution demonstrates a deep confidential quality as information given by the Islamic financial institution to Shari'ah scholars carries a non-public characteristic as bears high potentiality to affect the competitive power of the institution. In the context of Islamic finance, confidential information may be addressed in two parts: 1- information given by the Islamic financial institution with regard to its financial condition such as problems, challenges and abilities; 2-Information related to the structure of Shari'ah-compliant products and related fatwas. In this regard, the clarification of confidential information in Islamic financial institutions requires the definition of 'confidential information' in English Law. There are plenty of references in various cases over the definition of confidential information. However, there has been no identical definition and it is possible that '… no general definition can be given of confidential information-secrecy in this context is a chameleon".[544] As mentioned before having the quality of confidentiality is the main feature of confidential information.[545] Lord Green in *Saltman* declared that:' confidential information must not be something which is public knowledge.'[546] Also, Lord Denning Believes

[542] Paul Chaisty, Confidential Information- Fiduciaries and Third Parties p 1, http://clients.squareeye.net/uploads/3sb/events/080306_chaisty.pdf at: pdf> accessed 18 August 2015.
[543] Lord Greene M.R. in *Saltman Engineering Co. Ltd v. Campbell Engineering Co. Ltd* [1948] 64 R.P.C. 203 at 215
[544] Finn (n 431) Para. 336.
[545] *Saltman Engineering Co. Ltd v. Campbell Engineering Co. Ltd* [1948] 64 R.P.C. 203
[546] ibid; see also *Seager v Copydex Ltd* (1967)

confidential information should be out of 'public domain'[547] and it depends upon the circumstance of the case.[548] this subjective approach is confirmed by Megarry V. C. in *Thomas Marshall (Exports) Ltd v. Guinle* case: 'If one turns from the authorities and looks at the matter as a question of principle, I think (and I say this very tentatively because the principle has not been argued out) that four elements may be discerned which may be of some assistance in identifying confidential information or trade secrets which the court will protect……..Secondly, I think the owner must believe that the information is confidential or secret, i.e. that it is not already in the public domain.'[549]

In this regard, the specific form of information is not considered as a requirement and accordingly may take any form, such as being communicated orally.[550] However, it must have commercial potential[551] and also ability to affect the competition power of the confider. In assessing the confidentiality of information given by the Islamic financial institution to its Shari'ah board with regard to its functions such as giving advice on engineering of new Shari'ah-compliant financial instrument and the operation of the institution (Shari'ah audit), since the given information is not in public domain and carries commercial essence can be regarded as confidential. Accordingly, it gives the Islamic financial institution 'a right to pursue a breach of confidence action to remedy any unauthorised use or disclosure of information by the Shari'ah boars.'[552]

In this regard, the second requirement for confidential information is the establishment of a

[547] Woodward v Hutchins [1977] 2 All ER 751, [1977 1 WLR 760
[548] Scott J in *A-G v Guardian Newspapers Ltd* (1987)
[549] Hull (n 539) 48.
[550] see *Seager v Copydex Ltd* (1967)
[551] Hull (n 539) 100.
[552] ibid 89.

reasonable confidential relationship in which the information had been imparted in confidence and 'the confidant ought reasonably to have known that the information had been imparted in confidence.' [553] In the context of fiduciary relationships carrying financial characters, the existence of the relationship of confidence is relatively straightforward, as confidentiality has been a recognised feature.[554] Further, its existence is not dependent on any specific form of relationship such as contractual or equitable. In this regard, the examination of the purpose of disclosed information, whether it is disclosed for a limited purpose or not, is considered as a test for the existence of information.[555] This objective approach has been approved in several cases.[556]

In the context of Islamic finance, for instance a non-public information given by the Islamic financial institution to its Shari'ah board to develop a new financial product with regard to its client's specific needs, reflects a 'limited purpose' under which the confidential relationship is established. The application of limited purpose test is an objective evaluation and applicable to contractual and equitable relationships. The relationship of Shari'ah board's members with the Islamic finance basically is contractual and implies a promise to use disclosed information with good faith and fidelity. However, as mentioned earlier, the establishment of confidential relationship is not contingent on a contractual relationship. In other words, confidentiality is a

[553] *Megarry J. in Coco v. A.N. Clark (Engineers)* Limited (1968); *Campbell v. MGN Limited* (2004) 2 AC 457; Jennifer Davis, *Intellectual Property Law* (4th ed. OUP 2011) 97.
[554] Hull (n 539) 89.
[555] ibid 90.
[556] see, *Morison v. Moat* [1851] 9 Hare 241; *Saltman Engineering Co. Ltd v. Campbell Engineering Co. Ltd* [1948] 65 R.P.C. 203.; Ungoed-Thomas J. in *Torrington Mfg Ltd v. Smith* [1966] said: "Where information provided is to be considered as confidential, its use and disclosure is in my view to be limited to the purpose for which the information is given. This seems to me to arise from the ordinary meaning, as I understand it of 'confidential'…..This also seems to me to be established by a long line of cases from *Morison v. Moat*."; Hull (n 539).

general and broad-based obligation, even where the parties are contractually linked.[557] Hence, the concepts of conscience and good faith as the broad equitable obligations [558] present confidentiality a presupposed state between the members of Shari'ah board and the Islamic financial institution.

4.5 Accountability

In common law it is the Fiduciary law that imposes the most significant duties of stewardship.[559] In the context of corporate law, the main objective of those duties is to deter and control opportunitism and accordingly the conflict of interest or agency problems. However, it is not clear how conflicting duties and interests might be effectively dealt with. In this regard, accountability is an essential concept in the efficient governance of legal relations. It generally refers to a relationship between a fiduciary and a forum based on established legal rules, traditions (civil or criminal) and procedures upon which a fiduciary is obliged to explain his decisions and the forum can pronounce judgement. In other words, justification and enforcement are the main elements of an effective accountability. In the context of Islamic finance, directors and investors give Shari'ah boards a stewardship position to control the Shari'ah compliance of products and operations and accordingly expect punishment not a simple answerability when they fail to meet their duties. As Porter points out accountability 'implicitly embodies the notion of exposure to punishment in the event of unsatisfactory discharge of duties.' [560] In fact,

[557] *Ackroyds Ltd v. Islington Plastics Ltd* [1962]; Hull, ibid, p. 106
[558] Hull (n 539) 105.
[559] Barry Rider, 'Corporate Governance for Institutions Offering Islamic Financial Services' in Craig R. Nethercott (ed) *Islamic Finance, Law and Practice* (OUP 2012) 147.
[560] Brenda A. Porter, 'The Role of the Triparties Audit Function in Securing Corporate Accountability' (2008) Centre of accounting, governance and taxation research, working paper No. 64, 2 <

deterrence as the characteristic of accountability provides assurance about the legitimacy of governance process[561] as reduces risk of misconduct and enhances investor's confidence. In the context of Islamic law, the obligation to look after others property with loyalty and care bears religious and moral characteristics rather than a legal obligation in modern sense. The concept of fiduciary in Islamic law is not expressed and strict as in common law[562], and accordingly Shari'ah scholars have not reached to a uniform idea over their fiduciary duties in the context of Islamic finance. Further, due to the lack of contractual and non-contractual perception over fiduciary duties in Islamic law, it is not clear how a Shari'ah court would impose liability for breach of them.[563]In this regard, uncertainty in the interpretation and application of Shari'ah led to ambiguity in Shari'ah boards' scope of fiduciary duties and accordingly uncertainty in their accountability. In this regard, It is assumed that law as 'one of society's most important tool for directing behaviour' to enhance efficiency, autonomy and distributive justice[564] as its uncertainty destabilises not only predictability in decisions, also welfare of people. In the context of Islamic finance, this uncertainty would weaken the possibility of establishing an effective forum (internal or external) for controlling the efficiency of Shari'ah boards' rulings and their royalty in doing their duties.

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http://www.victoria.ac.nz/sacl/centres-and-institutes/cagtr/working-papers/WP64.pdf accessed 19 August 2015.

[561] M. Bovens, 'Analysing and Assessing Accountability: A Conceptual Framework' (2007) 13 (4) European Law Journal 447, 464.

[562] Rider (n 559) 149.

[563] Ibid 150.

[564] Yuval Feldman and Shahar Lifshitz, 'Behind the veil of legal uncertainty' (2011) 74 Law and contemporary problems 133, 136-137.

4.6 Conclusion

This chapter examined the legal relation between Shari'ah boards and Islamic financial institutions in the context of UK laws. It found that since the Companies Act 2006 and common law define no legal place for Shari'ah boards, we should examine their position with regard to fiduciary law concepts established in common law. In this regard, the recognition of a fiduciary relationship according to the fact-based approach is based on some factors. As in *Lac Minerals Ltd v International Corona Resources Ltd* and *Hospital Products Ltd v United States Surgical Corp* is explained, the existence of trust, vulnerability, discretion or confidentiality factors in a relationship indicate its fiduciary quality. In the context of Islamic finance, the nature of their function implies a kind of trust as Islamic financial institutions and investors expect them to provide legitimacy of the industry. Further, the vulnerability of investors and Islamic financial institutions in terms of lack of Shari'ah knowledge establishes a fiduciary position for Shari'ah boards. Also, the discretionary power of Shari'ah boards to control the Shari'ah compliance operation of Islamic financial institutions is explicit in their fatwas. In this regard, the main concern in Shari'ah boards' fiduciary relationships is loyalty as it protects economic and religious interests of investors and other beneficiaries. However, the lack of consensus over the concept and scope of *Shari'ah* led to inconsistency in expectations over their fiduciary duties.

Regarding fiduciary rules in the context of Islamic finance, Shari'ah boards as fiduciaries are required to observe the no conflict of interest, conflict of duties and no benefit rules. The no conflict of interest rule as the inflexible rule of equity requires Shari'ah boards' members to not put themselves in a position where their interests conflict. In this regard, they must discharge their duties impartially and not assist Islamic financial institutions in coming up with

non-Shari'ah compliant products or ignore their non-Shari'ah compliant operation. The conflict of duties in the context of Shari'ah boards' functions addresses their multiple employments. In this context, the confidentiality of information may be violated by using them in a way that is detrimental to the competitive power of the Islamic financial institution which is the owner of information. Further, the ability of Shari'ah boards' members in carrying out several functions at same time in different Islamic financial institution has raised questions over the quality of their practice. The no benefit rule prohibits Shari'ah boards' members from taking decisions with the principal purpose of furthering their own interests. In this regard, for instance, they must not use the given confidential information for their own benefits through self-dealing.

Chapter Five

The Duties of Shari'ah Boards in the Context of Islamic Finance

5.1 Introduction

The discussion over the duties of Shari'ah boards in the context of modern Islamic finance is the continuation of the authority of Shari'ah jurist (*faqih)* in Islamic law. The term 'authority' implies a kind of power to influence the structure and operation of an institution. In the context of Islamic finance it implies a religious power to influence the form and operation of Islamic financial products and institutions. Historically, the authority of Shari'ah jurists has not reflected a regulated and defined concept and as a consequence resulted in ambiguity over the duties of Shari'ah boards. Shari'ah authority and compliance have been known as the reflection of the authority of a specific *madhab*. Thus, the concept and the scope of law may differ according to each *madhab*. Further, the notion of 'authority' reflects a functional nature as historically, Shari'ah jurists and governmental authorities have been responsible for the well-being of people and discharged those duties through issuing fatwa and the institution of *Hisbah* as the monitoring and enforcement mechanism. In this regard, the main function of Shari'ah boards is conceived to be Shari'ah compliance auditing. However, their non-defined functions and also the lack of a code of conduct may result in Shari'ah non-compliance risk and deficiency in the management of

the financial institutions. This chapter examines the concept of authority and duties of Shari'ah boards from this point of view. The first part deliberates on the concept of 'authority' in the context of Islamic law and positivism. The next parts address the practical duties of Shari'ah boards and examine their implications for risk mitigation in the industry.

5.2 Authority and Shari'ah Ruling in Islamic Finance

In the legal arguments the notion of 'authority' is a complex concept. Its essential role in any discussion over the legitimacy of authorities' actions reflects its crucial role in the development of a legal system. In the context of Islamic finance, legal authority bears a dual concept as its legality is subject to religious factors. In this regard, the discussion over the authority of Shari'ah boards with regard to their duties such as auditing Shari'ah compliance (as the main and distinctive feature of the Islamic finance industry) of Islamic financial institutions, presents a pivotal concept. The power of Shari'ah boards reflects the alleged incompatibility of authority with reason, 'for reason requires that one should always act on the balance of reasons of which one is aware' and in contrast 'it is of the nature of authority that it requires submission even when one thinks that what is required is against reason.'[565] In this context, authority in the form of *taghlid* (imitation) in Islamic law is seen as a complete acquiescence to the opinions of Shari'ah jurists. In this regard, Shari'ah boards' rulings as the expression of authority indicate a kind of power over Islamic financial institutions since they provide legality and legitimacy of their operation. To illustrate the authority of Shari'ah boards in the context of Islamic finance industry, it is necessary to study concept of authority in positivism.

[565] Joseph Raz, *The Authority of Law* (2nd edn, OUP 2009) 3.

5.2.1 The Nature of Authority in the Context of Positivism

Authority is a practical concept in positive Law and rests on a non-relativized sense.[566] in Finnis words: 'a person treats something as authoritative if and only if he treats it as giving him sufficient reason for believing or acting in accordance with it notwithstanding that he himself cannot otherwise see good reason for so believing or acting, or cannot evaluate the reasons he can see, or sees some countervailing reasons, or would himself otherwise (i.e. in the absence of what it is that he is treating as authoritative) have preferred not so to believe or act.'[567] Authority is an ability to change the normative situation[568] such as creating obligations and rights on the part of others. This ability acknowledges a close relation between normative power and authority.[569] Further, authority as a kind of power over others is the ability to change reasons for actions.[570] This power is not only about the orders and laying down rules, but it can be a kind of influence over others actions. In other words, the power of authority can be derived from external (such as office and legal system) or internal (the charismatic influence of religious leaders) sources.

In the context of positivism, authority reflects a more functional than personal nature. In this regard, the concept of authority is rooted in human intellectual experience, as the identification of law and its moral value comes from a legal system established by human logic and mainly

[566] ibid 10.
[567] J. M. Finnis, 'Authority' in Joseph' Raz (ed) *Authority* (NYU Press 1990) 176.
[568] John Lucas, *The Principle of Politics* (OUP 1966) 16.
[569] Raz (n 565) 18.
[570] ibid 19.

supported by state and courts.[571] This argument expresses the nature of legal positivism as 'the legal positivist proceeds from the assumption that the law is a constituent element of social reality, in other words, that is exists as an institutional fact which is to be grasped and explained by legal science. Cognition of law is conceived of as cognition of a social reality. Accordingly it is a form of cognition which is dependent on experience….the legal positivist does not assume any a priori criteria of rightness of law which would be valid independently of human volition and of human institutions.'[572] Hence, reasoning in legal positivism is a sub-species of practical reasoning since the modern and actual positive law is the result of state's economic and financial policies.[573] Also, the methods of interpretation belong to the positive institutionalised elements of law as social reality.[574] Accordingly, the establishment and the content of law are based on the legal structure built by state as the ultimate national authority, and in the context of international financial law by governmental or non-governmental international standard and policy setting organizations.

This argument justifies the economic approach to law as the functional efficiency of authority in the context of financial and commercial markets is related to the economic efficiency of decisions. This reveals wealth maximization as the underlying ethical foundation of law in positivism. In this regard, the contractarian nature of firm requires agents (managers and board of directors) to interpret and perform their functions according to the normative essence of wealth maximization. As a consequence, the direct and indirect social functions (the actual social

[571] Although, the traditional positivism is based on the authority of state, globalization has changed it in terms of commercial and financial law. John Linarelli, 'Analytical Jurisprudence and the Concept of Commercial Law' (2009) 114 (1) Penn State Law Review 119, 119-215.
[572] Neil Mac Cormick and Ota Weinberger, *An Institutional Theory of Law* (Springer 1986) 116.
[573] Mac Cormick, *Institution of Law* (OUP 2007) 257-258.
[574] ibid 117.

consequences of the law)[575] of financial institutions are the expression of economic and legal policy of the legal system which secures their fulfilment.

The normative function of wealth maximization in the context of global financial markets bears a dual essence: micro as the expression of individualism and liberalism (such as freedom of contract); macro as the expression of social concerns of national and international legal orders. Wealth maximization in the context of corporate law establishes a normative foundation for the functions of authority (board of directors and other agents). For instance, corporate law Acts as the enabling means allow managers to establish the systems of governance without close examination from regulatory authorities.[576] In this regard, for instance the institution of 'business judgement rule' in the US legal system reflects a lenient approach by which US courts approve and acknowledge freehand managers authority over corporate resources and shareholders' investment.[577] In the UK, section 174 of the UK companies Act 2006 indicates the duties of directors (subjective and objective) with no reference to the business judgement rule. Although it requires a general knowledge and skill with regard to their functions, they should be considered in connection with the duty to promote the success of the company mentioned in

[575] Raz (n 565) 165; wealth is not valued for itself, but just as an instrument for pursuing other ends in social life. Wealth maximization focus is on the productive side of human activity. Richard A. Posner, 'Wealth Maximization Revisited' (1985) 2 Journal of Law, Ethics and Public Policy 85.

[576] Frank H. Easterbrook and Daniel R. Fischel, *The Economic Structure of Corporate Law* (Harvard University Press 1991) 2.

[577] The business judgement rule is a rule applied by the US courts and concerns decisions to not take actions relevant to managers' decisions over business operation of the corporation. The rationale behind the rule is that the modern commercial and financial competitions require an enabling approach with regard to innovative steps of managers. Accordingly restrictive law would act as a barrier to their responsibility. The rule is defined under section 141(a) of general corporation law of Delaware. Also, according to American Legal Institute principles of corporate governance, the rule is designed to stimulate risk taking and accordingly to flourish financial and commercial markets. Charles Hansen, 'The Duty of Care, the Business Judgement Rule, and the American Law Institute Corporate Governance Project' (1993) 48 (4) The Business Lawyer 1355.

section 172.[578] In other words, the centralized decision-making and authority, as the essential attribute of an efficient corporate governance system, implies a central goal for all who are involved in corporate business (such as auditors, lawyers and advisers) which should be considered in their functions.

The concept of authority in the context of international financial order is established based on rules which do not come from the force of state, but from the social acceptance of legal obligations.[579] As discussed before, international financial and commercial laws are the productions of non-state actors. In fact, globalization has led to the transformation of economic and legal rules, and accordingly policy making processes in different aspects particularly in finance. In this regard, traditional rule-making and governance processes (with central role of government) reciprocally compete with an increasing number of non-state actors in the international financial governance system.[580] In this regard, the concept of authority in the context of transnational legal order reflects a pervasive and non-restricted nature in producing a certain kind of order that solve problems.[581] In this regard, authority encompasses the associated public and private actors (such as international organizations and academic sources) that order behaviour without any direct force from states.[582] In other words, the concept of law in the context of transnational legal order is a social construct with a normative characteristic within a

[578] David Cabrelli, 'Presentation for Universita' Bacconi on the Reform of the Law of Directors' Duties in UK Company Law' (the University of Edinburgh) 26 <http://www.research.ed.ac.uk/portal/files/13215836/CABRELLI_D_PRESENTATION_FOR_UNIVERSITA_BOCCONI_ON_THE_REFORM_OF_THE_LAW_OF_THE_DIRECTORS_DUTIES_IN_UK_COMPANY_LAW.pdf> access 23 March 2014.
[579] Linarelli (n 571).
[580] Filippo M. Zerilli, 'The Rule of Soft Law: An Introduction' (2010) 56 Journal of Global and Historical Anthropology 3, 6.
[581] Terence Halliday and Gregory Shaffer, 'Transnational Legal Orders' (2015) UC Irvine School of Law Research Paper 2015-56' 6.
[582] ibid

normative group. In the context of transnational legal order, law presents a cosmopolitan characteristic in which authoritative power comes from normative community and is not surrounded by state boundaries.[583] In this normative community (such as IMF and world bank) 'the internal reflective attitude exists in both norm givers and norm users' towards rules, hence there is a more binding meaning for the concept of 'in force' than one is applied to municipal legal systems.[584] In other words, although these transnational legal norms are not formally binding in themselves, 'they are intended to stimulate law-making in nation-states'.[585] Further, the authority of a normative grouping like International finance and commerce is mainly non-hierarchical and lacks a formal top-down authority with regard to distribution of functions.[586] The authority of the normative group is recognisable from its normative consequences. In other words, opting out the normative rules raises negative attitudes of other group members.[587]

Norms, values and accordingly, the functions' of authority in the context of legal positivism depends on experience and cannot be justified purely cognitively.[588] Further, the functional notion of authority is attributed to the function of one's position or office (in authority) with established professional rules and expectations which experience changes according to the requirements of new state and environment.

[583] Linarelli (n 571) 196.
[584] ibid.
[585] Halliday and Shaffer (n 581) 7.
[586] Linarelli (n 571) 198.
[587] ibid.
[588] ibid 116-117.

5.2.2 The Nature of Authority in Islamic Law

The Concept of authority in Islamic law carries a dynamic nature. As professor Hallaq explains: 'in Islamic law, authority-which is at once religious and moral but mostly epistemic in nature-has always encompassed the power to set in motion the inherent processes of continuity and change.'[589] Further, it has experienced various stages and process of change, from absolute *ijtihad* to a relatively limited set of doctrines based on school's (*madhab*) doctrinal structure.[590] In this context, *taqlid* (imitation) is regarded as the path of continuity in Islamic law. It encompasses the general acceptance of the doctrines and the intellectual authority of past jurists.[591] Further, *taqlid* is a process by which *mughalid* scholar accepts the methodology and knowledge of the eponym to achieve authority (not necessary intellectual) that could act as the force.[592] In other words, while the approach of early scholars was purely *ijtihadic* by which they were able to establish the authority of their intellectual endeavour in its content completely, those in the regime of *taqlid* establish such an authority in a school or an individual to validate his legal opinions.[593] In fact, the authority in the regime of *taqlid* is based on the legal tradition of the associated school and its established doctrines rather to the primary sources of authority (scripture).[594] In the context of modern Islamic finance, this statement reveals the essentiality of another element in the process of *taqlid*, namely positivism.

Science is an important part of the modern legal reasoning. Particularly in the area of finance its interdisciplinary nature requires the knowledge of finance and economics too. As discussed

[589] Wael B. Hallaq, *Authority, continuity and change in Islamic law* (CPU 2001).
[590] ibid.
[591] ibid.
[592] Abdul-Rahman Mustafa, *On Taqlid* (2013 OUP) 18.
[593] ibid.
[594] ibid.

before, the significance of economic value and the efficiency of financial products necessitates revisiting the idea of *ijtihad* and *taghlid* in Islamic finance. In this regard, to facilitate internationalisation of Islamic finance and to enhance its value proposition for the global economy, it is imperative to evolve *fiqh* to provide an effective legal framework.[595]

In Islamic *fiqh*, the ultimate authority belongs to the founder of a school (absolute *mujtahid*) as the originator and the creator of legal methodology (*usul al-fiqh*).[596] In this regard, the hermeneutic of founding jurist 'is thoroughly grounded in the revealed text'[597] and accordingly his doctrine and principles are derived from those sources.[598] In this manner, the *imams* (leaders) of schools found the structure of methodology, principles and accordingly legal reasoning within the schools' definitions. Although, the doctrines of some later *mujtahids* are regarded authoritative, they are deemed second in Islamic law.[599] For example, in the *Hanafi* School, the doctrine of Abu Hanifa, as the founder of Hanafism and his immediate followers Abu Yusuf and Shaybani stand at the top and no later *mujtahid* is permitted to diverge from them.[600] As Khan asserts: 'Islamic *fiqh* permits no interpretive revolution.....precedent provides continuity and prevents normative shocks to the enterprise of Islamic *fiqh*. While each generation of jurists may freely interpret the Basic Code, no generation is allowed to subvert prior interpretive series by lifting all methodological constraints and completely discarding all previous entries. A strong

[595] Zeti Akhtar Aziz, Governor of the Central Bank of Malaysia, 'Banking on Islamic Finance-From Legality to Economic Value' (the 8th World Islamic Economic Forum (WIFE) Johor Bahru, 6 December 2012).
[596] Hallaq (n 589) 23-24.
[597] ibid.
[598] ibid.
[599] ibid.
[600] ibid 26; these doctrines are known as *zahir al-riwaya*, transmitted through several highly qualified jurists.

presumption of continuity applies to *fiqh*."[601] As a result of this continuum, tradition has got decisive place in *fiqh* and accordingly in the formation of different modes of authority as it has transformed pure *ijtihad* into the *taqlid* regime.[602]

The significance of the authority of *madhhab* is to the extent that a denial or any attempt to step outside of the boundaries of school is not acceptable and in a technical language is called *tafarrudat* or *gharib* to show the divergence from authoritative doctrine.[603] However, the concept of authority and *taqlid* is not restricted to the doctrines and encompasses the established principles of School with regard to different cases.[604] In this regard, unlike the case-by-case style of founders with regard to questions through the *istifta*, later works shows a hierarchical structure, wherein general principles are presented for solving future problems.[605] This transition from strict casuistry to a generalization illustrates the development of *taqlid* within the *fiqh*.[606] As a consequence 'the preoccupation of the authors is not with textual attestations from the Quran or the Sunna, but rather with authoritative principles that have dominated the school.'[607] In this regard, the concept of 'legality' within the context of *taqlid* reveals its two related aspects: one part is considered from the layman point of view and another one is considered from the authorities of Schools. While in the latter, jurists and Shari'ah experts examine the level of loyalty to the principles and methodology of school, the former encompasses the extent of

[601] L. Ali Khan, 'Fana and Baqa Infinities of Islam: Approaches to Islamic Law and Behaviour' (2010) 7 (3) University of ST. Thomas Law Journal 511, 530-531.
[602] Mustafa (n 592) 20; however, mughalid jurists can be mughalid (by the dual attribute of being mughalid to the founders of schools), simultaneously, be mujtahid through the process of takhrij. Hallagh (n 589).
[603] Hallaq (n 589) 63-6; tafarrudat is a term used when a jurist diverged from the mainstream of a school. For instance, in the Shafei School the Muzani's treaties are tafarrudat since they are not according to the Shafei's. Hallaq (n 589) 58.
[604] Hallaq (n 582) 90-114.
[605] ibid.
[606] ibid.
[607] ibid 98.

acceptance of the given opinion (without any technical study) by layman. In other words, in compare to the jurists of schools, the authority in *fiqh* from a layman point of view is purely individual. Further, the institutionalization of *taqlid* is believed was mainly for limiting the discretionary power of lower legal officials as they were obliged to adhere to a particular school.[608] In this regard, it is discussed that institutionalization of *taqlid* by collecting and organizing cases and fatwas enhances predictability, prevents Muslims to obtain legal rulings from other schools or adhere to isolated opinions, and at the same time compels scholars to adhere to school's established principles and methodology.[609] However, due to inflexibilities in sole adherence to one school and applying the rigid system of *taqlid*, the most of scholars from all schools did accept the practice of *talfiq* to validate an act whose individual parts would not be recognized as valid.[610]

5.3 Legality in Positivism

The Perception of legality requires an exploration over the concept of Law in positivism. The Concept of Law in positivism is discussed in the context of legal system as laws have some common qualities. In this regard, various scholars have presented different definitions. For example, while Austin regards Law as a command of sovereign upheld by the threat of a sanction, Kelsen considers a law as a norm directing officials on imposing sanctions within a legal system. In this regard, the concept of legal system in a broad sense is not only comprised of laws, also all of other legal rules with no necessity for applicability of those laws or legal

[608] Mustafa (n 592) 7.
[609] ibid.
[610] ibid.

rulings.[611] As Kelsen explains: 'this dynamic concept differs from the concept of law defined as a coercive norm. According to this concept, law is something that is created by a certain process, and everything created this way is law. This dynamic concept, however, is only apparently a concept of law. It contains no answer to the question of what is the essence of law, what is the criterion by which law can be distinguished from other social norms. This dynamic concept furnishes an answer only to the question whether or not and why a certain norm belongs to a system of valid legal norms, forms a part of a certain legal order.'[612] However, some scholars, such as Hart illustrates that the legal characteristic of rules can be derived only from their connection with a legal system. He argues that since the norms of any legal system are products of officials (human agents), it is possible that legal norms have no essence since their place is derived from actions of agents in a specific social environment.[613] In other words, the external applicability of rules by legal institutions such as courts and academics illustrates the effectiveness of those rules in the context of a legal system.

Legal norms refer to human behaviour in a given time and place and accordingly, their applicability and effectiveness are contingent on agents (courts or other formal and informal judicial authorities) behaviour.[614] In this regard, the qualification and modification of the conditions of applicability of norms in a legal system is an individualized process done by agents. Also, their effectiveness is 'a function to the extent to which it is compiled with by the agents to whom it applies.'[615] Practically, the interactive nature of the norms of a legal system has some effects on the applicability of the concept of illegality. In this context, the notion of

[611] John Gardner, 'the Legality of Law' (2004) 17 Ratio Juris 168, 169.
[612] Hans Kelsen, *General theory of Law and State* (The Lawbook Exchange 1945) 122.
[613] H. L. A. Hart, *the concept of Law* (2nd ed, Clarendon Press 1997).
[614] Pablo E. Navarro and Jose Juan Moreso, 'Applicability and Effectiveness of Legal Norms' (1997) 16 Law and Philosophy 201, 205-206.

illegality rests on the function of Law and agents.[616] In the context of Islamic finance, the scope and the application of notions, law, legality and compliance depends on the function of the authority of Shari'ah scholars. In other words, since *Shari'ah* as the ultimate law in Islamic finance is only comprised of general principles, Islamic *fiqh* explains and sheds light on those principles through various interpretations provided by Shari'ah jurists. Further, the opinions of Shari'ah jurists in terms of content and process differ from the concept of law in positivism. In this regard, it is hard to consider Shari'ah opinions as law in its modern sense since they are not the result of a system presenting an official procedure for law making. Although, the constitutions of some Muslim majority jurisdictions such as Saudi Arabia establish a legal place for Shari'ah, they are subject to various regulatory and statutory provisions. Further, although the influence of Islamic *fiqh* in explanation of legal rules is undeniable, this is the power of state which gives them legal place in the given legal system.

5.4 The Implications of Economic and Financial Policy for the Functions of Shari'ah Boards

It is assumed that successful development is the result of long-term inclusive economic and financial policy. In this regard, the ability to raise the rates of accumulation of physical and human capital and the efficient use of the resulting assets depends on the existence of an efficient financial intermediation which backs 'the establishment and expansion of institution, instruments

[615] L.W. Sumner, *the moral foundations of rights* (OUP 1987) 58.
[616] bindingness of law comes from social facts or social norms. Applicability (internal and external) is defined in the context of a legal system. Accordingly, law as social rule has functions based on legal policy and economic policy.

and markets that support this investment and growth process'.[617] In fact, the quality of the functions of a financial system and its impacts on economic growth is determined by: (i) the level of financial intermediation; (ii) the efficiency of financial intermediation; (iii) the composition of financial intermediation.[618] In this regards, the size of a financial system is important for economic growth as it affects all functions of financial intermediation. A large financial system reflects a progressive flexibility with regard to available credit, firms' borrowing power, and accordingly more investment opportunities[619] as they increase the resilience of the economy to external shocks by effective risk diversification between different sections which results in more investment and economic growth.[620]

In this regard, the efficient financial intermediation addresses market imperfections such as externalities and asymmetric information by long-time legal and institutional policy to further and ease its participation and integration into international economic. In fact, the functional perspective towards financial intermediation approves the mentioned functions. In this regard, the emphasise of functional approach is on the economic functions performed by financial intermediaries and accordingly its structure rests on two premises: '1) functions change less over time and vary less across geopolitical boundaries; and 2) competition will cause the changes in institutional structure to evolve toward greater efficiency in the performance of the financial

[617] Valpy FitzGerald, 'Financial Development and Economic Growth: A Critical View' (2006) Background paper for world economic and social survey 1, <http://www.un.org/en/development/desa/policy/wess/wess_bg_papers/bp_wess2006_fitzgerald.pdf> accessed 25 August 2015.
[618] ibid 4; financial systems serves five broad functions: 'first, they produce information ex ante about possible investments. Second, they mobilise and pool savings and allocate capital. Third, they monitor investments and exert corporate governance after providing finance. Fourth, they facilitate the trading, diversification and management of risk. Fifth, they ease the exchange of goods and services. FitzGerald (n 617).
[619] ibid 5.
[620] ibid

system.'[621] Notwithstanding, as the basic functions of all financial systems are essentially the same, a functional approach provides a more realistic perception over the functions of Islamic intermediaries as well. In this regard, to meet efficiency, intermediaries need a dynamic product development, interacting between them and markets through innovation.[622] In other words, markets and intermediaries have a complementary relation in which intermediaries reinforce markets by new products and in turn, markets support intermediaries to innovate more low-cost products.[623] According to this view, a functional approach to innovation in financial policy making and its implications for the development of markets is more reliable as it addresses deficiencies and try to present functional solutions for them.

Generally, different functions are recognised for innovation but among them reallocating risk, reducing agency costs and increasing liquidity are more common.[624] Although, the focus of the Bank for International Settlements is on the transfer of risk, the enhancement of liquidity and the generation of funds, the addressed functions share similar characteristics and goals.[625] However ensuring market integrity and improving the economic performance of financial intermediaries require government policy and regulation. In this regard, a holistic approach over innovative products and institutions is considered plausible for an effective regulatory policy. In other words, an effective innovation policy considers financial products and infrastructure together, 'that is the institutional interfaces between intermediaries and financial markets, regulatory

[621] Robert C. Merton, 'A Functional Perspective of Financial Intermediation' (1995) 24 (2) Financial Management 23.
[622] ibid 26.
[623] ibid 28.
[624] John D. Finnerty, 'An Overview of Corporate Securities Innovation' (1992) 4 (4) Journal of Applied Corporate Finance 23.
[625] 'Recent Innovations in International Banking' (1986) Bank for International Settlements Report.

practices, organization of trading and clearing facilities...'[626] on this subject, regulation and policy shape and also are shaped by the time path of innovation.[627] As Kane identified regulatory dialectic is a source of innovation since it lets markets and financial institutions respond to their needs efficiently.[628]

However, innovation regime is affected by court decisions and also by legal system as they affect the nature of contracts and the amount of innovation.[629] As discussed before, financial policy and innovation regime have a broad impact over financial institutions and their governance bodies in terms of policy. In this regard, although the underlying principles of Islamic finance are different, in practice their operation and function are within and according to conventional system. This fact is true in both jurisdictions with complete conventional system and jurisdictions with dual financial systems such as Malaysia.

In this regard, at macro level, globalization, financial crisis and economic integration push financial systems to more similar financial policies. In this context, the established goal in all financial systems is stability along with an innovative financial regime.[630] In the context of Islamic finance, although the industry is governed by *Shari'ah* law Meta-rules which over-ride conventional codes, the operation and function of Islamic products should be according to the conventional rules and policies. An empirical example is the operation of Islamic finance

[626] Merton (n 621) 36; there are five paths by which government affects financial intermediation: 1) as a market participant; 2) as an industry competitor or benefactor of innovation; 3) as both legislator and enforcer; 4) as a negotiator; 5) as an unwitting intervenor. Merton (n 621).
[627] ibid.
[628] E. J. Kane, 'Technology and the Regulation of Financial Markets' in A. Saunders and L.J. White (eds) *Technology and the Regulation of Financial Markets: Securities, Futures and Banking* (Lexington Books 1986) 187-193.
[629] Peter Tufano, 'Financial Innovation' in George Constantinides, Milton Harris and René Stulz (eds) *The Handbook of the Economics of Finance* (North Holland 2002) 307.

industry in Malaysia. To improve its financial system and meet development goals, Malaysia has experienced a series of financial programs, including the new economic policy, the national development policy and the third outline perspective plan. With these development policies, Malaysia gradually liberalized its financial system and has successfully shifted the structure of its economy from agricultural to manufacturing. In this regard, Malaysia Islamic finance industry has benefited from a facilitative business environment as it has supported liberalization and accordingly the investment of foreign financial institutions on its banking and capital markets sectors. The development strategy of Malaysia encourages innovation in product development and also in restructuring financial regulation. Thus, Malaysia development policy and internationalization of Islamic finance has contributed to the more efficient allocation of funds through introducing facilitative legal framework for market and the industry. In this regard, to meet development goals and ensure alignment with new market development Shari'ah boards are responsible to innovative more facilitative Shari'ah compliant products. In this context, Malaysia financial authorities endeavour to shift legality approach in the engineering of Islamic financial products to economic efficiency approach through innovative and flexible interpretation of Islamic *fiqh*.[631]

5.5 The Duties of Shari'ah Boards

As discussed before, *Shari'ah* is the backbone of the Islamic finance industry and accordingly the role of Shari'ah boards as Shari'ah compliance gatekeepers 'is very pertinent to ensure that

[630] Gary Schinasi defines financial stability as the financial system satisfying three conditions: efficiency, ability to assess and manage risks, and ability to withstand shocks. Gary J. Schinasi, *Safeguarding Financial Stability: Theory and Practice* (International Monetary Fund 2006).
[631] Akhtar Aziz (n 595).

the credibility and integrity of the industry are maintained.'[632] In this regard, it is believed that one of the main reasons for the fast development of Islamic finance is the dynamic role of Shari'ah supervisory boards in facilitating, monitoring and ensuring stakeholders over Shari'ah compliance of financial products and operation. In other words, Shari'ah compliance is the main concern of the industry, as it preserves the industry's reputation and stakeholders' confidence.

Shari'ah compliance risk management as the distinguished characteristic of Islamic finance is an ambiguous task. Its scope may encompass a wide range of tasks with no agreement over their concepts and contexts. In this regard, the primary roles of Shari'ah boards at the initial stage of modern Islamic finance were basically endorsement ones.[633]However, since globalization and technology advances have changed the needs of markets and accordingly necessitated innovative and inclusive financial policies, the roles of Shari'ah board have been expanded. Generally, to preserve the integrity of Islamic finance industry, they are responsible to supervise the application of Shari'ah principles and rules in the industry developed by local or international authorities. Further, the fast development of markets requires the permanent and regular training of Islamic financial institutions' employees by Shari'ah boards as they assist them to monitor the operation of financial products and the governance of Islamic financial institution. Moreover, to ensure productivity of financial products, Shari'ah scholars should have full knowledge of the purpose of financial products used in the markets to assess them according

[632] Mohamad Akram Laldin, 'Duties and Responsibilities of Shari'ah Boards from a Legal and Regulatory Perspective'
<http://www.amanie-iconnect.com/component/k2/item/31-duties-and-responsibilities-of-shari%E2%80%99ah-boards-from-a-legal-and-regulatory-> accessed 22 July 2014.
[633] Laldin, 'Roles and Responsibilities of Shari'a Scholars in Shari'a Advisory Services' in Ali Khorshid (ed) *Euromoney encyclopedia of Islamic finance* (Euromoney Institutional Investor PLC 2009) 198.

to *Shari'ah* objectives.[634] In other words, Shari'ah boards should concern about the prosperity of *ummah* and support facilitative initiations.[635]

However, differences in regulatory systems have some effects on Shari'ah boards' duties. For instance, jurisdictions with central Shari'ah council like Malaysia provide more effective and harmonised ground for the functions of Shari'ah boards as they should work closely with regulators to implement their Shari'ah decisions.[636] Generally, Auditing (*ex ante* and *ex post*) and advising over Shari'ah-compliant products and the governance of Islamic financial institutions are the main duties of Shari'ah boards. In this regard, the legality of Islamic financial products is provided by Shari'ah boards' endorsement through issuing fatwa, and accordingly the legitimacy of the operational aspects of financial products and the governance of the Islamic financial institutions are provided by auditing or Shari'ah review. In other words, the main duty of Shari'ah boards is auditing and supervision of Shari'ah compliance in the industry. The next part discusses the mentioned roles in terms of Shari'ah compliance risk management.

5.5.1 Operational Risk in Islamic Finance: the Role of Shari'ah Boards in Shari'ah Compliance Risk Management

In compare with conventional financial intermediaries, Islamic financial institutions in their operation carry the same task in managing the various risks such as credit, market and investment. Their common goal in risk management is to prevent and control losses arising from unforeseen events. Particularly, financial crises over the years revealed the importance of a

[634] ibid.
[635] ibid.
[636] ibid.

holistic risk management approach, through which all classes of risks are regarded important. In this regard, operational risk as 'the risk of direct or indirect loss resulting from inadequate or failed internal processes, people and systems or from external events'[637] got a crucial place in risk management policies and operations.

Before its manifestation, operational risk was considered as a residual category for other risks not covered by credit and market risks.[638] Regarding the importance of the definition of operational risk, it is argued that since definitions 'delimit the jurisdiction of practices in the system of professional knowledge',[639] the lack of an agreed definition in an organization may result in unclear functioning of the relevant profession. Accordingly, the definition of operational risk captured a significant place between scholars as its delimitation illustrates more potential sources of loss. Also, operational risk is considered as a basis for connecting different functions in the organization, as a result is so political.[640] In this regard, to provide more explicit boundary for operational risk, some distinguishing features have been defined for it. In this regard, the first feature is diversity. Operational risk is highly varied in terms of its origins, forms and effects.[641] Further, 'it can occur in any activity, function, or unit of the institution.'[642] Another feature of operational risk is the lack of concept of risk exposure as it is not related closely to any financial indicator[643] as is more related to the culture of the business and management.[644]

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[637] Basel Committee on Banking Supervision, 'Operational Risk' (2001) para. 6.
[638] Michael Power, 'the Invention of Operational Risk' (2003) ESRC Centre for Analysis of Risk and Regulation Discussion paper No. 16, 7.
[639] A. Abbott, *the System of Profession* (Uni. of Chicago press 1988).
[640] Power (n 638) 8.
[641] R. Buchelt and S. Unteregger. 'Cultural Risk and Risk Culture: Operational Risk after Basel II' (2004) Financial Stability Report 6.
[642] The Economist, 'Deep Impact: Judging the effects of new rules on bank capital' (*The Economist* 8 May 2003).
[643] R. de Koker, 'Operational Risk Modelling: Where Do we Go from Here?' in Ellen Davis (ed) *The Advanced Measurement Approach to Operational Risk* (Risk Books 2006).

The main goal of risk management is to prevent and control loss in corporate business. This goal is the manifestation of directors' duty to maximize shareholders value. Further, the nature of loss in risk management is mainly a pecuniary one which decreases, obstacles or destroys the current or potential value of the organization.[645] In this regard, the cause of the loss may be internal or external. In the context of operational risk for instance, the lack of a sound and robust internal compliance plan may result in the violation of regulations, accordingly loss.

It may be discussed that although some losses such as reputational damage resulted from operational risk do not have pecuniary appearance, may lead to unpredicted pecuniary losses. In the context of Islamic finance, there is a special risk in the products and the operation of Islamic financial institutions related to their Shari'ah compliance operation. The concept of Shari'ah here refers to 'fatwas, rulings, guidelines issued by Shari'ah supervisory board of the Islamic financial institutions and the accounting standards of the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI).'[646] Shari'ah non-compliance risk is regarded as a kind of operational risk in Islamic finance. In this regard, the Guiding principles of Risk Management for Institutions (other than insurance institutions) operational risk is part of the risk management in Islamic financial institutions.[647] According to the Guiding Principles, risk management steps

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[644] V. Rao and A. Dev. 2006. 'Operational Risk: Some Issues in Basel II AMA Implementation in US Financial Institutions' in Ellen Davis (ed) (n 643) 273–294; some other features are recognised by other scholars, such as being one-sided, idiosyncratic and indistinguishable from other kinds of risks. Imad A. Moosa, (2007) 16 (4) 'Operational Risk: a Survey' Financial Markets' Institutions & Instruments.

[645] The Basil committee tries to distinction between direct and indirect losses. However its endeavour has not been successful as in practice there is a high degree of ambiguity in the process of categorising losses and costs. Basel committee (n 637)2.

[646] Zurina Shafi, Supiah Salleh and Syahidawati Hj Shahwan, 'Management of Shariah Non-Compliance Audit Risk in the Islamic Financial Institutions via the Development of Shariah Compliance Audit Framework and shariah Audit Programme' (2010) 3-2 Kyoto Bulletin of Islamic Area Studies 3.

[647] IFSB, 'Guiding principles of Risk Management for Institutions (other than insurance institutions)' (2009) ; categories of risks are: credit risk, investment risk, market risk, liquidity risk, rate of return risk, and operational risk.

and process should be in accordance with *Shari'ah* principles and accordingly Shari'ah supervisory board is responsible to review the relevant reports.[648]

In this regard, although operational risk is identified as an independent risk, the content of the Guiding Principles reveals the operation of risk management department is completely related to the opinions of Shari'ah supervisory board. In other words, Shari'ah non-compliance risk is an inherent risk in all other risks. For instance, in managing credit risk, Islamic financial institutions should have a strategy for financing which applies Shari'ah-compliant instruments and accordingly to mitigate credit risk they 'shall have in place Shariah-compliant credit risk mitigation techniques...' [649] Regarding investment risk management, the guiding principles require the approval of Shari'ah supervisory board on equity investment activities such as *mudarabah* and *musharakah*.[650] The operational risk management as the last part of the guiding principles is based on the establishment of Shari'ah supervisory board as a control mechanism to ensure Shari'ah compliance in all Islamic financial institution's operations.[651]

Regarding the importance of the implementation of a Shari'ah auditing mechanism like Shari'ah supervisory board we can present two reasons: the first one arose from a pure religious belief that although there is no material punishment in this world for Shari'ah non-compliant activities, we are all responsible before God. The second reason carries economic nature. In this regard, since Shari'ah-compliant is the cornerstone and the base of Islamic finance reputation, Shari'ah non-compliance operation of Islamic financial institution results in reputational risk and

[648] ibid, principle 1.
[649] ibid, principles 2 and 5.
[650] ibid, principle 8.
[651] ibid, principle 14.

accordingly may affect stakeholders' confidence negatively and leads to economic difficulties in all parts.

Shari'ah boards are regarded as the main body of compliance control. However their extent of responsibility depends on the regulatory system. In other words, some regulatory systems such as Malaysia provide a defined interpretive boarder for *Shari'ah* to lend more predictability and coordination to Shari'ah compliance. Due to the importance of reputational effects of Shari'ah compliance[652]on the development of Islamic finance industry we shall consider it in the next part, and then discuss the implications of a central Shari'ah regulation for Shari'ah boards' duties.

5.5.1.1 Reputational Risk

Corporate reputation in the market economy is considered as an asset and 'as a concept embodies the image and values of a company, and was intimately linked with the concept of corporate responsibility.'[653] Reputational risk is associated with the possibility of loss in the going-concern value of the financial intermediary.[654] In other words, 'reputational risk comprises the risk of loss in the value of a firm business franchise that extends beyond event-related accounting losses and is reflected in its share performance metrics.'[655] The reputation of an organization is influenced by its operation and policies, but ultimately is under the control of the management.[656] Although reputation is not classed as an asset in balance sheet, is an intangible

[652] Although, due to a minimum regulatory operational risk capital charge, Basil committee on banking supervision's definition on operational risk does not include reputational risk.
[653] The Chartered Institute of Management Accountants (CIMA), 'Corporate Reputation: Perspectives of Measuring and Managing a Principal Risk' (June 2007) 6.
[654] Ingo Walter, 'Reputational Risk and Conflict of Interest in Banking and Finance: The Evidence So Far' (2007) INSEAD Working Paper 2007/02/EPS.
[655] ibid
[656] CIMA (n 653).

asset for the financial institution.[657] Moreover, reputational risk management is the management of stakeholders' expectations as it lies in the gap between expected and actual behaviour.[658]

Generally, reputational risk is linked to management's responsibility to increase financial institution's value and its operational issues. In the context of Islamic finance, Shari'ah compliance comprises an important (or the most important) part of the reputation of the industry and accordingly any deficiency in Shari'ah compliance risk management can increase reputational risk and resulting losses. The reputational Losses arose from non-Shari'ah compliant operation result in decrease in investment and accordingly unethical reputation for the industry. In this regard, the role of Shari'ah boards in reputational risk management is only monitoring and advising, not governing. In other words, the directors of Islamic financial institutions have to apply Shari'ah boards' fatwas and Shari'ah boards are only responsible for monitoring and reporting of Shari'ah compliance issues. In this regard, the stakeholders' reaction will determine the extent of reputational losses. For instance, if Shari'ah non-compliance operation of an Islamic financial institution leads to increase in shareholders' value, the reaction depends on the majority of Shari'ah sensitive shareholders, the level and scope of its operation (local or international) and the regulatory system. In this regard, if Islamic financial institution is active in a jurisdiction with central Shari'ah regulatory system such as Malaysia with preventive laws on Shari'ah non-compliant operations, the reaction would be more severe and negative as the central regulation monitor compliance and enforcement.

[657] ibid.
[658] ibid.

5.5.1.2 Audit

Audit is an official inspection of an organization's accounts by an independent professional. Audit is known as an accountability mechanism in corporate governance. In this regard, audit supports corporate governance to balance the interests of different corporate members and prevent the conflict of interests or agency problems.[659] As discussed earlier, it is assumed shareholders as de facto owners of the company[660] should have the ultimate control over their capital. However due to practical difficulties such as expertise and experience, they give power to managers as their agents to run the corporate in line with their interests. Managers and directors as fiduciaries are supposed to act in good faith and advance shareholders value[661]. But the increasing divergence between them, and the lack of adequate monitoring and control mechanisms leave directors to follow their own interests, and as a consequence results in agency problems. In addition, as we have seen in many scandals such as Enron, the lack of effective monitoring mechanisms opens doors for fraud and fraudulent practices of the agents. In this regard, corporate governance as a set of relationships between corporate members needs an effective auditing system as a control mechanism to mitigate recurring incidents of agency problems.[662]

Audit as a control mechanism is to ensure investors about their agents' fairness. Auditing practices in the context of conventional system have experienced many changes over time through changes in business and political environments. Auditors had no professional status and

[659] Oliver Hart, 'Corporate Governance: Some Theory and Implications' (1995) 105 (430) the Economic Journal 678.
[660] Erik Banks, *Corporate Governance, Financial Responsibility, Controls and Ethics* (Palgrave 2004) 17.
[661] ibid.
[662] The OECD Principles of corporate governance (2004).

the primary focus of auditing was on fraud prevention and accordingly 'was designed to verify the honesty of persons charged with fiscal responsibilities.'[663] Regarding the increased size of business organizations and the separation of ownership and management in corporates, auditing became more important.[664] In this context, the Industrial Revolution and the establishment of public companies increased the separation of ownership and management, as a consequence prompted the need for professional auditors.[665] Moreover, the inclusion of independent auditors in the 1862 Companies Act reflected the importance of public scrutiny over directors.[666] According to the Section 94 of the Companies Act of 1862 auditors were to report: 'whether in their opinion the balance sheet is a full and fair balance sheet containing the particulars required by these regulations and properly drawn up so as to exhibit true and correct view of the state of the company's affairs.' Regarding the purpose of auditing, since 1940 the emphasis has been on the fairness statement. According to ISA Standards: 'in the case of most general purpose framework, that opinion is on whether the financial statements are prepared fairly, in all material respects, or give a true and fair view in accordance with framework.'[667] However, fraud detection remained an important aspect of auditing task. According to ISA: 'An auditor conducting an audit in accordance with ISAs is responsible for obtaining reasonable assurance that the financial statements taken as a whole are free from material misstatement, whether caused by fraud or error.'[668]

[663] Banaga (n 292) 23.
[664] ibid.
[665] ibid.
[666] ibid.
[667] International Standard on Auditing (UK and Ireland) 200, 'Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing (UK and Ireland)' (2009) paragraph 3.
[668] International Standard on Auditing (UK and Ireland) 240, 'the Auditors Responsibilities Relating to Fraud in an Audit of Financial Statements' (2010) paragraph 5.

Auditing in the context of corporate economy is a profession established based on the defined standards, practices and ethics. Further, objectivity, independence and public responsibility are the pillars of this profession and protected by local and international auditing organizations and standards such as the International Auditing and Assurance Standards Board (IAASB) and Chartered institute of internal auditors.[669] In this regard, the word 'Profession' suggests a grouping of people who have made a study of an area of knowledge or expertise and have achieved a level of competence in their chosen field.[670] Gray describes professionalism 'a preference for the exercise of individual professional judgement and the maintenance of professional self-regulation.'[671] Independence is the cornerstone feature of a profession and accordingly the main concern of auditors and all involved parties. Several definitions for independence have been presented by various authorities. For instance, the UK Guide to professional Ethics (1985) states: 'professional independence is a concept fundamental to the accountancy profession. It is essentially an attitude of mind characterised by integrity and an objective approach to profession work.' International standards for the professional practice of internal auditing states: 'independence is the freedom from conditions that threaten the ability of internal audit activity to carry out internal audit responsibilities in an unbiased manner.'[672] In other words, any condition with negative effect on auditor's professional judgement is

[669] It is worth noting that internal and external auditing are different in terms of the duties and regulation. While internal audit is part of internal control system of a business and is to develop risk management policies and ensure their effective implementation and operation, external audit acts as independent organization. The internal auditor reports to audit committee and directors, external audit reports to shareholders. Regarding The establishment and harmonization of standards, internal audit standards in comparison to external audit are new. External auditing has experienced a long history of evolution and bears a more standardised status than internal audit.

[670] K H Spencer Pickett, *The Internal Auditing Hand Book* (3rd edn, John Wiley & Sons 2010) 421.

[671] S. J. Gray, 'Towards a Theory of Cultural Influence on the Development of Accounting Systems Internationally' (1988) 24 (1) *ABACUS* 1, 8.

[672] 'International Standards For the Professional Practice of Internal Auditing' (The Institute of Internal Auditors, USA 2012).

considered a danger to his independence. For example, an auditor concerns over his appointment and remuneration, may endanger his impartiality.

Regarding the dimensions of independence, Sharaf and Mautz suggested that: 'independence is a three dimensional concept. The auditor must be free from restriction or bias in all three dimensions concurrently if he is to be totally independent. Three dimensions are: 1- programming independence: this is freedom from undue influence in the choice of audit procedures and techniques and in the extent to which they are applied. The auditor must have freedom to develop his own program with respect to the steps included in the amount work to be undertaken. 2- Investigative independence: this is freedom from influence in the choice of activities, areas, managerial policies, etc, to be examined. No legitimate information source should be unavailable to the auditor. 3- Reporting independence: this is freedom from undue influence in the statement of facts revealed during the examination of in the expression of opinions, or recommendations resulting from the examination.'[673]

According to our discussion, fiscal auditing in conventional system bears a pecuniary characteristic which its aim is to preserve stakeholders' confidence and prevent imbalances in market. However, auditing in Islamic finance bears a religious characteristic too. In other words, Concerns about the Shari'ah compliance design of products and the operation of Islamic financial institutions demands an additional and distinguished dimension in auditing. The next part establishes a historical and legal analysis for this issue.

[673] Sharif and Mautz (1960) in Banaga (n 292) 42.

5.5.1.2.1 *Hisbah*

Shari'ah audit in Islamic law is relatively a new term. Its root is established in the institution of *hisbah*, which lies with the concept of enjoying the good and forbidding the evil. The institution of *hisbah* and the role of *muhtasib* (ombudsman) go back to the prophet (pbh) era. Historically, *Hisbah* has been a monitoring and corrective institution to regulate transactions that take place in the market. As Kahf says, *hisbah* comprises three aspects: 'one that all activities and transactions are undertaken within the boundaries of the rules of Shari'ah; two, all activities and transactions are done with observation of the moral values and ethical principles of Islam as religion; three, the ombudsman (*muhtasib*) is also charged with the function of ordaining what is known as good and forbidding what is known as wrong in the market.'[674] In other words, the function of institution *hisbah* is religious-economic as its aim, well-being of society, is done through Shari'ah principles. In this regard, it is discussed that as the term *ihtasab* shares the same root with *hisbah* as its function may mean 'to try to gain honour in God's eyes by acting righteously'.[675]

In this regard, *hisbah* implies two meanings: a general meaning implies a religious duty for all Muslims to order good and forbid evil; and a supervisory function by an official.[676] The institution of *hisbah* has experienced evolution in Islamic law. However, the codification of *hisbah* law by Ottoman Empire was a significant landmark in the history before the emergence of corporate economy.[677] *Ihtisab quanuunameleri* (hisbah law) was developed by Sultans

[674] Monzer Kahf, 'Islamic Government and Market Regulation: A Theoretical Framework' (the seminar on Government in Islamic economics, Tehran, October 2007) 8.
[675] Ronald Buckley, *the Book of Islamic Market Inspector* (OUP 1999)
[676] ibid.
[677] Khaled Fahad Benjelayel, 'An Investigation into the Foundation and Nature of Islamic Securities Market Regulation' (PhD thesis, Institute of Advanced Legal Studies, University of London 2013) 117.

Mehmed II and Bayazid II to be as part of the process of economic centralization by the state.[678] This law provides a comprehensive regulation of production standards, general instruction on measures, misdeeds committed by certain merchants and the punishments for violating the law.[679] hisbah law provided predictability with regard to the commercial and the religious consequences of market transactions and also secured fair competition in market to promote public interest.[680] Although, *muhtasib* was entrusted with supervising market by his discretionary powers, the position falls below of judge as he had no jurisdiction to hear cases but only to settle disputes where the facts were admitted.[681]

The institution of *hisbah* reflects concerns about consumer protection. Consumer protection by the Islamic state primarily included identifying and punishing usury and other haram activities by *muhtasib*.[682] In this regard, in performing his duties to ensure that the market transactions and conditions are sound, *muhtasib* was equipped with legal authority to impose discretionary sanctions (*tazir*) such as financial compensation.[683] In fact, the institution of *hisbah* was preventive as *muhtasib* sought to ensure the market regulation by imposing *tazir* against illegal activities.[684]

In summary, *hisbah* was a religious institution and had two goals: one, regulating and harmonizing market commercial transactions and activities based on hisbah law established

[678] Karen Barkey, *Bandits and Bureaucrats: The Ottoman Route to State Centralization* (Cornell UP 1994) 42; Benjelayel (n 677).
[679] Benjelayel (n 677).
[680] ibid 118.
[681] ibid; there is another type of *muhtasib*, called *al-mutatawwi* who was a volunteer and did not have public authority. He was not obliged to enforce the law, but to provide advice and report any breach of law like a good citizen. Benjelayel (n 677) 120.
[682] Ibid.
[683] ibid 123.
[684] Thomas Glick, 'Muhtasib and Mustafa: A Case Study of Institution Diffusion' in Lynn White (ed) *Viator: Medieval and Renaissance Studies* (Vol 2, University of California Press 1972) 70.

based on *Shari'ah* and customary rules; two, preventing misdeeds, fraud and other haram activities by *tazir*. Although, *hisbah* was a state institution and *muhtasib* had an official decree in pursuing his duties in pre corporate economy era, is similar to the audit institution as it monitors and detects defects in financial institutions transactions' and operations based on established rules. However, it enjoys independence and bears no religious aspect.

5.5.2 Shari'ah Audit

Generally, Shari'ah audit or review refers to 'an examination of the extent of an Islamic financial institution's compliance in all its activities with the *Shari'ah*.'[685] This examination encompasses all parts and aspects such as policy-making, contract, financial statements and any other activity pertinent to Islamic financial institution. AAOIFI defines Shari'ah audit: 'the primary objective of the internal Shari'ah review (carried out by independent division or part of internal audit department) is to ensure that the management of an IFI discharge their responsibilities in relation to the implementation of the Shari'ah rules and principles as determined by IFI's Shari'ah supervisory board (SBB).'[686] In other words, auditing of Islamic financial institutions is 'a systematic process of objectively of obtaining and evaluating evidence regarding assertions about religious and socioeconomic actions and events in order to ascertain the degree of correspondence between those assertions and those of the applicable financial reporting framework including the criteria specified based on *Shari'ah* principles as

[685] Rehman (n 298) 13.
[686] AAOIFI, 'Accounting, Auditing and Governance Standards for Islamic Financial Institutions' (No. 3, Accounting and Auditing Organization for Islamic Financial Institutions, Manamah 2010).

recommended by the Shari'ah supervisory board (SBB) and communicating the results to all interested parties.'[687]

Stability and financial performance of any business is contingent on stakeholders' confidence. Hence, the main concern is how to enhance and preserve stakeholders' value. In the context of Islamic finance, Since Shari'ah compliance is regarded as one of the most important reasons for the confidence in the industry; Islamic financial intermediaries endeavour to preserve the confidence of Shari'ah sensitive stakeholders and the industry reputation by implementing internal and external corporate governance mechanisms such as Shari'ah audit.[688] In this regard, due to the doubt over the individual ability of stakeholders to get assurance over the Shari'ah compliance of Islamic financial services, it is necessary to establish a Shari'ah audit mechanism in the system of corporate governance of Islamic financial institutions. in this context, generally, it is discussed that one way by which stakeholders can react to the performance deterioration in a business is to exert influence for change from within the organization.[689] However, complexity and diversity of Islamic *fiqh* and the lack of transparency and disclosure in Shari'ah discourses in Islamic financial institutions affect feasibility of this mechanism.[690]

There are two kinds of Shari'ah audits: 1) internal: which is the part of integral corporate governance system in Islamic financial institutions; 2) external: is an independent review of Islamic financial institutions operation which should be in support of internal audit. Shari'ah

[687] R. Haniffa, 'Auditing Islamic Financial Institutions: Islamic Finance: Instrument and Market' in OFinance *Islamic Finance: Instruments and Markets* (Bloomsbury 2010) 45.
[688] Wafik Grais and Matteo Pellegrini, 'Corporate Governance and Shariah Compliance in Institutions Offering Islamic Financial Services' (2006) World Bank Policy Research Working Paper 4054, 2 <http://ssrn.com/abstract=940709> accessed 27 August 2015.
[689] Ibid 3; A.O. Hirschman, *Exit Voice and Loyalty: Responses to Decline in Firms: Organizations and States* (Harvard University Press 1970).
[690] Hirschman (n 689).

audit is a new institution in Islamic finance and suffers from many ambiguities. According to the provided definitions, although the independence is a common factor for auditing, Shari'ah audit does not enjoy a comprehensive one. Further, the lack of a clear and specified scope for Shari'ah auditing raises questions over its specifications and function.

Shari'ah audit is claimed to bear a social function and accordingly its scope encompasses the social behaviour and performance of Islamic financial institutions.[691] However, the task of Shari'ah auditing in the culture of Islamic finance depends on the opinions of Shari'ah supervisory board. In other words, auditors are not only responsible to stakeholders and directors, also to Shari'ah boards since they must establish their work based on Shari'ah boards' fatwas and opinions. For instance, the responsibilities and authority of internal Shari'ah auditors are mentioned in a charter which should be consistent with Shari'ah rules and be approved and regularly reviewed by Shari'ah supervisory board.[692] On the other hand, although the task of external Shari'ah reviewing is supposed to be done by an independent organization, the dearth of Shari'ah experts in the industry has led to the multiple employments of auditors by Islamic financial institutions to execute the both kind of audits.[693] Even so, it is argued that: 'ideally, both SSB and external auditors should be from one organizational body since Islam does not recognize any separation between business and religion.'[694] In other words, although Shari'ah auditing (internal or external) is assumed as an independent and separate task, in practice the main responsible body is Shari'ah board. As the AAOIFI's auditing standards emphasises the accordance of financial statement to Shari'ah boards' fatwas and rulings is the main criteria for

[691] Hisham Yaacob and Nor Khadijah Donglah, 'Shari'ah Audit in Islamic Financial Institutions: The Postgraduates' Perspective' (2012) 4 (12) International Journal of Economics and Finance 226.
[692] Rehman (n 298).
[693] Banaga (n 292) 65.

being Shari'ah compliant. Thus, any deficiency or ambiguity in Shari'ah boards' duties may affect Shari'ah auditing task. In this regard, it is argued that the lack of a clear framework for Shari'ah auditing is the result of ambiguity over the scope of Shari'ah boards' duties as they follow no professional framework in their Shari'ah rulings. Further, there is no clear professional standards or codes to assess Shari'ah board's grounds of judgment. As Karim explains: 'SSBs are guided by their moral beliefs and obligations to religious peers and community.'[695]

In this regard, the absence of a professional judgement framework for Shari'ah boards may affect the independence and accordingly the accuracy of their rulings. Further, due to the lack of a clear mandate, it is possible Shari'ah board in disagreement with management opinion (for example, as business necessity) face pressure[696] and accordingly it may report the violation or gives way to management pressure.[697] In this regard, the implications of this situation for Shari'ah auditors may raise question over the independent place of Shari'ah auditing in the industry. In other words, due to the lack of a framework for Shari'ah auditing and the importance of Shari'ah boards' opinions as the criteria for Shari'ah compliance audit reports, auditing would not be an independent task. Further, the lack of professional code of conducts for Shari'ah boards and Shari'ah auditors casts doubt over the accuracy of their functions.

Audit as an accountability mechanism is effective when there is an accurate audit process[698] for auditor to seek information about the operation of the company and accordingly to identify

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694 R. A. A. Karim, 'the Independence of Religious and External Auditors: The Case of Islamic Banks' (1990) 3 (3) Accounting, Auditing and accountability journal 34.
695 ibid.
696 Banaga (n 292) 66.
697 ibid.
698 E. L. Normanton, *The Accountability and Audit of Governments (*Manchester University 1966).

material misstatements.[699] As discussed earlier, preventing and detecting fraud is part of auditing objectives. In the context of Islamic finance, due to the partnership structure of transactions (*mudarabah* and *musharakah*), they bear more complexity in operation as they give more discretionary power to directors in applying the principles of *Shari'ah* (prohibition of *riba*, *gharar* and *maisir*).[700] This issue particularly is evident in Islamic banking accounts. For instance, in investment accounts based on *mudarabah* (trustee contract) banks have complete management power without giving any guarantee to investors over losses. In this regard, it is held that the operation of Shari'ah-based transactions facilitate earning manipulation, accordingly fraud.[701] In addition, the adaptive innovation in the industry, which presents new Shari'ah-compliant products (such as Islamic cross-currency swaps based on *w'ad* and *murabaha* contracts) through the improvement or amalgam of classical Islamic *fiqh* contracts, can cause more operational and agency problems. In this regard, an effective Shari'ah auditing in fraud detection requires auditors to have complete knowledge on Shari'ah and also be aware of fatwas issued by Shari'ah boards. This requires Shari'ah boards to have a regular and close connection with directors and auditors. However, the dearth of Shari'ah scholars and regulations impede this goal.

[699] ISA (n 667) para 5.

[700] These contracts separate right of control from capital and give agents right to share in profits not in losses. See: Assem Safieddine, 'Islamic Financial Institutions and Corporate Governance: New Insights for Agency Theory' (2009) 17 (2) Corporate Governance: an International Review 142.

[701] Earning manipulation in finance occurs when managers use their judgement in structuring transactions to mislead stakeholders about the economic performance of the company.

5.6 Shari'ah Compliance in the Context of Malaysia Regulatory System

It is discussed that regulation in terms of a set of contracts (such as laws and supervisory actions) can be viewed as an incentive mechanism within a standard principal-agent relationship (where the principal is the regulator and the agent is the regulated financial institution) to encourage operations of the financial institutions with regard to the core objectives of regulation, namely, to sustain systemic stability, to maintain the safety and soundness of financial institutions, and to protect the consumer.[702] In the context of Islamic finance market in Malaysia, Shari'ah compliance is the foundation of the Industry and adherence to its principles in all aspects is an important objective. In this regard, the endeavour of Malaysian regulatory authorities has been to preserve the sanctity of the Shari'ah-compliant transactions and boost the public's confidence in the sector robust regulatory framework.[703]

As discussed before Islamic finance is a contract-based system established based on classical Islamic *fiqh* contracts. In this regard, Malaysia applies a contract-based regulatory system to provide more consistency and predictability to prevent fatwa shopping in the market. Malaysia the Islamic Services Act 2013 (IFSA) reflects a contract-based Shari'ah compliance system aims at providing more alignment between regulatory principles and *Shari'ah* precepts. In this regard, its End-to-End Shari'ah compliance regulatory model covers: Shariah standards, operational standards, oversight functions and resolution. The Act clearly defines the scope of assets and liabilities based on the underlying Shari'ah contractual features. To be Shari'ah compliant, all

[702] David Llewellyn, 'The Economic Rationale for Financial Regulation' (April 1999) Financial Services Authority Occasional Paper Series 1, 7-9.

activities and operations of the Islamic financial institution should be according to the rulings of the Shari'ah Advisory Council. In other words, the SAC has priority and authority over individual Shari'ah boards' rulings. Further, compliance in this context bears preventive and criminal nature. According to the Act: 'any person who fails to comply with any standards specified under subsection (1), commits an offence and shall, on conviction, be liable to imprisonment for a term not exceeding eight years or to a fine not exceeding twenty-five million ringgit or to both.'[704] in this regard, although the purpose of the establishment of Shariah board or committee is to advise the financial institution in ensuring its business, affairs and activities comply with *Shari'ah*[705], its duty bears more supervisory and auditing characteristic as Shari'ah board should report any non-Shari'ah compliant activity (violating the SAC rulings and standards) to the Bank.[706] In other words, Shari'ah boards' rulings and advices bear no independent nature as they must be consistent with the SAC rulings and principles. This complementary nature affects Shari'ah boards' functions. For instance in financial innovation, Shari'ah boards should supervise the structure of products according to the SEC principles and rulings.

This central regulatory approach to Shari'ah compliance provides uniformity for Shari'ah rulings and accordingly enhances certainty and public confidence in the Islamic financial transactions.[707] In sum, although Shari'ah boards' members enjoy characteristics of a profession as they produce independent fatwas based on their own Shari'ah knowledge, the sustainable

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[703] Malaysia Islamic Financial Centre, 'Shariah Compliance in all Matters: The Priority of a Robust Islamic Finance Ecosystem' (MIFC 2014) http://www.mifc.com/?ch=28&pg=72&ac=67&bb=uploadpdf accessed 27 August 2015.
[704] The Act 29 (6); according to subsection (1): 'the Bank may, in accordance with the advice or ruling of the Shariah Advisory Council, specify standards....'
[705] The Act 30 (1).
[706] The Act 36 (a) (I).

development goals of Malaysia requires uncertainty avoidance, providing predictability and accountability in operation of the financial institutions, and accordingly requires Malaysia central Shari'ah regulatory system to limit individualism in the interpretations of Shari'ah principles.

5.7 Conclusion

The examination of the duties of Shari'ah boards in the context of Islamic finance reflects the importance of the classical concept of Shari'ah jurists in Islamic *fiqh*. From a religious point of view the authority of Shari'ah boards' members is a subordinate authority as their rulings are restricted by the institution *taqlid*. *Taqlid* or imitation as the path of continuity in Islamic law is defined as the general acceptance of the doctrines and the intellectual authority of the past jurists. In this regard, Shari'ah boards' members use the methodology established in *madahib* to come up with their Shari'ah compliance duties. In fact, the legality of Islamic *fiqh* reveals the prohibition of any opinion issued outside of the boundaries of *madahib* and accordingly the restricted interpretation of Shari'ah compliance in the industry. In this regards, the main duty of Shari'ah boards is defined with regard to Shari'ah compliance risk (as a kind of operational risk) as they are responsible to supervise the Shari'ah compliance operation of Islamic financial institutions and endorse the structure of financial products. In this context, Shari'ah non-compliance risk management is related to all types of risk management as their steps and process should be Shari'ah compliant. Further, Shari'ah boards fatwas are the criteria for Shari'ah auditing and Shari'ah non-compliance risk management. In other words, auditing and giving advice are not the only duties of Shari'ah boards' duties. They are also involved in the

[707] ibid.

management of Shari'ah non-compliance risk as an inclusive task through controlling risk management mechanisms and processes.

The auditing role of Shari'ah boards is rooted in the institution of *hisbah* as a monitoring and corrective mechanism for the regulation of transactions. In this regard, although it is believed that Shari'ah audit is a task done by independent internal and external bodies, the lack of an agreed framework and the dearth of Shari'ah jurists cast doubt over its effectiveness as a control mechanism. In fact, the lack of consensus over the concept and the scope of Shari'ah boards' duties in the industry, has led to the ambiguity over the function and accordingly the effectiveness of other Shari'ah compliance control mechanisms such as Shari'ah audit.

Chapter Six

The Implications of Shari'ah Boards' Fatwas for the Roles of Directors

6.1 Introduction

This chapter examines the influence of Shari'ah boards' decisions on directors' duty to promote the success of the company. It analyses the importance of fatwas as a legitimacy-making means with regard to the control and the strategic roles of directors in the governance of Islamic financial institutions. In this regard, it considers the concept of value in terms of Shari'ah compliance and addresses the role of directors in value-making with regard to Shari'ah-compliant risk in the operation of Islamic financial institutions. In this context, to find the reasons for the existence of the board of directors in the governance of corporate, the first part studies their role in the history of company law. It examines the concept of 'legitimacy' in terms of the fiduciary duties of directors in the Companies Act 2006 and accordingly addresses the influence of fatwas on the roles of directors in the context of Islamic finance. The next part looks at the nature of director and directorship in the context of the Act and case law to clarify the importance of a functional approach in understanding the roles and responsibilities of directors. The last part explores the implications of Shari'ah board's rulings for the strategic and the control roles of directors.

6.2 The Place of Board of Directors in the Context of Modern Corporate Law

The purpose of a corporation as a bundles of resources and relationships is to reduce costs and to create sustainable long-term value.[708] In this regard, the creation of sustainable value requires efficiency in the creation, use and transformation of resources and the support of corporate governance through the application of the principles of good governance and expertise.

Corporate governance is about the internal and external control systems as they support a corporate to achieve its goals (mentioned or not mentioned in its constitution and the companies Act). In this regard, all parties involved in the governance system have express or tacit responsibility to endeavour for those goals through an efficient approach in discharging their duties. Generally, the Anglo-American corporate governance is known as a market-oriented system which 'enables the boards to retain flexibility in the way in which it organizes itself and exercises its responsibilities, while ensuring that it is properly accountable to its shareholders.'[709]

The Board of directors is considered as the leader of the company as its place in the corporate governance is to direct the performance of all other bodies for more value creation. This argument reflects the main rule of the modern corporate governance, namely the separation of ownership and control. In this regard, the delimitation of authority, control and the discretionary power given to the board of directors has been an important task for corporate law. Concerns over the violation of the fiduciary duties by directors with regard to their own personal

[708] Morten Huse, *Boards, Governance and Value Creation* (CPU 2007) 14.
[709] Financial Reporting Council, 'The UK Approach to Corporate Governance' (Oct. 2010) 8.

benefits and also concerns over their adherence to the purpose of company have urged the implementation of legal strategies to regulate managerial agency problems. However, to reduce agency costs resulting from managerial agency position, an efficient company law must establish balance between responsibility and authority.[710] Traditionally, the positive stream of agency theory has been the main stream and assumes that directors are the agents of shareholders and they should direct and distribute corporate resources according to the interests of shareholders. However, the concepts of value and principal-agent relationships have experienced changes. The statutory duties of directors in the Companies Act 2006 approve those changes as its ambit in s. 170 is: 'the general duties specified in sections 171 to 177 are owed by a director of a company to the company.'[711] According to the Act the director owes the duties to the company and not to the shareholders of the company. Thus, the company is the only plaintiff in relation to claims related to the breach of directors' duties.[712]

In this regard, a profound perception over the role and the duties of directors requires to have a look at the legal history of corporation. A corporation has not always been regarded as a separate legal entity. Historically, the concept of corporation and accordingly the duties of directors are influenced by trust law. In this regard, a company had no separate legal personality and only there was a partnership between the members of company and their property since beneficiaries were held on trust by company. The recognition of the separate legal personality for companies is the result of the House of Lords decision in *Saloman v A Saloman & Co Ltd*[713]. Before this decision the limited liability Act 1844 provided limited liability for shareholders to meet the losses of the company. Although the Act for the first time attempted to distinguish

[710] David Kershaw, *Company Law in Context: Text and Materials* (2nd ed OUP 2012).
[711] The Companies Act 2006, Chapter two s. 170.
[712] ibid.
[713] [1897] AC 22.

between companies and partnerships, no separate legal personality was given to companies. In fact, the speculative activities of companies at that time caused the illegality of formation of companies[714]. However, the industrial expansion of the nineteenth Century necessitated changes in companies' structure. As a result, the joint stock companies formed by the combination of partnership and trust legal techniques to circumvent the prohibitions.

6.2.1 Reasons for the Existence of Board of Directors

The origin of board of directors can be traced back to the European companies' structure. In the seventeenth century only large European companies such as the East India Company and the Dutch East India Company had board of directors, and no other large businesses owned and operated by non-Europeans had this body in their corporate structure.[715] In this regard, the Board of directors initially had two functions: legislative and adjudicative.[716] The legislative function of board of directors aimed at regulating the membership to the company. This function is the reflection of Western Europe political practice in the middle ages for the use of collective governance by a body of representatives.[717] On the other hand, the adjudicative function of board of directors aimed at resolving the disputes of members of the company.[718]

[714] The losses caused by speculative companies in the South Sea Bubble were regarded as the main cause of illegality of companies.
[715] Franklin A. Gevurtz, 'The European Origins and the Spread of the Corporate Board of Directors' (2004) 33 Stetson Law Review 925, 929 <http://justice.law.stetson.edu/lawrev/abstracts/PDF/33-3Gevurtz.pdf> accessed 3 August 2015.
[716] Franklin A. Gevurtz, 'The Historical and Political Origins of the Corporate Board of Directors' (2004) 33 HOFSTRA Law Review 89, 169 http://www.hofstra.edu/PDF/law_lawrev_gevurtz_vol33no1.pdf. Accessed 30 August 2015.
[717] ibid 129.
[718] ibid.

The institution of board of directors carries a representative quality derived from the central management (direct governance) in groups such as companies with the large number of members.[719] Further, as the result of inefficiency in directorship of large organizations the separation of ownership and control was necessary. Also, the superiority of group decision-making practice was a central belief in the medieval political philosophy.[720] In this regard, this central control approach in corporate governance explains the isolation of partnership law default rule under which all owners participate in managing the firm.[721]

In the context of modern corporate law, the board of directors as a central management institution meets its responsibilities through group decision-making too. The complexity of the structure and the operation of the modern corporations particularly financial intermediaries requires directors to be knowledgeable as they have to overcome the fast changing environment of markets. To that end, a group decision-making approach reinforces corporate directorship and leads to efficiency in the process and accordingly in the results of decision-making. This view is supported by company law under which an individual director has no power to act on the company's behalf, and only the board of directors as a collective institution bears collective decision-making responsibilities. In this regard, In *the Admiralty v The Divina (Owners) and Others,*[722] and in *Secretary of State for Trade and Industry v Griffiths and others*[723] although learned judges admitted collective responsibility of board of directors, they emphasised the importance of individual responsibility of each director to the company too. This reflects the importance of a realistic approach in the examination of board of directors' responsibilities

[719] ibid 167.
[720] The institution of parliament was the symbol of this belief; ibid.
[721] ibid 95.
[722] *HMS Truculent; The Admiralty v The Divina (Owners) and Others* - [1951] 2 All ER 968

particularly in Islamic financial institutions as Shari'ah compliance is the basis of their functions. In other words, directors in Islamic financial institutions should be equipped with the knowledge of Islamic finance techniques as they have to apply Shari'ah boards' fatwas and accordingly any deficiency in their work may lead to Shari'ah non-compliant risk.

6.3 The Relation between Legitimation and the Institution of Board of Directors

Another reason for the existence of board of directors is the need for legitimacy. Historically, parliament as a mediating institution contained representatives from various constituencies, has been considered the reflection of board of directors' function as they mediate between various corporate claimants.[724] In this regard, the practice of collective-decision making of this representative institutions reflects the need for legitimacy. In other words, the medieval councils 'provided the means to comply with the corporate law rule that what touches all be consented to by all, in circumstances when consent by assembly of the entire group was impractical'.[725] The concept of legitimacy here indicates not only a democratic process of decision making also a congruence between the expectations of owners and board of directors. In other words, this conception indicates the importance of consideration of reliability or correctness of decisions alongside the collective process of decision-making. This account of legitimacy clarifies the importance of applying two concepts of legitimacy, namely the political and normative, as they practically provide more effective results.

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[723] *Re Westmid Packing Services Ltd*; *Secretary of State for Trade and Industry v Griffiths and others* - [1998] 2 All ER 124
[724] ibid 168.
[725] ibid.

In this regard, the separation of control and ownership as the chief feature of the corporation which distinguishes it from other forms of business organization,[726] reflects technical and professional concerns over the governance of corporations. In fact the Companies Act 2006 as one of the main sources of the legitimacy of board of directors confirms this feature of the corporation by requiring all private and public companies to have directors.[727] However the Companies Act does not provide a detailed knowledge over the board of directors' power. It only establishes a vague conception over the legal place of directors by enumerating their fiduciary duties.[728] In other words, from a normative point of view, the Act does not deliver clear criteria for the legitimacy of board of directors' duties and only reflects a general expectation.

In the context of Anglo-American law, the legitimacy in the process and output of a company's direction reflects a conventional concept under which the creation of value is considered the main concern. In this regard, since the notion of value creation (and accordingly the success of company) in good corporate governance mainly bears an economic essence, the duty of board of directors to promote the success of the company requires them to have professional knowledge in finance and management.

In this regard, whatever is the reason for applying the idea of representation as the basis for the existence of board of directors (whether the efficiency of group decision-making or the protection of all constituents' interests) the truth is that legitimate authority in political or commercial forms requires consent.[729] The historical evidence approves this fact not only in commercial trade unions or parliaments also in religious groups such as church councils.

[726] S.M. Bainbridge, *The New Corporate Governance in Theory and Practice* (OUP 2009) 4.
[727] The Companies Act 2006, s 154.
[728] ibid ss 171-177.
[729] ibid ss 170-171.

However, there have been no religious board parallel to the board of directors in the history of corporate law. In this context, although religion is considered as an important part of the history of medieval Europe, it was not part of the structure of company and other commercial unions. Further, the conventional quality of the modern companies considers Shari'ah supervisory board as a unique governance body in the structure of Islamic financial institutions. In this regard, to have a comprehensive understanding of the implication of this religious layer of governance, it is necessary to look at the fiduciary duties of directors in the context of the Companies Act.

6.3.1 The Concept of Legitimacy in the Context of Fiduciary Duties of Directors

The history of fiduciary duties is connected with the evolution of the economy from one based upon land into one founded on capital and entrepreneurial activity.[730] The delegation of the responsibility of directorship to directors in the context of modern company law reflects their root in equity. Despite of having long legal history, the Companies Act 2006 introduced a statutory codification for directors' duties that does not indicate their substantive content. Instead it preserves the effect of previous case law and allows the future case law to determine the content of these duties according to the equitable principles which govern the liabilities of all fiduciaries.[731] Accordingly, the concept of legitimacy and its applicability in the context of the company law is contingent on the definition and direction of fiduciary duties.

Although, directors due to their office and position owe fiduciary duties, there is no conforming views over the range of their fiduciary duties across common law jurisdictions.[732] In

[730] Stafford and Ritchie (n 418) 1.
[731] ibid.
[732] ibid 5.

this regard, one approach lies on a narrow view which considers fiduciary duties as prospective. According to this approach, only 'no conflict' and 'no profit' rules comprise fiduciary duties.[733] On the other hand, the broad approach takes into account not only the proscriptive but also prescriptive rules to tell fiduciaries what to do.[734] The English law approach is not clear and the codification of directors' duties by the Companies Act 2006 has not resolved this ambiguity. In English Law, in *Bristol & West Building Society v Motthew*[735] Lord Millett described a fiduciary duties in these terms: 'The distinguishing obligation of a fiduciary is the obligation of loyalty. This core liability has several facets. A fiduciary must act in good faith; he must not make a profit out of his trust; he must not place himself in a position where his duty and his interest may conflict; he may not act for his own benefit or the benefit of a third person without the informed consent of his principal.'[736] The term 'good faith' has been construed as a duty 'to do in good faith whatever one had undertaken to do; in other words, it is a duty qualifying performance of some other activity, virtually a duty not to misbehave, rather than a duty to do any particular thing'.[737]

The Court of Appeal (of which Lord Millett was a member) pronounced the prospective view In *Attorney-General v Blake*[738] and repeated the passage from *Motthew* referred to the facets of the fiduciary duty of loyalty:[739] '…..equity is prospective, not prescriptive; see *Breen v Williams*.[740] It tells the fiduciary what he must not do, it does not tell him what he ought to do.'

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[733] The Australian approach.
[734] The North American approach.
[735] [1998] EWCA Civ 533, [1998] Ch 1
[736] Mummery LJ in *Gwembe Valley Development Company v Koshy* [2004] I BCL 131 approved this view.
[737] R. C. Nolan, 'A Fiduciary Duty to Disclose?' (1997) 113 Law Quarterly Review 220.
[738] [1998] Ch 439.
[739] At p 454.
[740] (1996) 185 CLR 71.

However, the decision of the Court of Appeal in *Item Software (UK) Ltd v Fassihi*[741] has adopted prescriptive concept of fiduciary duties. Further, in *GHLM Trading Ltd v Maroo*[742] Mr Justice Newey observed: 'Arguably, it breaks new ground in treating a fiduciary duty as prescriptive rather than merely proscriptive. Its result can perhaps now be justified also by reference to section 172 of the Companies Act 2006, which came into force on 1 October 2007. The duty to promote the success of a company which that provision imposes can be said to be expressed in prescriptive terms (a director "must act in the way he considers, in good faith, would be most likely to promote the success of the company …" – emphasis added). Be that as it may, *Item Software (UK) Ltd v Fassihi* is clearly binding on me. I therefore proceed on the basis that a director's duty of good faith can potentially require him to disclose misconduct. .... a company complaining of a director's failure to disclose a matter must, I think, establish that the fiduciary subjectively concluded that disclosure was in his company's interests or, at least, that the director would have so concluded had he been acting in good faith'.[743]

The uncertainty of English law approach over the fiduciary duties of directors implies the importance of the context in which directors operate. In this regard, the functional quality in directors' duties can be perceived from the broad discretionary power given to directors by the Companies Act 2006 to promote the success of the company in good faith. Further, the UK principle-based approach in corporate governance endorses the importance of flexibility in the efficiency of directors' decisions. In other words, there is an interaction between the concept of legitimacy and directors' duties in the context of the Companies Act that indicates a functional oriented concept in the process and output of directorship based on statute and common law.

[741] [2005] 2 BCLC 91.
[742] [2012] EWHC 61 (Ch)
[743] At Paras. [193] and [194]

In the context of English law, directors' sources of power and their legitimacy are the same. In this regard, statutes, constitution, common law, customary rules and professional requirements determine the legal factors in their conceptions. In this context, applying another governance layer with religious function to provide legitimacy by issuing fatwa for the operation of financial institutions poses some questions over the duties of board of directors. The concept of legitimacy with regard to Shari'ah boards' fatwas reflects a non-legal concept as there is no provision in statute and record in case law requiring the establishment of a religious governance layer. As a result, in the context of Islamic finance the implications of fatwas for the fiduciary duties of board of directors are not clear. In this regard, to have a comprehensive perception over this issue, we should examine the fiduciary duties of directors and the concept of legitimacy in the context of company law and accordingly have a look at the position of 'director' and its requirements.

6.4 Who is a Director?

The position of director in the Companies Act 2006[744]carries an immaterial concept as it provides no explicit definition for the term 'director'. In other words, the Act has a functional approach over the concept of 'director', and accordingly does not consider necessary a formal appointment or position for it. In this regard, a 'de jure' director who has been correctly appointed as a director in accordance with the appointment rules set out in the company's articles of association[745] and accordingly operates officially under the title of 'director' bears all responsibilities and fiduciary duties mentioned in the Act and common Law. From one aspect,

[744] According to s.250 of the Companies Act 2006: "any person occupying the position of director, by whatever called".
[745] Articles 16 and 19 in the Draft Model Articles for Private and Public Companies.

this elasticity provides a way to fix guilty individuals with liability, and from another aspect it may discourage counterparties from interfering with the managers of limited liability companies.[746] In this regard, the broad definition provided by s. 250 implies the risk of being director as this position requires competence to meet its duties and accordingly necessities bearing liabilities for the breach of those duties. This issue is more complicated in the governance of Islamic financial institutions as the position of director and its responsibilities must be carried out according to Shari'ah board's fatwas. In other words, the fiduciary duties of directors must be interpreted and performed in Shari'ah-compliant manner since the position and responsibilities of directors in English law are not the matter of a formal appointment.[747]The Act and common law indicate two other categories of directors: "de facto" and "shadow" directors.

6.4.1 De Facto Directors

A de facto director is a person (legal or natural) who is regarded as a director by the law even though she has not been formally appointed as a director.[748] There have been no definition for de facto director and courts only have provided guidance on the elements of the concept of de facto director.[749] In *Re Hydrodan (Corby) Ltd*[750], Millet J. held that: 'A de facto director is a person who assumes to act as a director. He is held out as a director by the company, and claims and purports to be a director, although never actually or validly appointed as such. To establish that a person was a de facto director of a company, it is necessary to plead and prove that he undertook

[746] David Milman, 'Directors, Governance and Managerial Responsibility: New Developments in UK Law' (2013) 346 Sweet and Maxwell's Company Law Newsletter 1.
[747] In the next sections we will discuss the implications of this approach for the governance of Islamic financial institutions.
[748] Kershaw (n 710) 320.
[749] ibid, de facto director is the result of judicial innovation in cases *Re Lo-Line Electric Motors Ltd* and *Re Hydrodam (Corby) Ltd*.

functions in relation to the company which could properly be discharged only by a director. It is not sufficient to show that he was concerned in the management of a company's affairs or undertook tasks in relation to his business which cannot properly be performed by a manager below board level'.

This decision was criticised by Lloyd J in *Richborough Furniture Ltd.*[751] he adopted a practical approach as he held that a de facto director should act on an equal footing with the others in directing the affairs of the company.[752] In this regard, in *Re Hydrodam (Corby) Ltd*[753] it was held that to be a de facto director it was no longer need for the individual in question to have held himself out as a director. In this regard, Lord Collins in *Re Paycheck*[754] observed that: 'the basis of liability is the assumption of responsibility.'[755] However Lord Hope DP, for the majority declared the importance of the person actual actions to see whether he assumed those responsibilities in relation to the subject companies.[756] In other words, to regard a person as a de facto director, the actual role and exercised power of the person in the governing structure of the company should be considered.[757] In this regard, Hildyard J. in *Secretary for State Business, Innovation and Skills v Chohan*[758] observed the importance of being part of the governance structure of the company by focusing on actions only be performed by a director.

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[750] [1994] BCC 161
[751] [1996] 1 B. C. L. C. 507.
[752] Ibid 524.
[753] [1994] 2 BCLC 180
[754] [2011] 1 BCLC 141
[755] ibid [96]
[756] [2011] 1 BCLC 141.
[757] Kershaw (n 710) 321.
[758] [2013] EWHC 680 (ch)

6.4.2 Shadow Directors

The concept of shadow directors in English Law is the reflection of concerns about the need for effective measures to hold those who exercise actual influence or control (direct or indirect) over the management of companies accountable for their conducts.[759] In other words, the provisions on shadow directors reflect legal expectations over the legal nature of companies and the way they should be managed and the qualities of managers.[760] The first formal reference to a shadow director in English law was in the Companies Act 1917 which included 'any person in accordance with whose directions or instructions the directors of a company are accustomed to Act.'[761] A similar definition was included in s 741 (2) of the Companies Act 1985[762]and in other statutes.[763] In this regard, Shadow directors as 'moving spirit' of the company[764]are entirely the creatures of statute'[765] and unlike de jure and de facto directors, the law on shadow director is not completely established as courts have been conservative in applying this notion. A shadow director in s 251 (1) of the Companies Act 2006 is defined as: 'a person in accordance with whose directions or instructions the directors of the company are accustomed to act'. Although, other Commonwealth jurisdictions such as Australia and New Zealand[766] have defined the concept of shadow directors similar to the English Companies Act, they have taken an integrated

[759] Kathy Idensohn, 'The Regulation of Shadow Directors' (2010) 22 (3) SA Merc L J 326.
[760] Chris Noonan and Susan Watson, 'The Nature of Shadow Directorship: ad hoc Statutory Intervention or Core Company Law Principle?' (2006) J B L 763.
[761] The Companies (Particulars as to Directors) Act 1917, s 3.
[762] The Companies Act of 1985 follows a separate approach and the definition of a Shadow director is not part of the general definition of a director.
[763] Including, the Company Directors Disqualification Act 1986 and the Insolvency Act 1986.
[764] *Re Kaytech International Plc ; Secretary of State for Trade and Industry v Potier* [1999] B.C.C. 390 CA (Civ Div), per Robert Walker L.J. at 401
[765] A. Walters and M. Davis-White, *Directors' Disqualification and Bankruptcy Restrictions* (2nd edn, Sweet & Maxwell 2005) 83.
[766] The Australian Corporations Law 2001, Ss 60(1) and 60(2); the New Zealand Companies Act 1993, s 126.

approach by including the definition of a shadow director within their general definition of a 'director'.[767]

The definition and application of the shadow director have been the subject of many judgments with different approaches. In this regard, earlier judgements such as *Re PFTZM Ltd (in liquidation)*[768] and *Re Unisoft Group Ltd (No 3)*[769]presented a narrow concept for the term.[770] The recent cases such as *Secretary of State for trade and industry v Deverell*[771]reflect a more practical approach. Generally, this case laid down the following general principles for the interpretation of the term Shadow director[772]: first, the definition must be according to the legislative aim of public protection; second, any particular communication, whether by words or conduct classed as a direction or instruction must be must be determined objectively. Further, the states of mind, intention and motives of parties in following the instructions are not conclusive, although the expectations of parties on the part of either parties may be a relevant factor;[773]third, it is not necessary for instructions to cover every matter related to directors or the company activities or affairs;[774] fourth, the directors must have been accustomed to act in accordance with the directions and instructions.[775] In other words, the outcome of communications and the

[767] Idensohn (n 759) 328.
[768] [1995] 2 BCLC 354 (ChD)
[769] [1994] 1 BCLC 609
[770] in *Re PFTZM Ltd* it was held that that a person would not be a shadow director if the directors had any choice as to whether to follow his or her directions or instructions, and in *Re Unisoft Group Ltd (No 3)* at 620 required evidence that the alleged shadow director had influenced a majority of the board and had been 'the master controlling a puppet board'.
[771] [2001] Ch 340
[772] Approved in *Ultraframe (UK) Ltd v Fielding* [2005] EWHC in in pars 1260-1
[773] *Secretary of State for trade and industry v Deverell* [2001] Ch 354C
[774] ibid at 375 A-B; *Re Kaytech, Secretary of State for Trade and Industry v Kaczer* [1999] 2 BCLC 144 (CA)
[775] The *Deverell* case (n 773) 375J

pattern of compliance which must be beyond one occasion, are the criteria for the term;[776]fifth, all or a consistent governing majority of directors must have been accustomed to following the directions of the Shadow director;[777]it is not necessary directors have a subservient role to obey the directions, although a relationship of dominance may be evidence of a shadow directorship.[778]

Further, although Millet J in *Hydrodam (Corby) Ltd*[779]provided a narrower account for determining a person as a shadow director in the context of section 214 of the Insolvency Act 1986; the essence of the judgement reflects the same principles mentioned above. In this regard, Millet J says: 'A shadow director, by contrast, does not claim or purport to act as a director. On the contrary, he claims not to be a director. He lurks in the shadows, sheltering behind others who, he claims, are the only directors of the company to the exclusion of himself. He is not held out as a director by the company. To establish that a defendant is a shadow director of a company it is necessary to allege and prove: (1) who are the directors of the company, whether de facto or de jure. (2), that the defendant directed those directors how to act in relation to the company or that he was one of the persons who did so; (3) that those directors acted in accordance with such directions; and (4) that they were accustomed so to act. what is needed is first, a board of directors claiming and purporting to act as such, and secondly, a pattern of behaviour in which the board did not exercise any discretion or judgement of its own, but acted in accordance with the directions of others.' In this regard, shadow directors influence the

[776] *Secretary of State for Trade and Industry v Becker* [2003] 1 BCLC 555; *Re Unisoft Group Ltd (No 3)* [1994] 1 BCLC 775 B
[777] *Ultraframe* case (n 772) in par 1272
[778] The *Deverell* case (n 773) 376C and 375J.
[779] [1994] BCC 161.

decisions of the board in relation to the company[780]and accordingly directors' act following the influence must in effect amount to a dictation of strategy and policy[781] in a consistent 'pattern of compliance with the instructions of the putative shadow.'[782]

However, the new cases reflect a more inclusive approach as the main concern is to judge objectively the real influence of instructions were relied by board of directors in relation to the business activities of the company.[783] Further, the essence of the principles reflected in recent cases implies that 'despite the use of the term shadow director, it is not necessary to characterise the person as 'lurking in the shadows' or for the latter's influence to be hidden; a shadow director can operate quite openly.'[784]

In the context of Islamic finance, since Shari'ah compliance is the ultimate goal, a shadow director in discharge of his duties like a de jure director is responsible for the application of Shari'ah board's fatwas. In other words, the primary liability of de jure directors regarding their wrongdoing or fraudulent actions related to their non-Shari'ah compliant decisions may lead to the liability of the shadow director too.

6.4.2.1 Shari'ah Boards as Shadow Directors

Shadow directorship is a kind of regulatory mechanism through which the legislator seeks to regulate and make transparent the conduct of a person who controls the board.[785] In other words, since the directions or instructions of a Shadow director amount to a dictation of "strategy and

[780] ibid 163.
[781] *Aviss [2006] EWHC 1846 (Ch); [2007] B.C.C. 288* per Lewison J. at [92].
[782] V. Finch, *Corporate Insolvency Law: Perspectives and principles* (2nd edn, CUP 2009) 301.
[783] See also *Re Kaytech, Secretary of State for Trade and Industry v Kaczer* (n 774); Idensohn (n 759) 330.
[784] Idensohn (n 759) 330.

policy"[786], they are subject to duties and liabilities imposed on directors. Further, the anti-avoidance rationale of the shadow director provisions implies the economic rationale of corporate law as they 'help to internalise the costs of the wrongdoing associated with the common enterprise of the shadow and de jure directors.'[787] This economic rationale also carries a deterrence quality as 'it deters a greater amount of wrongdoing than if there was no secondary liability.'[788] In the context of Islamic finance, the discussion over the liability of Shari'ah boards can be examined in terms of shadow directorship too as their functions and activities may result in influence over the economic directorship of the Islamic financial institutions.

In this regard, Shari'ah boards' functions in terms of Shari'ah compliance audit and advice over the operation of Islamic financial institutions reflect a kind of communication between them and the board of directors carrying an instructional quality through which they may insert influence over the management of the company's activities. Further, their communication bears a public quality too as their duties affect the operation of Islamic financial institutions and accordingly the interests of stakeholders. However, the objective approach in *Deverell* requires to assess their communication whether by words or conduct in the light of all evidence and accordingly it is suffice to prove the communication and its consequences.[789] In this regard, the existence of direction or instruction from Shari'ah board in their communication with board of directors should be examined in their advisory role. Although, advice given in a purely professional capacity is clearly excluded from a communication based on direction or

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[785] Noonan and Watson (n 760).
[786] *Secretary of State for Trade and Industry v Aviss [2006] EWHC 1846 (Ch); [2007] B.C.C. 288* per Lewison J. at [92].
[787] Noonan and Watson (n 760) 777.
[788] ibid.
[789] ibid 771.

instruction[790] Morritt L. J in *Deverrell* case duly stated that 'the exception for professional advice implies that the concepts of direction and instruction include advice' and share the common feature of guidance. In this context, the recognition of professional quality for Shari'ah boards' advices is not a clear topic as there are many questions over Shari'ah boards' membership as a profession in terms of education, regulation and accountability.[791] However, exclusion of professional advice does not exclude all other advice is included.[792] In other words, if Shari'ah board's advices appear to be instructions or directions which board of directors are accustomed to follow them and accordingly reflect Shari'ah board's expectation that its advices will be obeyed, the issue of shadow directorship could be a relevant subject. Further, the instructions and directions from Shari'ah board should reflect its influence or control over de jure directors' decisions.

6.4.3 The Importance of the Identification of Directors

Directorship is the ultimate power in the governance of a company. Officially, the board of directors is considered the leader of the company that bears all directorship responsibility. However, although various corporate governance systems characterize similar indicators for a good directorship, in practice the process of directorship is not perfectly defined. In this regard, the functional-oriented approach of the UK companies' law affirms the importance of the role of other players in the governance of the company by the recognition of shadow and de facto

[790] the Companies Act 2006, s 251(2); the Company Directors Disqualification Act 1986, s 22 (5); and the Insolvency Act 1986, s.251.
[791] The issue of professionalism in Islamic finance is discussed in chapter nine.
[792] Noonan and Watson (n 760) 771.

directors. Further, the s. 172 (1)[793] of the Act by incorporation of two concepts of 'success of the company' and 'enlightened shareholders value' indicates the importance of the applying of a functional approach in identification and interpretation of directors' duties. In this regard, the directors of a company may have a particular governance perspective for the application of s. 172 (1). In other words, the list in s. 172 is not exhaustive and the general duty to promote the success of the company may require directors to consider other factors or even relevant interests in every case.[794]

In practice directors interpret the concepts of success and the enlightened shareholders value and accordingly the concept and the context of strategy[795] according to the primacy of the company's goals. In other words, the concepts of success of the company and enlightened shareholders' value as the foundation of the other fiduciary duties should be analysed according to the specificities of a business. As a result, the functional and inclusive approach of the Companies Act 2006 towards the definition of the position of directors and their duties reflects the importance of the practical consequences of directorship and their systemic effects on financial markets. As a consequence of this all-embracing approach, fiduciary duties of directors included in the Act and case law would encompass all types of directors and not only de jure one.

Further, since the Act and common law are based on conventional not religious precepts, these duties are perceived according to economic and financial exigencies. However, directorship in Islamic financial institutions is not very straightforward. Although the concept of

[793] "s 172 Duty to promote the success of the company, (1) A director of a company must act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole…".
[794] The Company Law Review (n 452) 36 pa. 3.56.

directorship in the both type financial institutions is similar, the discretionary power of directors in Islamic financial institution is limited by Shari'ah boards' rulings and opinions. In other words, Shari'ah board as a religious governance layer influence directors' roles and accordingly the concept of their fiduciary duties as Shari'ah-compliance is the foundation for the legitimacy of directors' discretion.[796] However, the lack of a specific regulatory and accountability system in the UK requires us to analyse the duties of directors' in Islamic financial institutions according to the conventional institutions. We shall discuss the implications of Shari'ah boards' decisions on directors' duties and accordingly on the concepts of success and value-making through a strategic-legal point of view. Next part examines the implications of Shari'ah boards' fatwas for directors in two aspects: strategy and control.

6.5 The Implications of Shari'ah Boards' Fatwas for the Strategic Role of Directors

In the context of Islamic finance, the strategic role of directors should be analysed with regard to Shari'ah boards' fatwas as they imply the strategy of the company. The strategic role of directors is admitted by the Companies Act as it does not set out any specific roles for them and only establishes general criteria for their fiduciary duties. In this regard, those fiduciary duties indicate a strategic quality for directors as they imply the importance of setting, monitoring and assessment of strategic proposals[797] that affect the long-term performance of the company.[798] The discretionary power given to directors by the Companies Act must be applied in a way that

[795] Philip Stiles and Bernard Taylor, *Boards at Work: How Directors View Their Roles and Responsibilities* (OUP 2010) 31.
[796] This raises some questions over the possibility of regarding Shari'ah board as shadow or de facto director.
[797] Stiles and Taylor (n 795) 32.

would be most likely to promote the success of the company.[799] This discretion is in the form of decision (strategy) and non-decision making (monitoring) functions which should be examined according to the context of company. This part considers the decision-making function of directors in setting strategy for corporate in terms of context, conduct and content of corporate strategy. In other words, strategy-making is considered as a process in the performance of directors' strategy role. Further, the Companies Act provisions over the duties of directors do not only indicate amending and distributive functions for directors, also reflect a complete involvement in the formation of the content, context and conduct of strategy.[800]

Strategy generally is defined as 'A plan of action designed to achieve a long-term or overall aim'.[801] In Huse words: 'strategy may be defined as the development, maintenance and monitoring of the firm's core competencies with the purpose of achieving long-term results and survival.'[802] In this regard, corporate strategy as 'the pattern of company purposes'[803] is about the process of decision-making over the corporate values, objectives and operation. In other words, the concept of strategy is a comprehensive concept which involves all objectives such as financial and social could affect the business of corporation. In this regard, the Companies Act reflects this comprehensive conception in the strategic role of directors by requiring them to consider not only financial factors, but also social and long-term aspects in their decisions. Also,

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[798] William Q. Judge and Carl P. Zeithaml, 'Institutional and Strategic Choice Perspectives on Board Involvement in the Strategic Decision Process' (1992) 35 (4) Academy of Management Journal 766, 771.
[799] The Companies Act 2006, s. 172 (1).
[800] Huse (n 708) 241.
[801] Oxford Dictionary.
[802] Huse (n 708) 239.
[803] K. R. Andrews, 'Corporate Strategy as a Vital Function of the Board' (1981) 59 Harvard Business Review 180.

OECD declares the importance of strategic role of boards: 'the corporate governance framework should ensure the strategic guidance of the company…'[804]

In this regard, to identify corporate strategy, it is necessary to answer to two questions: where does the firm compete and how does it compete? These questions are concerned with the scope of the firm's activities and the firm's competitive plan. In this context, the strategic role of directors should be interpreted in the context of the firm's scope of activities defined according to internal and external sources such as the firm's goals and purposes mentioned in its constitution. As a consequence, the legitimacy of directors decisions depends on how much they act and how they perform within the defined scope.

In the context of Islamic finance, the fatwas of Shari'ah boards provide the path and criteria for corporate strategy. In this regard, Shari'ah boards through presenting specific mode for interpretation of *Shari'ah* which is profoundly affected by the region (Middle East, Europe or Malaysia), type of business (banking, insurance…) and composition of Shari'ah boards in terms of Schools of thought affect the corporate strategy. In other words, Shari'ah boards influence the role of board of directors in setting corporate strategy explicitly by issuing annual Shari'ah reports over the operation of Islamic financial institution and implicitly by giving ad hoc advisory opinions over contingent issues. for example, HSBC introduction to its Islamic investment indicates the importance of the Central Shari'ah Committee of HSBC Amanah[805]decisions over the scope of investment funds in equities as an asset class not to investing in prohibited business activities such as alcohol and gambling (sectorial screen) and in financial institutions exhibit prohibited financial characteristics such as their total amount of debt

[804] The OECD (n 662) Prin. VI.
[805] HSBC Amanah, 'Introduction to Islamic Investing' (2011).

trailing market capitalisation (financial screens). As a consequence, those Shari'ah decisions limit the strategy role of directors in terms of business development and value creation. In other words, the concepts of value creation and the role of directors in the success of company should be examined according to Shari'ah board opinions.

The strategic role of directors is an important factor for the long-term performance of the company. In this regard, the Companies Act indicates their effective strategic role by explaining the importance of the success of the company in terms of directors' fiduciary duties.[806] The essence of management in the context of the modern financial markets is the result of the combination of industry-specific experiential knowledge and the application of the general principles according to the markets exigencies and the company's values.[807] This market-based view towards management affected companies' law in Anglo-American jurisdiction under which directors cannot be questioned for their business decisions made 'by a bona fide regard for the interests of the corporation'.[808] In this regard, the exercise of discretion by directors is examined according to the legal standards of competence in relation to the quality of the decisions.[809]

In the context of Islamic finance, the mentioned combination does not bear a clear-cut concept as the board of directors in each Islamic financial institution must operate according to that Institution's Shari'ah board's opinions. Further, there is no harmonization in attitudes over the management of Islamic finance markets' exigencies such as liquidity risk management, and also the lack of a specific regulatory system in jurisdictions like UK led to ambiguity over the concept of discretion in the management of Islamic financial institution and accordingly over

[806] The Companies Act, s. 172 (1).
[807] Stiles and Taylor (n 795) 75.
[808] Doctrine of Business Judgement; *Gimbel v. Signal Cos.*, 316 A.2d 599, 608 (Del. Ch. 1974)
[809] Kershaw (n 710) 334.

value-creation and accountability issues. In other words, the process of strategy making and accordingly expectations arising from the duty of care in Islamic finance are not clear.

The concepts of success, value-creation and strategy in company law are interlinked. In contrast to the fiduciary duty to act in good faith in the best interests of the company reflected in common law, the Companies Act requires directors to promote the success of the company in terms of long-term increase in value.[810] This reflects a shift from a narrow approach to a broad approach towards the strategic role of directors. In fact, the law commission has been more concerned over the increasing role of directors particularly in financial institution over value-creation. This inclusive view has affected the concept of value and value-creation by directors as it reflects not only the financial performance of the company, but also social and environmental performances too. In this regard, the role of directors in creating and protecting wealth must be considered in a long-term with regard to social factors. In other words, the Act takes more distributive approach toward value-creation.

The value-creation in the context of financial markets is deeply related to three aspects: investment strategy, product development and risk management. This issue is more critical in Islamic finance as it is related to the Shari'ah-compliance risk. In this regard, Shari'ah non-compliance risk which is mainly known as operational risk, may be a source of risk at strategic level which boards are the main responsible body to control and manage it.[811] Shari'ah compliance is not only a concern in operation of an Islamic financial institution, also it may occur in setting values and pattern for company. For example, investment strategy and product development of business and structure of financial products must be compliant with Shari'ah

[810] DTI, 'Companies Act 2006-Duties of Company Directors, Ministerial Statements' (2007).

board rulings. In this regard, ex ante and ex post functions of Shari'ah boards in engineering and the performance of obligations under the contracts; and reviewing investment policies require implementation of hardware and software mechanisms by directors to meet Shari'ah compliant goals. In this context, directors' ultimate responsibility is 'to establish a mechanism that can be mobilized swiftly and efficiently, as and when required, to obtain rulings from Shari'ah scholars and monitor Shari'ah compliance'.[812] To that end, directors need to establish a proper cultural infrastructure based on Islamic financial institution's business and environment according which the organizational and communicational structure of the institution will be formed. Further, the innovation process including goal definition and alignment of actions to goals must be considered according to Shari'ah notions established by Shari'ah board.[813] This requires a close collaboration between directors, internal Shari'ah department and Shari'ah board.

The concept of value and value-creation with regard to the mentioned strategic aspects of financial institutions are more complex as all decisions and operation must be compliant with Shari'ah boards' fatwas and decisions. In theory, the main concern of board must be Shari'ah-compliance and not only economic value creation for the company members. As a result, the concept of success is deeply connected to Shari'ah-compliant value creation, not only to pure conventional perception of economic and social value creation. In this regard, purification of non-halal income gained in process and operation of products resulting from ex ante or ex post aspects of financial transactions reflects the limitations on the concepts of value creation and success in the context of Islamic finance. However, it is noteworthy that since

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[811] Strategic risk is defined as: 'the probability and consequences of a failure of strategy', G. Johnson, K. Scholes and R. Whittington, *Exploring Corporate Strategy* (FT-Prentice Hall 2007) 369.
[812] Ahcene Lahsasna and M. Kabir Hassani, 'the Shariah Process in Product Development and Approval' in Hassan and Mahlknect (n 299) 48.
[813] ibid 26.

providing Shari'ah-compliant financial services is the ultimate goal in Islamic finance industry, variety of investors, namely Shari'ah sensitive or non-Shari'ah sensitive, should not affect pursuing Shari'ah-compliant value creation models. Despite this goal, in practice directors may manipulate and overrule the resolutions of the Shari'ah boards by adopting different resolutions from other Islamic financial institutions.[814]

According to the IFSB: "Although the diversity of Shariah opinions might tempt an IIFS to adhere to the fatwas of other Shariah scholars at the expense of differing fatwa issued by the IIFS's Shariah scholars, the IIFS shall not change their allegiance and obedience to fatwa to suit their convenience. Such a practice could impair the independence of Shariah scholars and have a damaging impact on the integrity and credibility of the individual IIFS, in particular, and on the Islamic financial services industry as a whole. The adverse effect of such a practice on the reputation of the IIFS and the Islamic financial industry would be immense and difficult to repair. Therefore, the IIFS shall be transparent in the adoption and application of Shariah rules and principles issued by the IIFS's Shariah scholars."[815]

The success of company is the reflection of successful value creation. Value creation here is based on entrepreneurship encouraging long-term perspective over value 'by developing a work environment that supports corporate and individual growth, creating opportunities for employees to use their creative skills and fostering a culture of cross-functional collaboration'.[816] This definition is compatible with Islamic finance partnership and entrepreneurship goals and technics. However, setting innovation and value patterns must be according to Shari'ah board

[814] ibid 47.
[815] IFSB, 'Guiding Principles on Corporate Governance for Institutions Offering Only Islamic Financial Services (Excluding Islamic Insurance (Takaful) Institutions and Islamic Mutual Funds)' (Dec 2006). 12.
[816] S. A. Zahra, 'Governance, Ownership, and Corporate Entrepreneurship: the Moderating Impact of Industry Technological Opportunities' (1996) 39 (6) Academy of Management Journal 1713, 1715.

rulings. In other words, value creation in the context of Islamic finance requires establishing Shari'ah compliant culture and structure which are compliant to Shari'ah board's rulings. This issue raises questions over the limitation of innovation and directors' knowledge.

Strategic decisions over innovation is an internal value creation by which new products, production processes and organizational systems are created.[817] In finance, innovation and product engineering refers to strategies and techniques to lower transaction costs and achieve better return.[818] In this regard, value creation in terms of product and process innovation should be measured by its long-term impact on financial system and in the context of Islamic finance its conformity to the normative standards of Shari'ah.[819] The specific concept of value creation requires specific knowledge in understanding Islamic finance particularities by directors to involve in implementation of Shari'ah board fatwas in ex ante and ex post transactions' formation and operation of Islamic financial institutions. This issue indicates the importance of directors' duty of care in terms of their control role in proper implementation of fatwas.

6.6 The Implications of Shari'ah Boards' Fatwas for the Control Role of Directors

The term 'control' here refers to the power to make managerial decisions (as discussed before) and monitoring process of operation. In other words, as corporate strategy involvement is 'the determination of the basic long-term goals and objectives of the enterprise and the adoption

[817] Huse (n 708) 282.
[818] Kabir Hassan (n 812) 386; R. Merton, 'Financial Innovation and Economic Performance' 4 Journal of Applied Corporate Finance 12-22

of courses of action and the allocation of resources necessary for carrying out these goals'[820] it requires 'an oversight function that, in the normative literature at least, implies some degree of confrontation'[821] between directors and other corporate components. A control system is a process established to allow directors to monitor the operation of business according to corporate goals and assessing its continuation.[822] In this context, the ongoing success of corporate depends on an effective internal and its activities.[823] This control system operates by harmonizing various interests of stakeholders and coordinating different parts of organization.

The concept of control in this context signifies the importance of information. In other words, to establish an effective control mechanism directors need to set up an active system to get information from internal and external sources to assess operation of corporation in terms of its strategies in the context of market contingencies. Accordingly, the control system within the corporate provides feedback for directors that key aspects of operation and activities are properly running. The importance of directors' effective control role in Islamic finance is more convoluted as they must establish an internal control system to monitor Shari'ah-compliant operation of Islamic financial institution. In this context, the control role of directors can be considered in two aspects: operational and strategic.

Operational control generally is about short-time financial performance of an institution. Operational control mainly monitors past and present financial operation according to the corporate budget and business plan. It encompasses output and quantitative controls based on ex

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819 Kabir Hassan (n 812) 387.
820 Stiles and Taylor (n 795) 62.
821 ibid.
822 ibid 63.
823 ibid 61.

ante standards.[824] In this regard, the evaluation of investments, liquidity and risk management are considered the most important components of operational control responsibility of directors.

The operational control by directors in the context of Islamic finance is not only a matter of value in economic sense. The main concern is controlling financial operation according to Shari'ah boards fatwas and not only according to ex ante regulatory and business standards. For example, Shari'ah -compliant risk management and control is a complex area in Islamic finance as 'the risks are more aligned on the basis of contract types as a result of the special structuring of the contracts in Islamic banking' and relationships of parties changes during the lifetime of the contract.[825] To set a proper risk management, four elements should be well defined: the construction of the financial contracts; the identification of markets; the identification of the counterparties; and the behaviour of the above two within a time period.[826] In this regard, directors at each level of setting and monitoring must perform their control role according Shari'ah board rulings. In this regard, they are responsible to define a mechanism for asking fatwa and consulting with Shari'ah boards.

Strategic control refers to monitoring long-term goals and values of a business which are not necessarily financial. In the context of financial industry, the main focus of strategic control is on the boards' involvement in evaluating product quality and human resources. In this regard, directors need to establish active and substantial cooperation with internal control units such as audit units. The Cadbury Code states that: 'the directors should report on the effectiveness of the company's system of internal controls'.[827] The main responsibility of the audit unit is to monitor

[824] Huse (n 708) 250.
[825] Ioannis Akkizidis and Sunil Kumar Khandelwal, *Financial Risk Management for Islamic Banking and Finance* (Palgrave 2008) 28.
[826] ibid 42.
[827] Sir Adrian Cadbury, 'the Financial Aspects of Corporate Governance' (1992) s. 4.5.

operation of financial institution according to its established strategic goals and pattern. The audit unit in conventional systems is only responsible 'to improve the quality of financial reporting, to reduce the potential for fraudulent practice……to review the adequacy of the company's financial control systems.'[828] However, in the context of Islamic finance, shari'ah audit unit as an additional layer of audit is responsible for monitoring operation of Islamic financial institution based on the Shari'ah boards' rulings. It provides a link between directors' strategic control role and Shari'ah board by its continuous watch and information giving. It is a vehicle to increase legitimacy of Islamic financial institution operation and directors decisions.

6.7 Conclusion

The separation of ownership and control as the foundation of modern corporate governance reflects the crucial role of the board of directors in value creation. In this regard, the agency costs resulting from directors' agency role led corporate law to establish balance between their responsibility and authority. The Fiduciary duties of directors with regard to the success of company, reflect the nature of directorship as a legitimacy-making means in terms of the process of decision making and the efficiency of decisions. In this context, the strategy and control roles of board of directors in value-creation should be interpreted in an economic sense as they are based on the conventional precepts. However, the existence of Shari'ah board as an additional governance layer with religious function has raised questions over the concept of legitimacy and accordingly over the strategy and control roles of directors. In this regard, the concept of legitimacy in the context of Islamic finance bears a duality as it encompasses economic and religious factors together. As a consequence, strategy as the pattern of a company's purposes

[828] Stiles and Taylor (n 795) 69.

which reflects the values and objectives of the business must comply with Shari'ah board's fatwas. In this regard, the strategy role of directors in terms of business development and value-creation should be examined according to Shari'ah board's opinions. However, the lack of harmonization over risk management techniques and regulation of Islamic financial institutions led to ambiguity over the strategic role of directors and accordingly their discretionary power. Further, Shari'ah compliance affects the control role of directors in monitoring the operation of Islamic financial institution. In this context, their operational control approach in terms of short-term financial performance of the Islamic financial institution must be based on ex ante regulatory standards and Shari'ah board's opinion. Also, the board of directors in their strategic control role is responsible to set the long-term values in terms of product quality and human resources according to Shari'ah board's opinions through a strong internal communication with audit unite.

Chapter Seven

The Liability of Directors for the Violation of Shari'ah Boards' Fatwas

7.1 Introduction

Modern financial markets require all legal systems to provide effective legal mechanisms for the protection of investors' rights. In this regard, the existence of an accountability system in its legal sense implies the importance of legitimacy in flourishing financial markets. Also a coherent Legal accountability system is accompanied by supportive social norms formed by the exigencies of time. In other words, an effective accountability system should demonstrate path dependence in its content and a historical coherence in its development. This chapter examines the fiduciary and non-fiduciary duties of directors (as legal mechanisms) against directors' Shari'ah non-compliant decisions. First, it reflects on the Angelo-American concept of investor protection then studies the influence of social norms on the formation of corporate law and investor protection mechanisms. At the end, it analyses the applicability of fiduciary duty of loyalty and the non-fiduciary duty of care as legal mechanisms for the liability of directors with regard to their non-shari'ah compliant decisions.

7.2 Investor Protection In the context of Anglo-American Corporate Law

The examination of investor protection in the context of modern corporate law requires elucidation over the concepts of investment and investor. The concept and definition of investor is determined by the predominant concept of corporate and its governance structure. In this regard, the modern idea of corporate governance does not regard merely the concept of managerial capitalism[829] as stakeholders including shareholders and creditors have given right to control and question directors' decisions by the law. In fact, common law, equity, and statute developed fiduciary duties to limit discretionary power of directors and accordingly to provide a legal solution to make directors accountable for their decisions. In this regard, the concept of fiduciary duties mainly reflects a proscriptive essence as its main concern has been the prevention and prohibition of conflict of interests and other forms of abuse of trust by directors. Further, increasing competition and the need for more investment in financial markets necessitated a self-regulatory system in a broad sense to control and prevent directors' underperformance and accordingly takeover bid by other competitors.[830]

In the context of modern financial markets, the notions of investment and investor have changed alongside developments in the concepts of property and ownership. In this regard, the concepts of rights and corrective mechanisms also reflect consistency in their nature indicating historical changes in Law and markets. In other words, the modern notions of investment and investor are not based on the mere concept of ownership, but real control. As a result, the

[829] John Farrar, *Corporate Governance Theories, Principles and Practice* (3rd edn, OUP 2008) 12-13.
[830] ibid.

liabilities of corporate directors and managers are interpreted according to the exigencies of market and changes in the law.

The word 'invest' indicates 'the employment of money from which interest or profit is expected…..the obtaining of interest or profit is the defining characteristic of an investor'.[831] In this regard, In *Inland Revenue Commissioners v Rolls Royce Ltd*[832]Justice Macnaghten offered a general definition for the word 'investment': 'the word investment, though it primarily means the act of investing, is in common use as meaning that which is thereby acquired; and the meaning of the verb 'to invest' is to lay out money in the acquisition of some species of property'. This broad definition of investment reflects its financial nature as encompasses all types of property. As Lord Greene MR in *Inland Revenue Commissioners v Desoutter Brothers*[833] noted: 'the question whether or not a particular piece of income received from an investment must, in my view, be decided on the facts of the case… [Investment] is not a word of art but has to be interpreted in a popular sense'.

A profound perception on corporation in the context of corporate law is prone to a systematic view under which regulatory and legal forces are not the only creators of the modern corporation but the real association of all players such as investors and employees determines its concept and scope. In other words, 'corporations do not arise by spontaneous generation', and as a result the roles and responsibilities of directors and managers are assumed with knowledge of consequences.[834] In this regard, all kinds of promises made by directors and their actions taken to encourage investors to believe them are deeply dependent on how to prevent and reduce

[831] Jonathan Fisher and others, *the law of Investor Protection* (2nd edn, sweet & Maxwell 2003) 5.
[832] [1994] 2 ALL E.R. 340
[833] [1946] 1 ALL E.R. 58
[834] Frank H. Easterbrook and Daniel R. Fishel, *the Economic Structure of Corporate Law* (Harvard University Press 1991) 4.

conflict of interests by legal and social enforcement mechanisms.[835] In fact, legal and social enforcement mechanisms act as deterrence means to prevent misconducts and the breach of duties by directors. For instance, fiduciary duties reflected in common law and statutes are regarded as means to disincentivize corporate actors with regard to the violation of their responsibilities through the threat of liability. Further, dynamics of markets drive directors to act according to the interests of investors[836] as any underperformance and the breach of duty will result in loss of investor confidence.

From a legal point of view, it is assumed that legal systems with more protective laws and standards attract more investment, and as a result have better developed capital markets.[837] In fact, differences in the content, context and enforcement of laws reflect the existence of various patterns for corporate finance.[838] Although different legal systems establish different patterns for investor protection reflected in various legal sources such as corporate law, insolvency laws, criminal laws, securities laws and contract law; they pursue a common goal. In this regard, the protection of investors from expropriation by insiders is regarded as the main purpose for investor protection laws. Expropriation in Anglo-American sense refers to agency problems and consumption of 'perquisites' by managers.[839] Expropriation may take various forms based on different financial and legal systems.[840] For instance, insiders (such as directors) may steal and sell investors' profits and assets in financial institutions or projects which they are beneficiary.

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[835] ibid 5.
[836] ibid.
[837] Rafael La Porta and others, 'Investor Protection: Origins, Consequences, Reform' (1999) Harvard Institute for Economic Research Discussion paper Number 1883, 7 <ftp://ftp.repec.org/RePEc/fth/harver/hier1883.pdf> accessed 31 August 2015,
[838] Ibid.
[839] Rafael La Porta and others, 'Investor Protection and Corporate Governance' (2000) 58 Journal of Financial Economics 3, 4.
[840] La Porta (n 837).

Also, expropriation can be in the form of diversion of corporate opportunities from the firm or weak inside corporate governance system by employing unqualified directors.[841]

In this regard, the legal approach applied for investor protection explains the reasons for directors' responsibility to act in investors' interests, the return of profits, and accordingly the potential liability for the breach of any of them. This approach is expressed in contractual views over corporate law as they see a corporate comprised of a set of connected contracts between insiders and investors that give them right to claim for cash flows. As a result, 'changing the capital structure of the firm changes the allocation of power between the insiders and the outside investors, and thus almost surly changes the firm's investment policy.'[842] In this regard, to prevent or decrease the risk of expropriation and accordingly the loss of investors' confidence, a protective legal system should define effective legal rights for the relations between investors and insiders. In Jensen and Mecling words: 'this view of the firm points up the important role which the legal system and the law play in social organizations, especially the organization of economic activity. Statutory law sets bounds on the kinds of contracts into which individuals and organizations may enter without risking criminal prosecution. The police powers of the state are available and used to enforce performance of contracts or to enforce the collection of damages for non-performance. The courts adjudicate contracts between contracting parties and establish precedents which form the body of common law. All of these government activities affect both the kinds of contracts executed and the extent to which contracting is relied upon.'[843]

[841] ibid.
[842] La Porta (n 839) 5.
[843] Michael Jensen and William Meckling, 'Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure' (1976) 3 (4) Journal of Financial Economics 305, 311.

In this regard, the economic rationale behind the contractarian approach reflects a deep contradiction to legal approach over investor protection. According to contractarian view, the efficiency of financial contracts requires no regulatory intervention by law since they take place between sophisticated issuers and sophisticated investors.[844] Further, corporate as a nexus of contracts is comprised of various (explicit or implicit) contracts among stakeholders for economic returns.[845] Therefore, shareholders are not regarded as the owners of the company and accordingly their rights are similar to bondholders. In other words, from a legal point of view, shareholders and bondholders are all regarded as investors and their contracts' terms determine the level of protection they need. Further, the existence of effective enforcement mechanisms (through court or market) is the essential part of this theory. For instance, investors can penalize companies for not disclosing information and accordingly impose more costs on them. As a result, to avoid these risks and costs companies have an incentive to bind themselves through contracts to investors to limit expropriation.[846]

The role of law in this theory is a supportive one as it facilitates contracting through default rules and ensures a reasonable outcome in unexpected events such as the violation of investors' rights.[847] In other words 'the ideal corporate laws would be the most efficient default rules: the focus of legislatures and courts should be on enforcing those rules that the parties themselves would have entered into had they negotiated the matter.'[848] However, this theory does not regard the role of courts in enforcement very serious since due to time and resources restrictions they are often unable to ascertain facts related to complicated contracts. For instance, Legal systems

[844] La Porta (n 839) 7.
[845] Julian Velasco, 'The Fundamental Rights of the Shareholders' (2005) Notre Dame Law School, Legal Studies Research Paper No. 05-16, 34. http://ssrn.com/abstract=761904 accessed 31 August 2015.
[846] Jenson and Meckling (n 843).
[847] Velasco (n 845) 35.

based on common law institutions have more effective judicial and regulatory enforcement than civil law systems[849] as courts have power to establish new concepts according to new context. Further, legal rules in common law system are based on precedents inspired by general principles such as fairness and fiduciary duties.[850] In this regard, the expansion of those general rules to unprecedented conducts limits expropriation by insiders and accordingly provides more protective environment for the investment of all investors.[851] For instance, since from the seventeenth century courts in England came under the control of parliament and property owners, over time they extended protection to investors too.[852]

However, despite the existence of similar rules between common law systems, they have not experienced similar paths in the development of investor protection. It is discussed that, the contribution of common law in UK to investor protection at the beginning of the twentieth century in fact was devoid of antidirector rights provisions and protection of small investors.[853] In 1843 a landmark case *Foss v. Harbottle*[854] undermined the rights of minority investors to seek protection through the courts and accordingly this principle was upheld in the British company law.[855] In Lord Justice Hoffman words: 'A statutory remedy was provided for the first time in 1948 but this proved relatively ineffectual. It was not until 1980 that parliament forged the sword which is now section 459 of the Companies Act of 1985 and which enables the unfairly treated

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[848] ibid.
[849] La porta (n 839).
[850] Ibid 9; see also John C. Coffee Jr, 'Privatization and Corporate Governance: the Lessons from Securities Market Failure' (1999) Columbia Law School Working paper no. 158.
[851] ibid.
[852] ibid 12.
[853] Julian Franks and others, 'Ownership: Evolution and Regulation' (2009) 22 (10) the Review of Financial Studies 4009, 4010.
[854] (1843) 67 ER 189
[855] Franks (n 853).

minority shareholder to slay the dragon.'[856] In this regard, at the beginning of the last century the courts involvement in directors' breach of fiduciary duties was little, and there was only three cases in corporate crime and liability of directors over their fiduciary duties.[857] It is suggested that the reason why courts were reluctant to deal with directors' liabilities cases is that the articles of companies granted directors extensive discretionary power over the company transactions in the course of their business, and accordingly the principle of freedom of contract as an extra legal means supported directors to justify their discretionary decisions.[858] For instance in the cases of *Re Brazilian Rubber Plantations*[859] and *City Equitable Fire Insurance Company,*[860] even in the neglect or breach of fiduciary duties, the courts endorsed companies' articles of association with regard to the limited liability of directors.[861]

The main source of development of investor protection in the UK are in legislation and stock market rules. For instance, principles of *Caveat emptor* and listing rules were deeply embedded at the beginning of the twentieth century.[862] In 1944 due to increasing concerns over dispersion capital among an increasing number of small shareholders, the Cohen Committee on Company Law was set up.[863] As a result, the 1948 Companies Act introduced a variety of investor protection mechanisms such as resolutions for shareholders to remove directors easier. In other

[856] ibid 4015.
[857] Franks (n 853); the three cases are: *R v. Kylsani* Court of Appeal (1931); *Harris v. A. Harris* (1936) and *Nash Appellant*; and *Lynde Respondent* (1929).
[858] Franks (n 853) 4016.
[859] [1911] 1 Ch 425
[860] [1925] Ch 407
[861] Franks (n 853).
[862] ibid.
[863] ibid.

words, common law has not been an effective and sufficient means alone, rather statute and stock market rules strengthened investor protection.[864]

7.2.1 The Importance of Path Dependence in the Law of Investor Protection

To have a coherent legal system, the existence of dependency and consistency in its content is prerequisite. In this regard, consistency strengthens the effectiveness of legal enforcement and accordingly provides predictability for all legal relationships. However, the consistency in content drives the concept and form of 'path dependence' in context too. In other words, a profound study of origination and application of legal rules in a judicial system necessitates study over the role of social norms in their development. Particularly, from a historical point of view, since the law of investor protection does not reflect a mere legal and judicial essence, it is essential to consider social and legal norms together in the study. In this regard, for instance the development of the law of investor protection in the UK should be searched in provincial stock market rules.[865] The rapid increase in the number of provincial companies and the application of concentrating ownership among local investors played an important role in promoting shares' issues as local vendors realized the importance of elimination of dishonest promotion in their business reputation and accordingly in their business value.[866] Further, securities exchanges were mainly informal and placed by private negotiation among local people.[867]In other words,

[864] ibid 4017.
[865] In the first half of the twentieth Century there were eighteen provincial stock exchanges (without London Stock Exchange) in the UK. Franks (n 853) 4017.
[866] ibid 4018.
[867] Ibid.

the informal relations among investors and firms were based on social norms with non-legal characteristics and consequences emphasized on trust and fairness in the market.

Regarding the importance of liability of directors in corporate law, the informal relations of trust in the development of investor protection mechanisms and capital markets reflect an informality in the concept of liability in connection to investors' rights. In other words, legal history shows a kind of formal 'no liability' rule with regard to directors' duties.[868] In this regard, it is discussed that extra-legal mechanisms such as social norms provide security against corporate mismanagement and malpractices.[869] The importance of social norms in the UK with regard to investor protection mechanism can be described in terms of trust in informal relations between investors and firms. Trust in those relations bears economic and legal meanings. It refers to 'conformity with accepted norms of behaviour in the absence of explicit incentives or penalties to do so. It can derive from repeated interactions, moral and ethical codes, or the social conventions and networks discussed in the extensive sociological literature on the subject.'[870] In other words, the concept of trust implies a kind of commitment between investors and directors which produces value according to social norms. For instance, one of the reasons for the development of trust between investors and directors (and as a result the development of capital markets) in the UK is the role of local stock exchanges and the close proximity of investors to firms.[871] This account reveals the role of culture[872] in the formation of law and its path dependence.

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[868] Renee M. Jones; Law, 'Norms, and the Breakdown of the Board: Promoting Accountability in Corporate Governance' (2006) 92 Iowa Law Review 105.
[869] ibid.
[870] Franks (n 853) 4040.
[871] ibid.
[872] Culture in subjective terms refers to the aggregate of prevailing beliefs and meanings about legitimacy or illegitimacy of actions in society. Cultural norms guide social institutions' goals and functions. As a

In this regard, social norms, customs and traditions as informal institutions play an important role in the development of law.[873] Since these informal institutions are linked to all social and legal institutions, they have strong influence on the way a society conduct itself.[874] In this context, culture operates as a means to harmonize incentives and expectations in formal and informal interactions. It impacts the formation of organizational policies and individual decisions through influencing the content of formal legal rules.[875] In this regard, legal rules on investors' rights established in various laws reflect not only the practice of justice and the structure of a society, also demonstrate the cultural orientation.[876] For instance, the cultural value of uncertainty avoidance in Germany is the reason for the existence of tightly controlled legal procedure which is completely in contrast with relatively unpredictable lawyer-dominated American trial.[877]

In this regard, the legal and economic accounts of social and cultural norms, particularly in corporate law only consider external reasons (mainly economic) for their application and disregard the process under which those norms have been originated and internalized.[878] In fact, the belief-system of actors reflects the power of obligational and non-obligational norms in providing incentives and disincentives.[879]From the legal point of view, legal rules as obligational norms are the main factors to affect human conduct by providing legal liability and sanctions. On the other hand, non-obligational norms such as social and ethical norms are regarded as

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result, social actors draw on these values and norms to evaluate and justify their actions. See Amir N. Licht, Chanan Goldschmidt and Shalom H. Schwartz, 'Culture, Law, and Corporate Governance' (2005) 25 International Review of Law and Economics 229.

[873] Licht (n 872).

[874] ibid 232.

[875] ibid.

[876] ibid 234-236.

[877] Oscar G. Chase, 'Legal Processes and National Culture' (1997) 5 Cardozo J. Int'l & Comp. L. 1.

[878] Melvin A. Eisenberg, 'Corporate Law and Social Norms' (1999) 99 Columbia Law Review 1253, 1262.

internalized obligations which there is no utility or cost-benefit consideration in their choice by players.[880] In other words, sympathy and commitment are the sources of motivation and obligation.[881] Those non-legal sources are established based on traditions and beliefs coming from social and religious norms. In this context, social norms have been applied in corporate governance principles and codes in terms of ethical considerations relevant to the conduct of business even if corporate profit is not enhanced.[882]

7.3 The Fiduciary and Non-Fiduciary Duties of Directors With Regard to Shari'ah Board' Opinions

Directors due to their position are regarded as fiduciaries and accordingly bear all fiduciary obligations established in equity and statute. Further, the scope of their fiduciary duties are mainly defined by case law and social norms. However, the efficient function of obligational norms requires support by liability mechanisms provided by legal rules as the consequence of the breach of those norms. In this regard, also it is discussed that the non-legal factors such as belief-system may induce change in norms (norm-shift) and accordingly legal authorities through judgements or legislation induce change in belief-system.[883]

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[879] ibid 1261.
[880] ibid.
[881] ibid.
[882] American Law Institute, 'Principles of Corporate Governance: Analysis and Recommendations' (1992), s 2.01 (b).
[883] Eisenberg (n 878) 1265.

Generally, the controversy over the core character of fiduciary accountability[884] arose in the second half of the twentieth century as the result of changes in economic and financial transactions.[885] In this regard, the main regulatory function of fiduciary rules was deemed to control opportunism.[886] The application of this approach (mainly proscriptive) in the function of fiduciary rules are well described in two cases.[887] In *Parker v McKenna* Lord Cairns outlined: '……no man can in this Court, acting as agent, be allowed to put himself into a position in which his interest and his duty will be in conflict…all that the court has to do is examine whether a profit has been made by an agent, without the knowledge of his principal in the course and execution of his agency.' This approach is based on the moral essence of fiduciary duties as they are prudent default governance mechanism and function as barrier to human opportunistic behaviour.[888] Further, the function of fiduciary duties implies the importance of loyalty in value-creation. In this regard, the production of value for others means limited access[889] to assets since they should be used only for specific goals. Further, 'opportunism is a generic mischief and it attracts a generic regulation across all limited access relations'.[890]

Directors' fiduciary duties in corporate law are mainly concerned about loyalty and good faith of directors in exercising their functions. In this regard, there has been two main streams in fiduciary duties: negative and positive. As the result of the differences over the meaning and scope of directors' fiduciary duties in common law jurisdictions, the provided remedies are also

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[884] Fiduciary accountability is different from fiduciary liability. The former is determined by potential for opportunism, the latter is determined by benefit or conflict. Robert Flannigan, 'Fiduciary Duties of Shareholders and Directors' (2004) JBL 277.
[885] Robert Flannigan, 'the Core Nature of Fiduciary Accountability' (2009) 2009 New Zealand Law Review 375, 376.
[886] ibid.
[887] *Parker v McKenna* (1874) LR 10 Ch App 96 (HL), 118; *Bray v Ford* [1896] AC 44 (HL), 51–52.
[888] ibid.
[889] ibid.
[890] Flannigan (n 885) 383.

different. This issue is particularly more convoluted under English law as there are different approaches in case law. For instance, the approach of the directors' duty to promote the success of the company in *Attorney-General v Blacke*[891] and the approach in *Item Software v Fassihi* reflect no defined legal idea for the interpretation of fiduciary duties.[892]

In this regard, it is discussed that the function of fiduciary rules is not to supervise the management of directors, but to perform as a civil liability to regulate self-interested conduct.[893] Further, to understand the nature of directors' fiduciary duties it is important to distinguish between nominate and fiduciary regulation.[894] According to this view, the duty to act in the best interest of the principal is not a fiduciary duty but a nominate duty.[895] In Flannigan words: 'the fiduciary duty is a separate parallel or general obligation designed to support the nominate undertaking in one specific respect - to suppress regard for self'.[896] However, this view is controversial in the context of directors' fiduciary duties since there has been no analysis either in the source or content of duties and remedies.[897] Further, 'the success of the company' in the companies Act 2006 implies a positive obligation for directors to perform in the best interests of the company. This broad view is supported by the US courts too.[898]

In this regard, the history of corporate law in the UK reflects development in fiduciary relations and obligations. When joined stocked companies acquired the form and status of corporation, the legal position of parties undergone profound changes. In this context, the partner position of former stockholders was replaced by shareholder position and accordingly they were

[891] [2001] 1 AC 268
[892] [2005] 2 B.C.L.C. 91
[893] Flannigan (n 884); Robert Flannigan, 'The [Fiduciary] Duty of Fidelity' (2008) 124 LQR 274.
[894] Flannigan (n 885).
[895] ibid.
[896] ibid 384.
[897] Stafford and Ritchie (n 418) 61.

no more principal in relation to business. As the result of those changes, all contractual and vicarious liability of former partners were transferred to the new corporation and as a consequence, new shareholders as statutory investors have been no longer fiduciaries as their fiduciary statute transferred to corporation. However, the fiduciary position of management (now directors) has gone no change and only the identity of the person (corporation) to whom they owed fiduciary duties changed.[899] In this regard, shareholders granted open access to corporation with regard to assets and discretionary power.[900] Further, the fiduciary obligations of directors have been not only statute-based, but fact-based as 'one actor has trusted the other with limited access.'[901]

Regarding directors' nominate obligations; they are subject to different layers of regulation[902] such as agency law, corporate law and specific sectorial rules. In this context, since fiduciary accountability and liability are subject to different layers of regulation, the nature and scope of fiduciary duties such as loyalty also do not reflect a fixed concept in all cases. In other words, these additional layers modify the content of the conventional regulation without representing a specific fiduciary regulation.[903]

The issue is more complex in Islamic financial industry as directors should apply Sharia boards' rulings. We have two issues over the application of Shari'ah boards' rulings by directors: first, as we discussed in the last chapter, directors as fiduciaries have to apply Shari'ah boards' fatwas. The question here is: what is the criterion for the loyalty of directors as they are only responsible (according to the statute) to the company not stakeholders? This question has an

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[898] This issue is discussed in the next part.
[899] Flannigan (n 884) 280.
[900] ibid.
[901] ibid.
[902] ibid.

implicit dimension with regard to the application of proscriptive or prescriptive approaches. Second, we have a gap in the concepts of accountability and sanction in the event of the violation of Shari'ah boards' fatwas by directors. The root of those ambiguities rests on the social gap in the establishment and application of Islamic finance principles and also the governance mechanisms applied in the context of conventional regulatory system.

7.3.1 The Fiduciary Duty of Loyalty

Regarding the confusion over the nature of fiduciary obligations and liabilities, it is a failure to focus on the meaning of loyalty without considering the context of fiduciaries.[904] Particularly in the context of Islamic finance the meaning of duty of loyalty is more complex as it bears a religious character and also there is no established perception over the concept of board of directors' duty of loyalty in applying Shari'ah boards' fatwas.

From a narrow point of view, the function of directors' duty of loyalty should be described as a mechanism for controlling opportunism. This proscriptive view over the nature and scope of fiduciary obligations is founded upon the no conflict and no profit rules. In this regard, two famous cases illustrated the application of this theory. In *Regal (Hastings) v Gulliver*[905], there was no breach of the duty to promote the interests of the company, and only the unauthorised profit was the basis for the breach of no profit rule and therefore the breach of fiduciary duty. In *Cook v Deeks*[906] the defendants acted in the breach of 'no conflict' and 'no liability' duties since

[903] ibid 281-282.
[904] Stafford and Ritchie (n 418).
[905] [1967] 2 AC 136.
[906] [1916] AC 554.

they diverted contracts which should have been fulfilled by the claimant company to their new company.[907]

Those rules convey the concept of trust in directors' duties. In this regard, although in some cases judges have been distracted by the issue of whether directors are fiduciaries, it is clear that they were meant the idea that fiduciary rules against opportunism are originated in the trust context.[908] Lord Cranworth in *Aberdeen Rail Co v Blaikie Brothers*[909] outlined the agency nature of directorship. Directors convey their agency duty to promote the interests of the company and a separate fiduciary duty to act without conflict of interests in the course of that agency.[910]

In this regard, it is discussed that the discretionary power of directors are their capacities and are not fiduciary in essence.[911] They acquire fiduciary characteristic when they are exercised by fiduciaries.[912] Consequently, other nominate obligations such as duty to act in the best interest of the company are obligations assigned to them by the general law.[913] In fact, this duty as Flannigan observes, is a positive default rule of agency law and accordingly has a distinct application: 'the best interest rule has a wider ambit than the fiduciary proscription. Serving one's own interest is but one way in which directors might fail to act in the best interest of the corporation.'[914] Further, the fiduciary responsibility is only concerned with whether a decision is compromised by conflict or a personal benefit.[915] In this regard, it is discussed that, this duty is

[907] Stafford, and Ritchie (n 418) 63.
[908] Robert Flannigan, 'The Adulteration of Fiduciary Doctrine in Corporate Law' (2006) 122 LQR 449.
[909] (1854) 23 L.T. 315, HL.
[910] ibid
[911] Flannigan (n 908).
[912] ibid.
[913] ibid.
[914] ibid 288.
[915] ibid.

outside of trust-like relationships and is 'one of those exceptional duties of care which requires positive action but does not exclude self-interest.'[916] As a result, a generic fiduciary regulation cannot provide content to the duty of care and such an obligation is the preserve of the contract or the assumption of responsibility in tort.[917]

However, the operation of the prospective regime is questioned. As Professor Birks observed: 'the obligation of disinterestedness cannot be served from the obligation to promote and preserve. It does not make sense without that principal obligation. An independent obligation to abstain from pursuing interests of one's own is unintelligible, certainly unworkable. The very formulation of the chief restatement of this obligation shows that it is an obligation of disinterestedness in the course of doing something: the trustee shall not pursue any interest of his own which might possibly conflict with his duty to the beneficiary, scilicet his duty to promote and preserve the interest of the beneficiary…the core obligation of trustee is the compound obligation and it is indivisible at least in the sense that while the positive obligation of care can exist on its own, the obligation of disinterestedness cannot.'[918] Further, the essence of 'no conflict' and 'no profit' duties serve as deterrence means to prevent directors from breaching their positive obligations.[919] Consequently, this approach is regarded impractical as is not consistent with the current prescriptive approach of English law demonstrated in case law and statute.

In the context of Islamic finance, Shari'ah compliance and directors' fiduciary duty of loyalty in the application of Shari'ah boards' fatwas should be examined with regard to the both

[916] Peter Birks, 'the Content of Fiduciary Obligations' (2002) 34 Isr. L. Rev. 16.
[917] Stafford and Ritchie (n 418) 65.
[918] ibid 62.
[919] Charles Harpum 'Fiduciary Obligations and Fiduciary Powers-Where Are We Going?' in Peter Birks (ed) *Privacy and Loyalty* (Clarendon 1997) 145.

proscriptive and prescriptive approaches. As discussed before, there is a trust-like relationship between directors, company and shareholders in terms of Shari'ah compliant financial products and the governance of Islamic financial institutions. From a proscriptive point of view, if we only consider no conflict and no interest rules we would have a narrow perception over directors' duty of loyalty in the application of fatwas. In this regard, directors would be liable if they compromise discretion for their own interests. For instance, if applying a Shari'ah ruling in the structure of a product will impact negatively the competitive level of a financial institution in which they are shareholder. The problem in this approach is its narrow view over the concept of 'interest'. In Islamic finance the application of Shari'ah boards' fatwas conveys a religious duty which must be observed even it decreases economic value or profit. In this regard, to ensure stakeholders over Shari'ah compliant decisions of directors, it is necessary to consider directors liable for their non-Shari'ah compliant decisions even there is no element of opportunism in their functions. However, since there is no specific regulation for fiduciary obligations of directors of Islamic financial institutions, we must establish the legal debate according to common Law institutions.

From an economic point of view, the concept of loyalty can be defined based on the economic relationship between legal and social norms. According to this view, fiduciary principles are contractual devices[920] and should be considered in terms of their efficiency. This view is Contrary to the 'fraud-on-the-market' theory under which the reliance required in rule 10b-5 can be disposed of in efficient capital markets as its focus is on the effect of misrepresentation on the

[920] Jonathan R. Macey and Geoffrey P. Miller, 'Good Finance, Bad Economics: an Analysis of the Fraud-on-the-Market Theory' (1990) 42 Stanford Law Review 1059.

security's prices rather than on the individuals' reliance on a misrepresentation.[921] In Macey and Miller words: 'this economic perspective is important because it generates a mechanism by which courts can decide cases. In particular, when scrutinizing managerial behaviour, courts should treat an allegation of a breach of fiduciary duty as they would treat any alleged breach of contract. This analytic method often is described as the 'hypothetical bargain' approach. Under this approach to fiduciary duty, courts would evaluate whether the managers' actions were consistent with the terms of a hypothetical fully specified, contingent contract that informed, value maximizing investors would have agreed to *ex ante*.'[922] Based on this view, directors should be exempted from liability if their lies are made with good faith to increase shareholders' interests and do not create negative externalities.[923] In other words, this view supports an instrumental approach in fiduciary obligations and ignores the expressive function of law.[924]

The application of this view in the context of Islamic finance is problematic not only with regard to the expressive function of law (and its negative social impacts), also in respect to economic reasons. In this regard, economic reasoning does not affirm such an approach since it reduces trust between directors and investors, as a consequence reduces the benefits of corporation. In this context, directors' fiduciary duty of loyalty over the application of Shari'ah boards' fatwas cannot be understood as a mere contractual duty as law imposes it too.[925]

From a prescriptive approach, the duty of loyalty requires directors to act within their powers and any diversion from company's constitution leads to their liability.[926] Contrary to the

[921] Brad M. Barber et al, 'the Fraud-on-the-Market Theory and the Indications of Common Stocks' Efficiency' (1994) the Journal of Corporation Law 285.
[922] Macey and Miller (n 920) 1068-69.
[923] ibid 1075.
[924] Eisenberg (n 878) 1273.
[925] ibid.
[926] The Companies Act 2006, s171.

proscriptive approach under which the application of the best interest is not the main concern of fiduciary duties, the prescriptive interpretation of loyalty necessitates concerns about the prosperity of the company. In other words, in contrast to the proscriptive approach under which directors exercise their power only for 'proper purpose' regardless of the best interest of the company,[927] directors in prescriptive approach are required to have a broad view about their loyalty and accordingly being concerned about both proper purpose and the efficiency of their decisions. In the context of Islamic finance, since Shari'ah compliance as the ultimate goal is mainly about the implementation of fatwas by directors, the duty of loyalty in terms of the success of the company should be defined according to application of fatwas too. In other words, the loyalty of directors and the success of company are defined according to the Shari'ah boards' fatwas.

7.3.2 The Non-Fiduciary Duty of Care, Skill and Diligence

The concept and scope of directors' duty of care, skill and diligence has been developed by courts. This duty is not fiduciary duty and as the Companies Act in s 178 (2) expresses, it is a statutory statement of common law duty of care. In this regard, the distinction between fiduciary and other duties should be examined in terms of consequences for the breach of those duties. Millett LJ in *Bristol & West Building Society v Mothew*[928] elucidated that while the breach of fiduciary duties attracts equitable remedies which are mainly restitutionary and restorative, the breach of other duties such as duty of care attract compensatory remedies. Further, he pointed out the importance of the breach of loyalty in fiduciary duties and not a mere lack of

[927] Flannigan (n 884) 289.
[928] [1996] 4 A11 ER 698 at 711-12.

competence.[929] In this regard, the liability for the breach of duty of care may be examined in tort or in contract when a director has a contract of employment.[930]

Regarding the concept of the duty of care, skill and diligence, it is assumed that this is one duty and contrary to its form, it does not consists of three separate obligations since the emphasis on the strength of the standard of care, skill and diligence has not been mentioned specifically for each of them.[931] However, despite the unified structure of this duty, its components reflect different meanings. In this regard, The Honourable Justice recognises the different elements of care and skill as: '[skill refers to the] 'special competence which is not part of the ordinary equipment of the reasonable man but the result of aptitude developed by special training and experience which requires those who undertake work calling for special skill not only to exercise reasonable care but to measure up to the standard of proficiency than can be expected from persons undertaking such work.' Care involves the manner in which the skill is applied….in the past, skill has not been regarded as a requirement, and the standard of care expected has been low.'[932] Moreover, on duty of care Mackenzie states: 'the former [i.e. the duty of care] refers to any duties concerning factors which the layman might employ in debating issues which he is called upon as a director to consider.'[933]

The term 'diligence' has been explained as 'expected level of active engagement in company affairs.'[934] In this regard, it is believed, although the term diligence should be interpreted with

[929] ibid; see also *Extrasure Travel Insurances Ltd v Scattergood* [2003] 1 BCLC 598 at 618.
[930] *Lister v Romford Ice & Cold Storage Ltd* [1957] 1A11 ER 125.
[931] Demetra Arsalidou, *The Impact of Modern Influences on the Traditional Duties of Care, Skill and Diligence of Company Directors* (Kluwer Law International 2001) 30.
[932] The Honourable Justice Ipp, 'the Diligent Director' (1997) 18 Company Lawyer 162, 163.
[933] A. L. Mackenzie, 'A Company Directors' Obligations of Care and Skill' (1982) Journal of Business Law 460, 461.
[934] J. E. Parkinson, *Corporate Power and Responsibility-Issues in the Theory of Company Law* (Clarendon 1994) 99.

considering the limited ability of directors to have a number of skills, it is generally expected that they act carefully.[935] Diligence equates to consciousness and attentiveness of a director to take an active interest in ensuring that the affairs of the company are properly looked after.[936] Further: 'in *Dorchester Finance Ltd. v. Stebbing*, Foster J, suggests that the law imposes an objective standard of 'care'; that of the ordinary man acting on his own behalf. The standard of 'skill' however is said to be subjective; that which may reasonably be expected from a person with his knowledge and experience.'[937] In this regard, the development of case law over the nature of a director's position as fiduciary and its difference from trustee position has affected the duty of care. It is admitted that directors cannot be regarded as trustees since they are expected to take risk and carry on business according to business rules and exigencies and[938] accordingly, their duty of care should be interpreted with regard to the characteristics of the company's business and the context they function.

Further, In English law directors have collective responsibility in the management of the company, but equally directors' duties are 'personal and inescapable duties'[939], and accordingly each director must meet the standard of care, skill and diligence.[940] As Lord Woolf MR in *Re Westmid Packing Services Ltd, Secretary of State for Trade and Industry v Griffiths*[941] states: '….the collegiate or collective responsibility of the board of directors of a company is of fundamental importance to corporate governance under English Company Law. That collegiate or collective responsibility must however be based on individual responsibility. Each individual

[935] A. Hicks, 'Director's Liability for Management Errors' (1994) 110 LQR 390, 393.
[936] John Davis, 'A Guide to Directors' Responsibilities under the Companies Act' (July 2007) Certified Accountants Educational Trust 38.
[937] ibid.
[938] *Land Credit of Ireland v. Lord Fermoy* (1890) 5 Ch App 763.
[939] See *Secretary of State for Trade and Industry v Goldberg* [2004] 1 BCLC 557 at 608.
[940] Brenda Hannigan, *Company Law* (3rd edn, OUP 2012) 206.

director owes duties to the company to inform himself about its affairs and to join with his co-directors in supervising and controlling them.'

The development of standard of care in common law has been gradually. In this regard, the traditional view implies a low standard of care for directors as directorship was regarded as the representation of a class of society, not qualification and skill.[942] In this context, professionalism or the expectation of certain professional qualities was not required as directors were appointed for their status, rather than for their business ability.[943] In this regard, in *Overend, Gurney & Co v Gibb*[944] a test of 'ordinary prudence' was introduced: 'whether or not the directors exceeded the powers entrusted to them, or whether, if they did not,….they were cognisant of facts of such a character, so plain, so manifest, and so simple of appreciation, that no men with any ordinary degree of prudence, acting on their own behalf, would have entered into such a transaction as they entered into.'

In the case *Re City Equitable Fire Insurance Co*[945], Romer J recognised the lack of clear authorities[946] for directors and reviewed the traditional standard: '(1) A director need not exhibit in the performance of his duties a greater degree of skill than may reasonably be expected from a person with his knowledge and experience ... It is perhaps only another way of stating the same proposition to say that directors are not liable for mere errors of judgment. (2) A director is not bound to give continuous attention to the affairs of his company. His duties are of an intermittent nature to be performed at periodical board meetings...He is not, however, bound to attend all such meetings, though he ought to attend whenever, in the circumstances, he is reasonably able

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941 [1998] 2 BCLC 646 at 653
942 Arsalidou (n 931) 35.
943 ibid.
944 (1872) LR 5 HL 40, 486-7. See also *Re Brazilian Rubber Plantations and Estates Ltd* [1911] 1 Ch 425
945 [1925] Ch 407.

to do so. (3) In respect of all duties that, having regard to the exigencies of a business, and the articles of association, may properly be left to some other official, a director is, in the absence of grounds for suspicion, justified in trusting that official to perform such duties honestly.'[947]

In contrast to the traditional approach in English law[948], in the US, states previously did not regard negligence (for any degree) the main factor for directors' liability, and instead they were only liable for fraud or intentional misconduct.[949] The term 'negligence' has been described as 'a state of mind opposing an intentional action, which is done not with the desire to producing a particular result by carelessness or indifferent.'[950] Also, the term 'negligence' can be defined as the careless conduct without any reference being made to any duty being imposed to take care.[951] In the older cases, the term 'negligence' was used to explain the omission to perform a required act.[952] In this regard, the modern American case law has applied three standards for the breach of duty of care which all have some degree of negligence: 1) only the degree of care required to avoid gross negligence; 2) the degree of care that an ordinary prudent director in a like position would exercise under similar circumstances; 3) the degree of care that an ordinary prudent person would exercise in conducting personal business affairs.[953] However, the modern US trend requires the exercise of a degree of care from an ordinary prudent person under similar position and circumstances.[954] According to the Model Business Corporate Act: 'A director shall

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946 Ibid, at p 427.
947 Ibid, at pp 428-9.
948 See *Turquand v Marshall* (1869) LR 4 App 376; *Land Credit of Ireland v Lord Fermoy* (1870) 5 Ch App 763.
949 Marcia M. McMurry, 'Special Project: An Historical Perspective on the Duty of Care, the Duty of Loyalty, and the Business Judgment Rule' (1987) 40 Vanderbilt Law Review 605, 607.
950 *Charleston & Percy on Negligence* (Sweet & Maxwell, 1990) at 3.
951 Arsalidou (n 931) 5.
952 ibid.
953 ibid.
954 McMurry (n 949); see M. H. Ubelaker, 'Director Liability under the Business Judgment Rule: Fact or Fiction?' (1981) 35 775, Southwestern Law Journal 787.

discharge his duties as a director, including his duties as a member of a committee:…..2) with the care an ordinary prudent person in a like position would exercise under similar circumstances;..'[955]

Further, the fiduciary duty of care in the US is concerned about the standard of conduct and review applicable to directors who act or fail to act in a matter that does not involve his own interest.[956] In this regard, s. 4.01 (a) of The American Law Institute's Principles of Corporate Governance sets the modern standard of care as fpllows: 'A director or officer has a duty to the corporation to perform the director's or officer's function in good faith, in a manner that he or she reasonably believes to be in the best interests of the corporation, and with the care that an ordinary prudent person would reasonably be expected to exercise in a like position and under similar circumstances. This Subsection (a) is subject to the provisions of Subsection (c) (the business judgement rule) where applicable.'

In this regard, the connection between business judgement rule and the duty of care in the US law is considered in the sense that if directors' taken decision was rational, in an informed manner and without self-interest, it will not be in the breach of the duty of care.[957] Further, the business judgement rule in the US law is rooted in tort law as the directors' decisions must be reasonable and accordingly 'is designed to stimulate risk taking, innovation and other creative entrepreneurial activities.'[958]

[955] Model Business Corporation Act (rev .ed. 1991), Para 8:30.
[956] Arsalidou (n 931) 156.
[957] Ibid.
[958] The American Law Institute (n 882) 176.

However, the introduction of business judgment rule in the UK has not been recommended by the Law Commission[959]as the application of the rule is established in the practice of English courts. In this regard, Parkinson has argued that the rule is an 'articulate version of the policy of judicial reticence that is implicit in the practice of the English courts.'[960] In fact the business judgement rule is well reflected in the English courts' approach in commercial cases under which 'to substitute [their] opinion for that of the management, or indeed to question the correctness of the management's decision…..if bona fide arrived at.'[961]

The expected standard of care laid down in the Companies Act 2006 reflects a dual objective and subjective test.[962] In this regard, the objective standard set in the law requires a minimum standard of care in the context of the directors' functions, which the personal attributes of directors (subjective standard) cannot lower them.[963]

[959] Law Commission and Scottish Law Commission, *Company Directors: Regulating Conflicts of Interests and Formulating a Statement of Duties* (Law Com No 261, 1999) and (Scot Law Com No 173, 54).

[960] Parkinson (n 934) 109.

[961] *Howard Smith Ltd v Ampol Petroleum Ltd* [1974] AC 821, 832 (PC); see also e.g. *Re Smith& Fawcett Ltd* [1942] Ch.304; *Re Tottenham Hotspur plc* [1994], BCLC 655,660; *Runciman v Walter Runciman plc* [1992] BCLC 1084; and *Devlin v Slough Estates Ltd and others* [1983] BCLC 497, 504 per Dillon J: "The court does not interfere with the business judgment of directors in the absence of allegations of mala fides".

[962] The Companies Act 2006, s 174: "(1) A director of a company must exercise reasonable care, skill and diligence. (2)This means the care, skill and diligence that would be exercised by a reasonably diligent person with—(a)the general knowledge, skill and experience that may reasonably be expected of a person carrying out the functions carried out by the director in relation to the company, and (b)the general knowledge, skill and experience that the director has."

[963] ibid s. 174 (2) (a); see Hannigan (n 940); this approach is according to courts decisions (prior to the Companies Act 2006) taken based on the Insolvency Act 1986, s 214 (4) under which conduct of directors must be measured against the objective and subjective standards. See *Norman v Theodore Goddard* [1992] BCC 14 *and Re D'Jan of London Ltd* [1993] BCC 646 which were followed by *Nelson J in Bairstow v Queen's Moat Houses plc* 23 July 1999, unreported. *Re D'Jan of London Ltd* was also followed by Hart J in *Re Landhurst Leasing plc*, *Secretary of State for Trade and Industry v Ball and others* [1999] 1 BCLC 286, 344.

The examination of the breach of duty of care by directors in the context of Islamic finance requires inquiry over the existence of any formal legal regulation such as legislation or case law, and the standard of care in the context of Shari'ah finance. The Shari'ah finance industry in the UK is established according to the conventional institutions and there is no specific regulation or privilege for it. As a result, the violation of Shari'ah rulings by directors must be examined according to the UK laws and custom. In this context, since Islamic finance industry has not presented a real self-regulation system, the regulation of Shari'ah compliance and the application of Shari'ah boards' fatwas by directors are mainly discussed according to conventional laws.

In the English law, from a contractual point of view, directors are responsible for proper care, skill and diligence. In this regard, one consequence of the corporate separate legal personality is that a director may be the employee of that company. In this regard, although executive and non-executive directors have collective responsibility for the governance of the company, executive directors due to their management power delegated to them by the company articles of association and their service contracts bear more responsibility. Further, executive directors due to the nature of their service contracts may be considered office-holders (as they are in the position of authority) and accordingly as employees.[964] In this regard, non-executive directors are not regarded employees as they do not have service contract with the company.

In employment law, regarding the nature of the contract, some obligations of directors over their duty of care are more implied and do not appear in service contracts.[965] In this context, as directors are senior employees, according to employment law they are subject to two implied

[964] S. Deakin, *Labour Law* (Butterworths 1998) 211.
[965] Arsalidou (n 931) 39.

terms: first, employees must show reasonable skill[966] and secondly they must perform their duties with reasonable care.[967] In this regard, the unreasonable performance of directors results in liability for loss by virtue of their negligence.[968] Further, the use of reasonable skill and care implies the importance of being competent to the job since incompetence is a breach of contract.[969]

Regarding the implied contractual standard of care and skill expected from directors of a company, it is discussed that reference to 'reasonableness' implies the objective standards of care in employees' performance which are based on an ordinary employee in his duty.[970] In the context of Shari'ah finance industry, the objective standards of care and skill are not as clear as the conventional one. For instance, although the objective standards for the performance of a reasonable finance director are established according to conventional knowledge precepts, we do not have clear standards for the Shari'ah compliant performance. The problem is more severe in the single regulatory systems, such as the UK as there is no regulation for Shari'ah compliant directorship. Further, the existence of many Shari'ah boards without agreement over the concept of Shari'ah compliance impedes the industry to present objective standards of care and skill. However, customs in the market made by practitioners and well-known Shari'ah scholars can fill this gap and accordingly serve as objective standards. In this regard, the lack of the concept of professionalism in terms of rules and practices has prevented the formation of a harmonised objective standards in the industry too.

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966 *Harmer v Cornelius* (1858) 5 CBNS 236.
967 *Janata Bank v Ahmed* [1981] ICR 791.
968 Arsalidou (n 931) 40.
969 *Harmer v Cornelius* (1858) 5 CBNS 236; see Perrins, *Harvey on Industrial Relations and Employment Law* (Butterworths, 1999) at 181
970 See *Printers and Fisheries Ltd v Holloway* [1964] 2 A11 ER 731.

It is discussed that directors' statutory duty of care and the application of its objective standard should be construed with regard to directors' functions. In *Re Barings plc (No. 5), Secretary of State for Trade and Industry v Baker (No 5)*[971], Jonathon Parker J underlined that the competence of directors must be assessed in the context of and the management role in the company assigned to them or which he in fact assumed and by reference to their responsibilities in that role.[972] He stressed that: 'thus the existence and extent of any particular duty will depend upon how the particular business is organized and upon what part in the management of that business the respondent could reasonably be expected to play (see *Bishopsgate Investment Management Ltd (in liq) v Maxwell* (No 2) [1993] BCLC 1282 per Hoffmann LJ).'[973] In this regard, the general content of the duty of care and the function of directors should be interpreted with regard to the complexity and size of business. In other words, the relevant minimum functions of directors must be considered with regard to the role, structure and financial position of the company.[974]

In the context of Islamic finance, directors' statutory duty of care must be interpreted with regard to their functions in the Islamic financial institution. To assess their duty of care, the objective standards are required according to their functions. In other words, statutory objective standards must regard Shari'ah factor in the assessment of directors' duty of care. Shari'ah factor here includes not only the rulings and opinions of Shari'ah board and Shari'ah department of the relevant Islamic financial institution, also the practice in the market. Further, directors' duty of

[971] [1999] 1 BCLC 433, aff'd [2000] 1 BCLC 523, CA.
[972] Hannigan (n 940); see [1999] 1 BCLC 433 at 489, aff'd [2000] 1 BCLC 523 at 535; *Re Continental Assurance Co of London plc, Secretary of State for Trade and Industry v Burrows* [1997] 1 BCLC 48 at 57-8; *Re Produce Marketing Consortium Ltd* (No 2) [1989] BCLC 520 at 550; *Re Vintage Hallmark Ltd, Secretary of State for Trade & Industry v Grove* [2007] 1 BCLC 788 at 793.
[973] [1999] 1 BCLC 433 at 484.
[974] Hannigan (n 940); see *Re Produce Marketing Consortium Ltd* (No 2) [1989] BCLC 520 at 550.

care in the Islamic finance industry cannot be assessed without inquiry over their personal knowledge and experience (subjective test). Since the Islamic finance bears some particular characteristics, it is reasonable to expect directors practicing in this area to enjoy expertise and experience for the business.

This subjective test is connected to the content of the directors' duty of care in Islamic fiancé industry. Both English and US law[975] recognise the duty of care, skill and diligence that includes duty of knowledge, inquiry and supervision too. In this regard, sufficient knowledge is required for understanding company's business, taking informed decisions and controlling the operation of the company. In *Re Barings plc (No 5) Secretary of State for Trade and Industry v Baker (No 5)* Jonathan Parker J recognised and emphasised on those duties.[976] Further, the delegation of power does not abolish directors' responsibility for supervision.[977] In this regard, the residual duty to supervise depends on the nature of the transaction and the potential risk or loss involved.[978] In this context, the individual role of a director requires him to examine the quality of the system he is responsible for, and at the board level the collective responsibility require all directors to ensure about the proper internal and external control systems in terms of risk management.[979] in this regard, in cases *Francis v United Jersey Bank*[980] and *Smith v Van Gorkom*[981] (the *Trans Union Case*) US courts stressed on the importance of directorial activity,

[975] See the American Law Institution (n 882).
[976] [1999] 1 BCLC 433 at 489, [2000] 1 BCLC 523 at 535, CA.
[977] ibid.
[978] Hannigan (n 940).
[979] Ibid; see the UK Corporate Governance Code (2010) Main Principle C.2.
[980] (1981) 432 A 2d 814.
[981] (1985) 488 A 2d 858.

familiarity with the company business, continuous supervision[982] and the examination of the actual process.[983]

In the context of Islamic finance, since Shari'ah compliance is the core objective of the industry, Shari'ah risk management must be the individual and collective responsibility of directors and accordingly the breach of duty of care must be examined with regard to this core objective. In this regard, directors are responsible to implement an effective internal Shari'ah compliance risk management system and have regular connection with Shari'ah board and Shari'ah department. However, the Companies Act and common law don not consider any religious element in the duty. In fact, the purpose of the fiduciary and non-fiduciary duties have been to inspire entrepreneurship, innovation, and to prevent self-interested behaviours by directors. In this regard, the concept of loss resulted from directors' breach of duty of care bears an economic essence and not religious. The question is if Shari'ah non-compliant decisions and activities of directors of an Islamic financial institution result in increase in economic value, can we consider them liable by common law legal institutions such as negligence? Or, only in the case of loss or injury resulted from their non-compliant Shari'ah decisions we can apply those mechanisms? In the context of UK legal system, Shari'ah non-compliant liability of directors is mainly a self-regulatory issue as legislation and common law do not provide any specific legal institution or privilege for Shari'ah-compliance and only internal control and accountability mechanisms of Islamic financial institutions can manage this issue. For instance, the common remedy for the purification of Shari'ah non-compliant incomes is paying *zakat* and there is no conventional mechanism to deal with this issue. However it is possible that courts in cases over the breach of duty of care by directors serving in Islamic financial institution, consider the

[982] *Francis v United Jersey Bank,* ibid at 823.

Shari'ah non-compliance factor in their judgement if it only causes loss or injury for the company.

7.4 Conclusion

This chapter examined the importance of legal accountability mechanisms in the protection of investors' rights in terms of Shari'ah compliant decisions of directors. In this regard, investor protection in Islamic finance is mainly concerned about the Shari'ah compliance and responsibility of directors over the Shari'ah compliant operation of Islamic financial institution. In this context, since there is no special regulation for Islamic finance industry in terms of legal accountability mechanisms, the implication of non-Shari'ah compliant decisions of directors should be examined according to the common law and statute institutions. Various Judgments in case law over responsibilities of directors demonstrate the crucial place of fiduciary duties for the accountability of directors. In the context of modern corporate law, directors' duty to promote the success of the company can be considered as the foundation of other fiduciary and non-fiduciary duties and accordingly in the context of Islamic finance directors' responsibility to apply Shari'ah board's fatwas should be examines with regard to that positive obligation. However, the concept and the scope of loyalty in directorship of Islamic financial institutions is more complex as it bears religious and economic factors together. In other words, duty of loyalty in the context of Islamic finance reflects religious duty of directors to apply Shari'ah board' fatwas even when they decrease the economic value of the company.

Duty of care, skill and diligence also reflects the complexity of directors' duty in the governance of Islamic financial institution as no objective or regulatory standard is defined for it.

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[983] *Smith v Van Gorkom*, ibid at 924.

In this context, it is discussed that directors' duty of care should be examined with regard to contractual terms of their service contract and also the implied terms such as: reasonable skill and reasonable care in employment law. However, due to the lack of consensus over the concept and scope of Shari'ah compliance, and accordingly knowledge required for directors to manage Islamic financial institution, it is not clear how can we consider them liable under negligence law for their non-Shari'ah compliant decisions.

Chapter Eight

The Role of Shari'ah Boards in Shari'ah Governance

8.1 Introduction

Corporate governance is about control mechanisms in a corporate to resolve conflict of interests between internal and external stakeholders. In this regard, Shari'ah governance as the second layer of governance is about how to assure stakeholders over Shari'ah compliant operation of an Islamic financial institution. This chapter questions how Shari'ah boards role in Shari'ah governance can result in good corporate governance. The first parts examines the Anglo-American concept of corporate governance. Next, it analyses the concept of governance according to the Shari'ah sources and definitions provided by International organizations. At the end it examines the impact of deficiencies in Shari'ah governance in terms of Shari'ah boards' role on corporate governance of an Islamic financial institution.

8.2 The Concept of Corporate Governance

The concept of corporate governance must be studied by reference to the definition of corporation. A corporation as a bundle of resources and relationships is actually an enterprise[984], which its purpose is to create long-term value.[985] In this regard, governance system of the corporation should be established according to requirements of value-creation. In other words, corporate resources should be transformed to create more value and accordingly the corporate governance should consider individuals and instruments by which this conversion process takes place better.[986]

In this regard, although corporate governance may get different definitions according to values of different users, it reflects a system of directorship and control under which all internal and external actors contribute to value creation.[987] The Cadbury Report defines corporate governance as 'the system by which companies are directed and controlled'.[988] Further definitions provided by various reports in other common law jurisdictions such as Australia and Canada imply the same understanding of the term. For instance, in Australia the Owen report on the collapse of HIH insurance Ltd says: 'corporate governance refers generally to the legal and organizational framework within which, and the principles and processes by which, corporations are governed. It refers in particular to the powers, accountability and regulations of those who participate in the direction and management. There are aspects of the corporate governance

[984] The word 'Enterprise' here refers to a business driven by initiative for a designated purpose or purposes.
[985] Huse (n 708).
[986] ibid.
[987] ibid.
[988] The London Stock Exchange, 'Report of the Committee on the Financial Aspects of Corporate Governance' (Gee 1992) para 2.5.

regime that have an impact on the relationship between shareholders and the company.'[989] Further, the Toronto Stock Exchange Committee on Corporate Governance in Canada provides this definition: 'Corporate governance means the process and structure used to direct and manage the business and affairs of the corporation with the objective of enhancing shareholder value, which includes insuring the financial viability of the business. The process and structure define the division of power and establish mechanisms for achieving accountability among shareholders, the board of directs and management. The direction and management of the business should take into account the impact on other stakeholder such as employees, customer, suppliers and communities.'[990]

To meet a corporate intended objectives, an effective governance system provides a framework for corporate according to rules and principles formed based on established social and legal norms. It provides mechanisms for accountability of actors.[991] In this regard, an effective corporate governance framework also is about interactions between multiple stakeholders in terms of definition and representation of their interests. Its emphasis is on the relationships and interactions between governance actors in the process of decision-making.[992] According to this interactive view, corporate governance is about the structure of rights and responsibilities in stakeholders' relationship and also about interactions between actors (mainly shareholders, directors and creditors) which shape the direction of the company in pursue of value-creation. In this regard, corporate governance reflects a systematic order. In other words,

[989] Background Paper 11 (HIH Royal Commission), *Directors' Duties and other Obligations under the Corporations Act* (Australia 2001) para 76.
[990] Toronto Stock Exchange Committee on Corporate Governance in Canada, 'Where Were the Directors?' (The Committee 1994) 7.
[991] Australia Securities Exchange, *Principles of Good Corporate Governance and Best Practices* (2nd edn, ASX 2007)
[992] Huse (n 708) 21-22.

corporate governance could be defined as 'the system of regulating and overseeing corporate conduct and of balancing the interests of all internal stakeholders and other parties (external stakeholders, governments and local communities) who can be affected by the corporation's conduct, in order to ensure responsible behaviour by corporations and to achieve the maximum level of efficiency and profitability for a corporation.'[993]

An effective corporate governance requires not only value-creation, also fair value distribution between actors. This implies the importance of independence of directors and prevention of conflict of interests in their decisions. Accordingly, 'the purpose of the corporate governance is to facilitate cooperation- in addition to resolving conflicts between stakeholders and monitoring control. A more important purpose may be solving the problems of coordination and engaging in the collective processes of search and discovery.'[994]

As mentioned before, the definition of corporate governance has changed according to different users and contexts. However, the separation of ownership and control resulted from changes in corporations' legal structure, from partnership to limited liability in the nineteenth century sparked debates over proper theoretical framework for corporate governance. Further, changes on the perception over the nature of company influenced the formation of various corporate governance theories.[995] At first, the maximization of shareholders' value was the main theory under which shareholders are the owners of the company since they are the most important providers of capital. This theory for a long time has been the fundamental norm in most jurisdiction particularly in the US corporate law. This approach was first confirmed in 1919

[993] Jean Jacques du Plessis, Anil Hargovan and Mirko Bagaric, *principles of contemporary corporate governance* (2nd edn, CUP 2011) 10.
[994] Huse (n 708) 23.
[995] Jean Jacques du Plessis (n 993) 6.

in the case *Dodge v. Ford Motor Co.*[996] and reconfirmed in *Katz v Oak Industries.*[997] Accordingly, directors are seen as agents for shareholders since they are principals and their primary duty is to protect shareholders from managers' opportunism.[998] The shareholders' maximization value theory mainly is focused on the internal actors' roles and duties with regard to shareholders interests. In other word, this theory reflects a unitary perspective[999] on corporate governance under which increase in short-term interests is regarded an important indicator of the company susses.

However, as the result of the influence of ethics in corporate law and finance this approach gradually changed. The new approach considers interests of other stakeholders and interprets value-creation and value-distribution in a broader sense than maximization of shareholders' value. The role of stakeholders' interests in good corporate governance and success of companies has been confirmed by various laws and codes. For instance, according to the OECD Principles of Corporate Governance: 'the corporate governance framework should recognise the rights of stakeholders established by law or through mutual agreements and encourage active co-operation between corporations and stakeholders in creating wealth, jobs, and the sustainability of financially sound enterprises.'[1000]

In the Europe, The EU Green Paper presented the importance of stakeholders' interests In terms of corporate social responsibility as companies integrate social concerns in their business

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[996] *Dodge v. Ford Motor Co.*, 170 N.W. 668, 684 (Mich. 1919): 'A business corporation is organized and carried on primarily for the profit of the stockholders. The powers of the directors are to be employed for that end. The discretion of directors is to be exercised in the choice of means to attain that end, and does not extend to a change in the end itself, to the reduction of profits, or to the non-distribution of profits among stockholders in order to devote them to other purposes.'

[997] *Katz v Oak Indus.*, Inc., 508 A.2d 873, 879 (Del. Ch. 1986).

[998] Huse (n 708).

[999] ibid 23.

[1000] The OECD (n 662) 16-17.

operation and interaction with their stakeholders.[1001] In this regard, the European Commission states: 'The growing perception among enterprises that sustainable business success and shareholder value cannot be achieved solely through maximising short-term profits, but instead through market-oriented yet responsible behaviour.'[1002] Further, the Commission acclaimed the importance of effective and appropriate protection of stakeholders' interests by recognizing inclusive approach in the area of company law:[1003] 'a sound framework for protection of members and third parties, which properly achieves a high-degree of confidence in business relationships, is a fundamental condition for business efficiency and competitiveness. In particular, an effective regime for the protection of shareholders and their rights, protecting the savings and pensions of millions of people and strengthening the foundations of capital markets for the long term in a context of diversified shareholding within the EU, is essential if companies are to raise capital at the lowest cost.'

In the UK, as discussed before, the concept of 'enlightened shareholder' reflects an integrative (although implicitly) approach towards corporate law and corporate governance. In Davies words: "…the statutory formulation clearly rejects the 'pluralistic' approach to the law of directors' duties….however, the rule of shareholder primacy was not intended by the Government to be adopted in an unsophisticated way. Instead, the degree of overlap between the interests of the members and those of other stakeholders is emphasised through the directors'

[1001] Jean Jacques du Plessis (n 993) 41.
[1002] Commission of the European Communities, *The Commission Communication Concerning Corporate Social Responsibility: A Business Contribution to Sustainable Development* (2nd edn 2002) 5.
[1003] Communication from the Commission to the Council and the European Parliament, *Modernising Company Law and Enhancing Corporate Governance in the European Union: A Plan to Move Forward* (COM/2003/0284 final).

duty to 'have regard' to the interests of other stakeholders …..[giving rise to] adopting a modernised version of shareholder primacy…."[1004]

8.2.1 Stakeholders' Interests and Good Corporate Governance

The term 'stakeholder' does not bear a clear definition. Various theories in corporate governance define 'stakeholder' and its scope according to their priorities and views towards the interests of corporate, shareholders and society. From an economic point of view, the perception over the role of internal and external corporate players in economic value making defines the concept of stakeholder. In this regard, Mallin provides this definition: 'the term 'stakeholder' can encompass a wide range of interests: it refers to any individual or group on which the activities of the company have an impact.'[1005] However, a comprehensive definition encompasses the influence of external groups and individuals on corporate activities too. In this regard, since stakeholders may contribute to wealth creation for corporate and also may be affected by corporate activities, they "have a stake in the operation of the firm, in the same sense that business parents have a common stake in their venture or players on a team a common stake in the outcome of a game. Stakeholders share a common risk, a possibly of gaining benefits or experiencing losses or harms, as a result of corporate operation."[1006] This definition is more compatible with practice of providers' of financial services as their external and internal governance may have broad impacts on financial markets. In other words, in its broadest sense

[1004] Paul L. Davies, *Gower and Davies' Principles of Modern Company Law* (8thedn, Sweet & Maxwell 2008) 507-8.
[1005] Christine Mallin, *Corporate Governance* (2ndedn, OUP 2007) 49.
[1006] James E. Post, Lee E. Preston and Sybille Sachs, *Redefining the Corporation: Stakeholder Management and Organizational Wealth* (Stanford University Press 2002) 22.

the term ‘stakeholder’ includes not only the internal groups and individuals (such as employees and shareholders), but external ones who affect or may be affected by the governance of corporate.[1007]

There has been many discussions over the relationship between stakeholders’ interests and good governance. From an integrated point of view, good corporate governance is the result of efficient decisions taken by directors not only on the bottom line also society as a whole since it ensures effectively a company long-term interests and accordingly its sustainable growth.[1008] The integrated view requires all governance bodies such as audit, control and compliance follow the corporate strategy as it is according to the corporate broad view to the concept and techniques of value-creation. In this regard, Value-creation in a stakeholder corporate governance model implies the importance of all risk takers’ interests in their relations (directly or indirectly) with the corporation not only for negative impacts of directors and other governance bodies’ decisions, also for distributive impacts. In other words, value is not an independent concept, but a concept made from cooperation between various social, economic, ethical and political factors.[1009] As a result, “the question of value creation is therefore tangled up with that of the distribution or appropriation value.”[1010] In this regard, from a broad approach, since value bears social or ethical purposes, its essence reflects economic and non-economic characteristics. For instance, intrinsic values such as equality, distributive justice and virtue are the results of internal strategies and decisions with regard to economic activities of a corporate.

[1007] Jean Jacques du Plessis (n 993) 24.
[1008] ibid 53.
[1009] Antonio Argandona, ‘Stakeholder Theory and Value Creation’ (2011) IESE Business School-University of Navarra working paper WP-922, 4 < http://ssrn.com/abstract=1947317> accessed 25 November 2014.
[1010] ibid 3.

In fact, the importance of stakeholders' contribution to wealth-creation reflects the significance of the existence of an efficient stakeholder management in a good corporate governance system. in Preston and Sachs words: "although the ultimate justification for the existence of the corporation is its ability to create wealth, the legitimacy of the contemporary corporation as an institution within society-its social charter, or 'licence to operate'-depends on its ability to meet the expectations of an increasingly numerous and diverse array of constituents. The modern, large, professionally managed corporation is expected to create wealth for its constituents in a responsible manner (that is, not by theft or deception). The connection between wealth and responsibility has been stressed by both business leaders and critics for more than a century, and if the corporation can continue to survive and succeed today it must continue to adapt to social change." [1011] In this regard, effective stakeholder management constitutes intangible and social resources which enhance corporate competitive ability in terms of long-term value creation.[1012]

The effective management of stakeholders' interests enhances cooperation between stakeholders since the value of their relationships determines the success of the company. In this regard, the long-term value creation requires cooperation in internal structure of governance by which all direct (such as director and managers) and indirect (such as advisors) governance bodies cooperate for the objectives of the company.

In the context of Islamic finance, the role of Shari'ah boards must be interpreted in relation to other governance bodies in terms of corporate long-term economic and social value-creation

[1011] Post (n 1006) 9.
[1012] Amy J. Hillma and Gerald D. Keid, 'Shareholder Value, Stakeholder Management, and Social Issues: What's the Bottom Line?' (2001) 22 (2) Strategic Management Journal 125-139, 127 http://faculty.wwu.edu/dunnc3/rprnts.shareholdervaluesocialissues.pdf > accessed 25 May 2015.

goals. In this regard, there should be an effective and systematic relationships between Shari'ah board, board of directors, auditors and other governance bodies in terms of knowledge and time. This systematic cooperation between Shari'ah boards and other governance bodies enhances stakeholder management. Further, presentation and prescription a proper model for all Islamic financial institutions is unlikely as the Shari'ah and Shari'ah governance bear different meanings in different Islamic financial institutions. In this context, a good corporate governance requires a cooperative relationships, conceptually and instrumentally, between governance bodies and Shari'ah board. In this regard, external governance factors such as regulation, laws and macro strategies defined by government may be regarded as guidance for an efficient cooperative relationship between Shari'ah board and other internal governance bodies. However, in conventional financial systems without any formal regulatory direction with regard to Shari'ah governance, this may result in unpredictability.

In this regard, an instrumental perception over stakeholders' interest influences the governance bodies' duties and consequently Shari'ah governance in Islamic financial institutions too. From an economic sense the ultimate goal of an instrumental view is wealth maximization for main stakeholders (such as shareholders, employees and creditors). It justifies stakeholders' interests not on the basis of intrinsic values, but on the ground that effective stakeholder management as a means improves efficiency, profitability, competition and economic success.[1013] Further, Legitimacy of corporation and stakeholders' interests are based on economic interests (mainly shareholders') since 'individuals well endowed with economic and social capabilities will be more productive; companies which draw on the experience of all of

[1013] Steve Letza, Xiuping Sun and James Kirkbride, 'Shareholding Versus Stakeholding: a Critical Review of Corporate Governance' (2004) 12 (3) Corporate Governance: an International Review

their stakeholders will be more efficient; while social cohesion within a nation is increasingly seen as a requirement for international competiveness.'[1014] As a consequence, a good corporate governance system in an instrumental view assigns control rights and responsibilities to stakeholders that contribute specialised input.[1015]

In the context of Islamic finance, an instrumental point of view over good corporate governance shares similar characteristics with Islamic law in the sense that both defend private ownership and property rights, at the same time they do not solely concentrate on owners' rights since the legitimacy of ownership depends on non-owners interests too. For instance, in Islamic law '*La darara ve la dırar*' (there shall be no unfair loss nor the causing of such loss) principle prohibits any ownership and right which is harmful for others' interests and rights. In this regard, Shari'ah governance system including Shari'ah board, Shari'ah department and Shari'ah audit in an Islamic financial institution should have cooperative relation with other governance bodies such as directors and financial auditors since they bear responsibility for making strategic decisions and also are more in connection with different stakeholders in terms of their interests and rights. In this regard, Good governance in an instrumental point of view requires a network of connections between governance bodies in terms of knowledge and information to refurbish governance system with new requirements.

However, the core normative reason for having respect for stakeholder's interests in Islamic finance bears an ethical essence too. Generally, an ethical view in corporate governance is

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242-262, 251 < http://onlinelibrary.wiley.com/doi/10.1111/j.1467-8683.2004.00367.x/pdf > accessed 25 May 2015.

[1014] Gavin Kelly, Dominic Kelly and Andrew Gamble, 'Stakeholder Capitalism' In G. Kelly, D. Kelly and A. Gamble (eds) *Stakeholder Capitalism* (Macmillan 1997) 244.

[1015] Margaret M. Blair, (1995) *Ownership and Control: Rethinking Corporate Governance for the Twenty-first Century* (Brookings Institution 1995) 274.

consistent with two principles: principle of corporate rights under which the corporation may not violate the rights of others to determine its own future; principle of corporate effects under which the corporation are responsible for the effects of their actions on others.[1016] The gist of these principles, in terms of an ethical view over corporate governance, implies that property rights are not absolute and stakeholders have the right "to be treated, not as a means to some corporate end, but as an end in itself."[1017] However, the intrinsic value of stakeholder's interests and its relation to good corporate governance in the context of Shari'ah finance must be examined according to Shari'ah ethical principles interpreted by Shari'ah boards. In other words, a good corporate governance system must provide a governance plan to ensure protection and enforcement of stakeholders' interests in an ethical ground provided by Shari'ah board.

8.3 Governance in Islam

The Shari'ah texts do not reflect the existence of the term 'governance' in its modern sense. *Shari'ah* in its broad sense[1018] provides ethical, legal and spiritual essence for the concept of governance. In this regard, the concept of *tawhid* (full submission to God) is the backbone of all governance principles in Islam as it is the ultimate guidance to justice. *Tawhid* calls a person to be responsible to human beings and everything in the universe as all are created by the one God and has a purpose.[1019] In this regard, the Quran asks mankind to use reason to understand man's

[1016] William M. Evan and R. Edward Freeman, 'A Stakeholder Theory of the Modern Corporation: Kantian Capitalism' in Jeremy Moon, Marc Orlitzky and Glen Whelan (eds) *Corporate Governance and Business Ethics* (Edward Elgar 2010) 138.
[1017] ibid.
[1018] Shari'ah in a broad sense encompasses *fiqh* (human interpretation of Islam) and main *shari'ah* sources (the Quran and the Sunnah).
[1019] Abdullah Ahsan and Stephen B. Young (eds), *Guidance for Good Governance, Explorations in Qur'anic Scientific and Cross-Cultural Approaches* (International Islamic University Malaysia and Caux Round Table 2008) 8.

relationship with everything and accordingly to benefit humanity.[1020] The Quran regards mankind as one community (*ummah*) and askes human beings to overcome and resolve negative conflicts. In this regard, the Quran regards trust (*amanah*) and justice as the foundation of good governance since they provide framework for human reasoning in all aspects of life. The Quran defines good governance as a just and ethical order. The Quran declares: "Those when given authority in land, establish *salah*, give *zakat* and enjoin what is good (*ma'ruf*) and forbid what is wrong."[1021] Further: "O you who believe stand up as a witness for Allah in all fairness, and do not let the hatred of people deviate you from justice (*adl*). Be just, this is closest to piety."[1022] In this regard, trust and justice require accountability and transparency in a good governance system. As the Quran states: "..Lo the hearing and the sight and the heart –of each of these will be asked".[1023] Further, the Prophet (pbuh) said: "every one of you is a guardian and accountable for his charge. Thus the *amir* is a guardian of the people and he is accountable for them; and a man is a guardian of his household and he is accountable for them…..and a servant is guardian of his master's property, ever yone of you is accountable for his subject."[1024] In this regard, while trust and justice provide the ontological basis, the Shari'ah and *Shura* furnish the practical mechanism for good governance.[1025]

Participation among Muslims in every aspect of private or public affairs is recognized as a crucial principle. The Quran says: "….and consult with them in the conduct of affairs, and when

[1020] ibid; see the Quran 4:82; 23:68; 38:29; 47:24. There has been many debates on compatibility of reason and revelation in Islam. The Shari'ah main sources never have accepted a conflict between reason and revelation and any doubt about it is the result of an incorrect interpretation or lack of knowledge.
[1021] Hajj 22:41.
[1022] Al-Maiedah 5:8.
[1023] Bani Iraeil 17:36.
[1024] Bukari, al-jam' al-Sahih.
[1025] Al-Ahsan (n 1019) 10.

you have resolved then put your trust in Allah."[1026] And "… those who have responded to their lord and established prayer and whose affair is [determined by] consultation among themselves, and from what we have provided them, they spend." [1027] *Shura* is an Arabic word for consultation. *Shura* in a good governance system is based on the opinions of competent and capable people who are knowledgeable in their field. *Shura* is deemed as a mechanism to restore trust in society as the Quran says: "Lo Allah Commands you that you restore trust to those who are capable and if you judge between mankind, that you judge justly."[1028]

The ethical rules in the Shari'ah over governance, although not backed by enforcement mechanisms in a conventional system, imply a stakeholder approach in understanding of good corporate governance. In this regard, since human being's interest (material and spiritual) is considered as part of a corporate interest, it must regard interest of society as a whole in its operation in pursuant of defined objectives. This reflects the importance of social considerations in good corporate governance in Islam. However, Islamic fiqh in its traditional sense and Islamic finance in its modern sense have not provided specific mechanisms for an effective and efficient governance. In other words, spiritual concept of governance solely cannot guarantee its effectiveness and as a consequence it must be supported by conventional governance system mechanisms.

8.4 The Concept of Shari'ah Governance

Shari'ah compliance is the ultimate goal of Islamic finance industry. As a result, the success of Islamic financial institution depends on a proper Shari'ah governance framework able to

[1026] Al-Imran 3:159.
[1027] Al-Shura 42:38.

assure stakeholders over Shari'ah compliant operation and structure of Islamic finance products. The term 'Shari'ah governance' generally is about the alignment of corporate governance to Shari'ah principles[1029]. In other word, Shari'ah governance is about structures and processes adopted by stakeholders to ensure the compliance of the company with Shari'ah rules and principles.[1030] The IFSB regards Shari'ah governance a system comprised of "the set of institutional and organizational arrangements through which an IIFS ensures that there is effective independent oversight of Shari'ah compliance over each of the following structures and processes…."[1031] In other words, the concept of Shari'ah governance is connected to the concept of risk management in corporate governance as it is about 'putting in place systems that are capable of demonstrating that general and specific risks to an enterprise are identified and addressed in a manner that is acceptable in terms of the law, current business morality and good sense.'[1032]

As discussed before, Shari'ah compliance is the distinct feature of Islamic finance and accordingly the aim of Shari'ah governance in every Islamic financial institution is to provide investors with the ultimate assurance over Shari'ah compliance by setting required rules and system. This fiduciary responsibility of Islamic financial institutions to their customers requires a balanced approach in the creation of value for the shareholders while paying attention to the interests of stakeholders.[1033] In other words, having an efficient and effective Shari'ah risk

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[1028] Al-Nesa 4:58.
[1029] Imran Hussein Minhas, 'Shari'ah Governance Model (SGM) and Its Four Basic Pillars' (2012) Islamic Finance News Malaysia Published by Red Money Publication, 1 <SSRN: http://ssrn.com/abstract=2153106> accessed 12 May 2015.
[1030] IFSB (n 278) 1.
[1031] ibid 2.
[1032] Barry Rider, 'Corporate Governance for Institutions Offering Islamic Financial Services' (n 559) 5.21.
[1033] IFSB, Guiding Principles (n 815) 2.

management is an essential part of the concept of Shari'ah governance. In this regard, Shari'ah compliance is the result of a good Shari'ah governance procedure. As Professor Rider states: "there is little, at least in traditional systems of governance, whether characterised as 'good governance' or not, that actually prescribes a 'good result'. The beneficial situation, which it is desired to achieve, is to be attained through adherence to demonstrable procedures…..in other words, the analysis is transferred from the end to the means, with the hope that a certain means will result in a 'good' end."[1034]

It is discussed that Shari'ah governance is comprised of various parts that their characteristics depend on Islamic financial institution's type of business and governance structure. According to Engku Rabiah Adawiah, there are seven parts for Shari'ah compliance governance: 1- Inception and Conceptualization of Islamic Instrument; 2-Structuring the Product according to Shariah; 3-Legal Documentation; 4-Execution and Implementation of Islamic Instrument; 5- Audit and Review; 6- Restructuring (if needed); 7-Recovery mechanisms and dispute resolution.[1035] However, since internal governance system of each financial institution may be different from other financial institutions, the IFSB recommends more general framework for Shari'ah governance system as covers these structures and processes: a) issuance of relevant Shari'ah pronouncements; b) dissemination of Shari'ah pronouncements by monitoring Shari'ah bodies (internal Shari'ah compliance unite or Shari'ah compliance officer); c) an internal Shari'ah

[1034] ibid.
[1035] E. R. Adawiah, 'Shariah Framework for Shariah Compliance Review, Audit &Governance' (Paper presented in Workshop on Shariah Review, Audit and Governance for Islamic Financial Institutions, Kuala Lumpur, July 2007) in Shafii (n 646) 3–16.

compliance review/audit for verifying that Shari'ah compliance has been satisfies; d) Shari'ah compliance review.[1036]

Shari'ah governance system complements the existing corporate governance. Therefore, its structure like corporate governance system depends on the laws of the jurisdiction in which the Islamic financial institution operates and the type of its business. In this regard, there is no single model for a good Shari'ah governance model as the characteristics of markets in terms of law, economy and development vary from one jurisdiction to another.[1037]

An effective Shari'ah governance system requires the participation of stakeholders as their monitoring role benefits robustness and stability of the company. Further, stakeholders' contribution results in an efficient corporate governance too as it enhances value-creation through supporting the reputation of Islamic financial institution. However, this comprehensive understanding of Shari'ah governance necessitates the implementation of an informative or educative plan for stakeholders over the fundamentals of Shari'ah finance products and operations. In this regard, to have a transparent and effective monitoring system, it is necessary to provide stakeholders with 'proper information' and education. However, what constitutes 'proper information' depends on the opinion of board of directors as they are responsible for the management of the company and it is likely they influence on the content and issuance of Shari'ah board's or Shari'ah department reports.

[1036] IFSB (n 278) 2-4.

[1037] ibid; the universal wisdom of "the no single model and no single cure" is an international recognized principle of corporate governance. International organizations such as OECD confirms the importance of this principle in good corporate governance by stressing the necessity of consideration of relevant economic, legal and financial characteristics of each country in applying its principles. OECD (n 662) 29.

8.4.1 The Role of Shari'ah Boards in Shari'ah Governance

The term 'Shari'ah board' implies a kind of expertise which requires special training or knowledge on Islamic financial industry. In other words, membership in a Shari'ah board should be considered in a broad sense as it requires knowledge in *fiqh al muamalat* and Islamic finance. In this regard, Shari'ah board's members engage professionally in the process of Shari'ah compliance and complements the existing compliance system.[1038]

In this regard, the responsibilities of Shari'ah board members may vary from one institution to another since there is no agreement over their obligations.[1039] However, they are generally regarded responsible for advising and monitoring the process of Shari'ah compliance. In this regard, their role resembles the governance role of board of directors. As a result, Shari'ah compliance and governance shares similar features required for a proper governance system.

According to IFSB principles, the first role of Shari'ah boards in Shari'ah governance system is the issuance of juristic opinion (Shari'ah pronouncements), ex ante and ex post, over any matter pertaining to Shari'ah issues.[1040] In this regard, it is supposed that the Shari'ah pronouncement is the result of a due process. The Principles of due process such as transparency are enhanced more in jurisdictions with central regulatory system or proper self-regulatory mechanisms in jurisdictions without central regulation. The requirements of 'due process' in this context depends on the governance system and the business type. However, the high moral content of Shari'ah obligations and the highly regarded position of Shari'ah board members led to ambiguity over the concept of due process with regard to Shari'ah pronouncement.

[1038] IFSB (n 278) 4.

Further, Shari'ah pronouncement by Shari'ah boards' members resembles the strategic role of board of directors as both bodies have discretionary power over the structural and operational aspects of corporate governance. In this regard, the enforcement of Shari'ah in corporate governance is the matter of contract law or fraud since the Islamic character of financial services in conventional jurisdictions such as UK is an additional dimension.[1041] In other words, the concept of 'due process' in the context of Shari'ah finance must be interpreted according to the established conventional principles. In this context, due to the technical complexity of ijtihad in Islamic *fiqh*, it is important to consider a Shari'ah-based aspect for the concept of due process.[1042] However, the Lack of a clear concept for due process in Shari'ah pronouncement may lead to legal risk as stakeholders can question the legality of pronouncements. This issue requires a balance between conventional and Islamic perceptions on the concept of due process of governance.

The other role of Shari'ah board members in Shari'ah governance can be explained in terms of compliance and control. Compliance and control are essential aspects of governance as they manage different risks and prevent undue losses. According to IFSB principles Shari'ah boards have a key role in the functions of internal Shari'ah compliance and audit units. In this regard, Shari'ah board's pronouncements and resolutions are the criteria for the function of Shari'ah audit units in terms of reviewing the operation of Islamic financial institution. Further, the internal Shari'ah audit unite reports directly to Shari'ah board over Shari'ah issues in the

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[1039] As Professor Rider says: "to some extent this a result of the high respect accorded to such persons and their own obligation to observe the strictures of Shari'ah." see, Barry Rider (n 559) 172.
[1040] IFSB (n 278).
[1041] Rider (n 559).
[1042] As explained in chapter four, Shari'ah jurists have had a strong authority in the interpretation of Shari'ah sources and establishing technical procedure for their ijtihad. Further, since *ifta* has been

management and operation of Islamic financial institution. Accordingly, Shari'ah boards are also responsible for the annual Shari'ah review since they contribute to the process of reviewing of feedbacks and reports received from internal Shari'ah audit unit over the Shari'ah compliance operation of the Institution.

8.5 Issues in Shari'ah Governance

Governance is about the accomplishment of goals of a company by the use of cost effective tactics and strategies according to law and moral principles. A good corporate governance system establishes mechanisms to safeguard the process of governance to promote the efficient use of scarce resources to the benefit of society as a whole.[1043] In this regard, a comprehensive approach considers the principles of corporate governance required for the prevention or solving of the governance failures according to the feature of the corporate. In other words, the principles of corporate governance enhance risk management and accordingly wealth-creation. Further to the risk management and value-creation aspects of good corporate governance is corruption. In this regard, the implementation of principles of good corporate governance weaken facilitative routes for corruptive behaviours in the corporate.

Good corporate governance as a tripartite framework in terms of fiduciary duties of care, loyalty and good faith[1044] reinforces the values of rule of law, transparency and fairness and as a

considered as an individual and personal relationship between a questioner and *mufti*, no could ask about the quality of the process of ijtihad.

[1043] Stijn Claessens, 'Corporate Governance and Development', (2003) 10 Global Corporate Governance Forum, Focus The World Bank.

[1044] *Cede & Co v Technicolor*, Inc 634 A. 2d 345, 361 (Del. 1993).

consequence targets the supply and demand sides of corruption.[1045] In this regard, good corporate governance can be understood as public good since it benefits society as a whole in terms of stability and wealth-creation. In the Anglo-American perception of good corporate governance, public good is translated in terms of agency theory. The aim of agency cost management as the dominant theory in corporate law is to minimise the agency costs resulted from the misuse of power by managers and other agents. Regarding its roots in financial economics, it typically takes the maximization of shareholders' value as the primary standard for assessing the corporate performance.[1046] It addresses public good in terms of the control of opportunities and information asymmetry. However, a good corporate governance system also considers 'trust' and 'trust-making' in its principles with regard to agency relationships. In fact a comprehensive perception of good corporate governance includes stewardship as the core meaning. Stewardship implies an ethical characteristic which enhances governance procedure resulted by applying good motives and good rules.[1047]

In the context of Islamic finance, it is supposed that Shari'ah boards serve as agents of stakeholders and accordingly are responsible for the prevention and control of directors' misconducts in terms of the operation of Islamic financial institution. In this regard, despite of this belief that the adherence to Shari'ah would led to good and responsible governance as there is a strong ethical obligation of stewardship on Muslims[1048], the actual governance procedure in Islamic financial institutions is established according to conventional perspective and principles.

[1045] Aleksander Shkolnikov (ed), 'Corporate Governance: An Antidote to Corruption' (Centre for International Private Enterprise 2002) 3.
[1046] Huse (n 708) 45.
[1047] As Professor Rider states: " The application of certain obligations to those who assume or are taken to have assumed the responsibilities of a steward has provided, at least a conceptual, basis for much of the current law in common law jurisdictions for the duties imposed on directors and those who formally look after other peoples' wealth." Rider (n 559) 148.

In this regard, the principles of good corporate governance are formed in a long term to prevent and control governance failures resulted from agents' misbehaviours. This issue is more important in Islamic finance as agency problems are more likely due to types and structure of assets. Further, regulatory gaps resulted from the lack of a comprehensive perception over the concept and principles of Shari'ah reflects the importance of conventional principles as the accepted requirements for the assurance over the good governance procedure. In this regard, also IFSB guidelines stress over the importance of application of international corporate governance standards in cultivating a good governance culture.[1049]

8.5.1 Transparency

Transparency is an essential element for a good corporate governance system as it provides the proper basis for shareholders, stakeholders and potential investors decision-making in relation to capital allocation, corporate transactions and the monitoring of financial performance.[1050] According to the OECD principles of corporate governance, a strong disclosure regime promotes transparency and accordingly plays a crucial role in enabling shareholders to exercise their ownership rights on an informed basis.[1051] Further, it enables board of directors to evaluate the operation of the company and to take early corrective actions when necessary. Transparency literally means: easily seen through, recognized, understood or detected.[1052] It empowers stakeholders by providing efficient free markets and supporting the circulation of information. Transparency in the context of modern corporate governance leads to capability and

[1048] ibid.
[1049] IFSB (n 278) and IFSB (n 815).
[1050] Benjamin Fung, 'The Demand and Need for Transparency and Disclosure in Corporate Governance' (2014) 2 (2) Universal Journal of Management 72-80.
[1051] OECD (n 662) Pr. V.

clarity when it encompasses a more comprehensive and proactive disclosure rather than the release of corporate governance details in a reactive fashion.[1053]

Transparency is the basis for trust-making in financial markets. In this regard, an effective transparency system is the result of the culture of transparency under which essential information flow freely.[1054] In this regard, Board of directors bears the responsibility to cultivate the culture of transparency by establishing policies and monitoring mechanisms which decisively facilitate the establishment of transparency culture.[1055]

Transparency has been addressed in different perspectives. Some such as the revision of the Basel II framework by the Basel Committee on Banking Supervision[1056] and the report of the Financial Stability Board on Enhancing Market and Institutional Resilience[1057] focus on the micro-level by emphasising its role in restoring confidence. Others pursue a broader approach as they consider transparency in terms of ethical behaviour.[1058] For instance the IFSB states: 'the need for transparency is, above all, an important Shari'ah consideration. Any form of concealment, fraud or attempt at misrepresentation violates the principles of justice and fairness in Shari'ah as mentioned in the Quran in, among others, Surah An-Nisa' Verse 135 and Surah Al-Mutaffifin 1 to 3.'[1059]

[1052] Oxford English Dictionary (OUP 2010).
[1053] Fung (n 1050) 72.
[1054] ibid 75.
[1055] ibid.
[1056] Bank for International Settlements, 'International Convergence of Capital Measurement and Capital Standards: A Revised Framework (integrated version)' (Basel Committee on Banking Supervision (BCBS) June 2004)
[1057] Financial Stability Forum, 'Enhancing Market and Institutional Resilience' (April 2008).
[1058] Christine Kaufmann and Rolf H. Weber, 'The Role of Transparency in Financial Regulation' (2010) 133 (3) Journal of International Economic Law 779.
[1059] IFSB, 'Disclosures to Promote Transparency and Market Discipline for Institutions Offering Islamic Financial Services' (December 2007) para 2.

In the context of Islamic finance, due to the existence of Shari'ah board as the second layer of governance, transparency bears more complex function since it must be considered in the context of Shari'ah boards' duties. However, the basic and the most important dimension of transparency is its institutional aspect which is mainly focused on procedure and decision-making. In this regard, the first issue is the opacity in the process of Shari'ah pronouncement. There is no clear and universally accepted framework for 'due process' in Shari'ah ruling. This issue exposes the industry to uncertainty. From a macro-level point of view, it 'effectively places the industry hostage to the change of attitude by scholars who have gained prominence through their years of serving the industry.'[1060] From a micro-level point of view, the lack of a clear concept for Shari'ah pronouncement leads to uncertainty since Shari'ah boards can change their views unexpectedly without a clear process. As a consequence of this uncertainty financial institutions are more exposed to legal risk and loss. Further, it may pose questions over the possibility of negative influences on Shari'ah boards to pronounce the favourable rulings. Consequently, it leads to unethical behaviour of Shari'ah boards, and also supports fatwa shopping in the industry. In this regard, due to the lack of a professional perception over fatwa pronouncement, it is possible to choose individuals as Shari'ah board's members who charge less and provide more convenient fatwas for the financial institution. This issue is more severe in jurisdictions such as UK where there is no central Shari'ah board and accordingly there is no regulatory provision to monitor Shari'ah governance. In this regard, Board of directors are required to take a cooperative approach with Shari'ah boards in establishing an effective and fair Shari'ah pronouncement.

[1060] Sayd Farook and Mohammad Omar Farooq, 'Shariah Governance, Expertise and Profession: Educational Challenges in Islamic Finance' (2013) 5 (1) ISRA International Journal of Islamic Finance 137, 151. < http://ssrn.com/abstract=1813483> accessed 12 May 2015.

Opacity in Shari'ah reviewing is another institutional aspect of transparency in Islamic finance. In this regard, although International standard setting organizations such as the AAOIFI tries to set standards for the process of Shari'ah reviewing, due to diversity in the governance structure, regulation and types of business there is no single accepted model for Shari'ah review. Further, in practice most of Islamic financial institutions do not disclose the process of Shari'ah review.[1061]In this context as AAOIF[1062] recommends, there should be a professional planning in Shari'ah review under which the planning review procedures, executing review procedures, preparation and the review of working paper as well as procedures in documenting conclusions and preparation of the Shariah review report are considered.[1063] In other words, there should be a detailed exchange of information between internal bodies such as directors, internal auditors and shareholders and external governance players such as creditors and other investors. Further, an effective Shari'ah review by Shari'ah boards requires a clear mandate supported by enforcement and accountability mechanisms.

8.5.2 Accountability

Accountability is about mutual relationship in a certain ground restricted by some established rules which require answerability to a formal forum. There have been various literal definitions for accountability with the emphasis on responsibility. For instance, Oxford dictionary defines 'accountable' as 'liable to be called to answer for responsibilities and conduct; able to be

[1061] Grais and Pellegrini (n 688) 9.
[1062] See AAOIFI GSIFI No 2.
[1063] Mohd Hairul Azrin Haji Besar and others, 'The Practice of Shariah Review as Undertaken by Islamic Banking Sector in Malaysia' (2009) 5 (1) International Review of Business Research Papers 294-306, 297 < http://bizresearchpapers.com/attachments_2009_01_13/24.shukr.pdf> accessed 12 May 2015.

reckoned or explained.' And according to Black's law dictionary accountability refers to 'the state of being responsible or answerable.'[1064]

Accountability reflects a corrective nature in relation to opportunistic and self-interested behaviours resulted from agency relationships in a corporate. In this regard, The OECD principles of corporate governance highlights the protection of shareholders' rights and stakeholders' interests by establishing an effective governance framework through transparency, effective supervision and enforcement.[1065] This perception over the effective corporate governance framework reflects the importance of accountability not only as a corrective means also as a process. In this regard, accountability reflects an ethical nature under which decision makers in any organization are responsible to justify their belief and actions to others based on established norms. In other words, accountability is the social norm of governance in injunctive sense since it prescribes certain legitimate modes of wielding power according to what most approves or disapproves.[1066]

The corrective nature of accountability is based on an individualized process[1067] which, corporate authorities play their roles in a disciplinary manner. In this regard, the 'individualized process' in the definition of accountability is formed according to the type of business and disciplinary rules such as accounting and financial rules. In this context, there is a constant relationship between the enhancement of disciplinary rules, transparency and accountability.

[1064] Mel Dubnick, 'Clarifying Accountability' in Noel Preston and Charles Sampford (eds) *Public Sector Ethics: Finding and Implementing Values* (Federation Press 1998) 69-70.
[1065] OECD (n 662).
[1066] Amir N. Licht, 'Accountability and Corporate Governance' (2002) Interdisciplinary Center (IDC) Herzliyah - Radzyner School of Law; European Corporate Governance Institute (ECGI), 15-16 < http://ssrn.com/abstract=328401> accessed May 2015.
[1067] John Roberts, 'Trust and Control in Anglo-American Systems of Corporate Governance: The Individualizing and Socializing Effects of Processes of Accountability' (2001) 54 (12) Human Relations

More transparent governance system results in efficient changes in disciplinary rules and accordingly more visible corporate governance [1068] as disciplinary rules through constant surveillance provide accountability and corrective mechanisms based on the established perceptions over the business of corporate.

In the context of Islamic finance, there is no established individualized process since there is no established disciplinary rules to correct Shari'ah boards' misconducts. This issue in the context of UK law is grounded in the fact that the concept of duty of loyalty of corporate agents is established according to conventional precepts. In this regard, there is a mutual relationship between rules of professional conduct and clear mandates since an effective accountability system in corporate governance requires clear definition for responsibility of bodies assumed in charge of governance. As a consequence of clear mandate, law will provide effective accountability mechanisms and remedies. In Islamic law, although it is emphasised that Shari'ah requires personal integrity, fair dealing and imposes very similar obligations on persons with the position of trust, there is no rigorous concept of fiduciary accountability such as in common law.[1069] For instance, in *Regal (Hastings) Ltd v. Gulliver*[1070] Lord Russell of Killowen sates: 'The rule of equity which insists on those, who by the use of a fiduciary position make a profit, being liable to account for that profit, in no way depends on fraud, or absence of bona fides; or upon such questions or considerations as whether the profit would or should otherwise have gone to the plaintiff, or whether the profiteer was under a duty to obtain the source of the profit for the plaintiff, or whether he took a risk or acted as he did for the benefit of the plaintiff, or whether

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1547 <http://citeseerx.ist.psu.edu/viewdoc/download?doi=10.1.1.196.9158&rep=rep1&type=pdf> accessed 15 May 2015.

[1068] ibid.

[1069] Rider (n 559) 149.

[1070] [1942] 1 All ER 378.

the plaintiff has in fact been damaged or benefited by his action. The liability arises from the mere fact of the profit having, in the stated circumstances, been made. The profiteer, however, honest and well intentioned, cannot escape the risk of being called to account'.

8.6 Corporate Ethics

The ultimate aim of law is to coordinate human behaviour through coercive measures. Also, it shapes human conduct through clear and certain legal norms.[1071] Contrary to law, morality presents less prescriptive concepts and there is no official and systematic sanction for the breach of moral rules.[1072] Despite the contrast, moral norms or in a narrow sense ethics are the foundation of legal rules and the basis for the reform of law.[1073] The core concern of morality is about how to resolve the actual or potential conflict of interest between parties.[1074] In this regard, although business is a self-contained activity and governed by clear standards, moral and ethical norms also govern relations between private individuals and resolve their conflict of interests.[1075]

Corporate ethics here refers to the company behaviour towards its stakeholders and aims to enhance the operation of principles related to integrity, respect and transparency of a company.[1076] In this context, corporate ethics has had various trends. Within the last fifty years the major concerns were price-fixing, environmental and social destructive activities, bribery, insider trading and the moral capacity of individuals. However, despite of various trends the essence of corporate ethics is to support corporate governance in providing a proper level of

[1071] Jean Jacques du Plessis (n 993) 419.
[1072] ibid.
[1073] ibid 420.
[1074] ibid.
[1075] ibid.
[1076] Erik Banks (n 660) 319.

internal control.[1077] Further, its primary goal is to protect and reinforce a company reputation as that is an essential factor for the success of a company. Particularly In financial services in which investors possess no physical assets and rely only on the reputation of the financial intermediary, the role of ethics in good corporate governance is more crucial. Therefore, there is a mutual relationship between the corporate ethics and culture as corporate ethics forms the tone and character of the company, and accordingly the corporate culture enhances corporate ethics.[1078] In other words, an effective corporate ethics must be actually based on corporate culture and develops through repeated activity.[1079] Ethical culture is the result of the ongoing reinforcement of ethical standards by corporate directors. In this regard, board of directors is responsible for the establishment of an ethical framework which defines ethical norms, monitoring and accountability mechanisms.

Islamic finance is known as an ethical industry and Shari'ah boards are considered as Shari'ah compliance gate keepers. In this regard, the responsibilities of Shari'ah boards concerning Shari'ah review has a deep influence on the formation of Islamic financial institutions' ethical culture as they present Shari'ah values and help directors in defining ethical norms. Further, Shari'ah boards can help directors in developing a formal code of ethics as an important part in the institutionalization of ethical norms. A code of ethics reflects a company values and norms and is defined as a 'distinct and formal document containing a set of prescriptions developed by and for a company to guide present and future behaviour on multiple issues for at least its managers and employees toward each other, the company, external stakeholders, and /or society

[1077] ibid 318.
[1078] ibid.
[1079] ibid.

in general.'[1080] Further, it helps to preserve the reputation and legitimate operation of a company, and also prevents misconducts by promoting ethical rules in resolving conflict of interests.[1081] In this regard, Shari'ah boards can play a crucial role in the comprehension of stakeholders such as employees over the ethical values of the industry through providing more education and training on Islamic values and the operation of Shari'ah compliant products. Further, continuous training helps to promote the content and the application of code of ethics and accordingly prevents a culture of 'form over substance' in Islamic financial institution. In this context, the existence of an effective monitoring and reporting system is a crucial feature of an ethical culture as it enhances compliance through locating ethical problems or violations. In this regard, a cooperative mandate for the functions of Shari'ah board or sharia department with regard to monitoring ethical issues in Islamic financial institution improves corporate ethical culture, accordingly prevents misconducts and enhances reputation.

8.7 Conclusion

Corporate governance reflects a unified concept in corporate law. Corporate governance as a system is about establishing a proper control framework to manage and resolve conflict of interests between different stakeholders to meet value maximization as its ultimate goal. In the context of modern corporate law the concept of value demonstrates an inclusive essence based on economic and ethical perception over interests of various stakeholders' interests. In this regard, value-maximization encompasses interests of internal and external stakeholders in a

[1080] Muel Kaptein and MarkSchwartz, 'The Effectiveness of Business Codes: A Critical Examination of Existing Studies and the Development of an Integrated Research Model' (2008) 77 Journal of Business Ethics 11, 113.

long-time and accordingly directors' fiduciary duties must be interpreted in an inclusive sense as they are responsible for impacts of corporate activities on society as a whole.

Although, Islamic law does not reflect the exact term and concept for 'governance', Shari'ah texts provide a sound framework for governance in terms of principles of fairness and justice. Further, Islamic law shares similar view with conventional law on value-creation as they both respect private ownership and property rights and at the same time respect the interests of society as a whole. In other words, property rights in Islam and conventional law are not absolute. However, classical *fiqh* and the sources of Shari'ah principles do not provide practical mechanisms for the governance of in its modern sense. Though, the concept of good corporate governance in the context of Islamic finance should be considered according to conventional precepts and principles. In other words, to provide an effective framework for corporate governance, corporate activities and the impacts of their operation on stakeholders must be examined with regard to the principles of good corporate governance. In this regard, the main concern of good corporate governance is the prevention and control of risks. In the context of Islamic finance, despite common belief over the supportive role of Shari'ah boards in good corporate governance, the lack of transparency and accountability as the foundations of an efficient governance system have exposed the industry to various risks such as legal and operational. The Lack of transparency in the process of issuing fatwa and Shari'ah auditing raise many questions over the effectiveness of Shari'ah governance frameworks. Further, the failure of the industry to present accountability mechanisms for Shari'ah boards' misconducts facilitates unlawful activities by financial institutions and accordingly opens a gate for fraudulent conducts.

[1081] Luis Rodriguez-Dominguez, Isabel Gallego-Alvarez and Isabel Maria Garcia-Sanchez, 'Corporate Governance and Codes of Ethics' (2009) 90 Journal of Business Ethics 187, 188.

Chapter Nine

The Issue of Professionalism in the Regulation of Shari'ah Boards' Functions

9.1 Introduction

Professional knowledge is the basis of the operation of the modern financial markets. A profession as a vocation founded upon specialized education to serve others objectively, is the foundation of an efficient and effective regulatory system in terms of value-creation and accountability. This chapter examines the lack of professionalism in the functions of Shari'ah boards and its implications for their regulation. The first part reflects on the concept of 'regulation' and examines its varieties. The next part explains issues in the regulation of Shari'ah boards in terms of the integrity of Islamic finance industry. Finally, the last part examines the concept of 'profession' and its requirements in the context of Shari'ah boards' functions.

9.2 The Concept of Regulation

The concept of 'regulation' has been subject to many debates. In this regard, as Barak Orbach says: 'the evasive nature of the term 'regulation' is largely a product of confusion between two unrelated matters-the abstract concept of regulation and opinions about the desirable scope of

regulatory powers or desirable regulatory policies.'[1082] Generally, regulation is perceived as control or constraint since it implies the concepts of governance and directorship. It is considered as a means to an end since it facilitates the achievement of goals by adopting 'conducting rules' and putting mechanisms to enforce those rules.[1083] In this regard, Black's Law Dictionary defines regulation as 'the act or the process of controlling by rule or restriction.'[1084] However, the provided definitions reflect only a narrow concept. In other words, although restriction and control are the main aspects of regulation, but it carries facilitative and enabling function too.[1085]

The concept and function of regulation may be examined in an economic sense which is fundamentally influenced by different economic systems and legal forms. In this regard, the economic-oriented concept of regulation implies a 'sustained and focused control exercised by a public agency over activities that are valued by a community.'[1086] In this context, market systems emphasis on individuals' will and freedom in pursuing their goals. Further, the role of law is mainly facilitative as 'it offers a set of formalized arrangements with which individuals can clothe their welfare-seeking activities and relationships.'[1087] In other words, regulation in the market system supports cooperation between individuals through providing a legal framework and enforcement which secure the efficiency of contractual forms in terms of transaction

[1082] Barak Orbach, 'What Is Regulation?' (2012) 30 (1) Yale Journal on Regulation Online 1 http://ssrn.com/abstract=2143385 accessed 1Jun 2015.
[1083] The National Consumer Council, 'Models of Self-Regulation-An Overview of Models in Business and the Professions' (Oct. 1999) 1.
[1084] Black's Law Dictionary (9th ed. 2009) 1311.
[1085] Regulation in its restrictive and preventive sense is called 'red light' concept under which the primary function of regulation should be to control excesses of power and subject it to the rule of the law courts. On the other hand, 'green light' concept of regulation reflects a broader view under which regulation may be enabling or facilitative. Regulation in green light sense is seen as a vehicle to support administrative state in pursuing welfare of society. In other words, regulation is proactive in green light theory. See, Carole Harlow and Richard Rawlings, *Law and Administration* (3rd ed, CUP 2009) 22-40.
[1086] P. Selznick, 'Focusing Organizational Research on Regulation' in R. Noil (ed) *Regulatory Policy and the Social Sciences* (University of California Press 1985) 363.
[1087] Anthony I. Ogus, *Regulation, Legal Form and Economic Theory* (Clarendon Press 1994) 2.

costs.[1088] Further, regulation in the market system mainly encompasses private laws such as contract law and self-regulatory principles delivered by private agencies. In contrast to the market systems, regulation in the collective systems is about the direction of individuals' relationships in the market for the public interest. In this regard, regulation reflects a directive function exercised by a central superior authority which is mainly the state.[1089] Further, the fundamental role of the state in the formation and enforcement of public law and all kinds of obligations resulted from individuals' cooperative relationships, reflect the centralized concept of regulation.[1090] The centralized concept of regulation implies the importance of the public interest in its reasoning. In this regard, asymmetric information between individuals and service providers and spillover effects of some transactions are regarded as the main reasons for regulation in the both systems.[1091] In fact, the massive social and economic effects of the mentioned reasons for regulation encouraged central intervention by state which its content has matured during the time. Further, the regulatory practices in terms of administrative processes have developed from sector specific such as financial services and consumer protection to a generic set of instruments and strategies deployed by the state.[1092] In this regard, in the context of the modern capitalism which competition is recognized as the best way to secure investors' rights, regulation is proper when the market operation solely cannot meet important goals of public interest. To meet those objectives regulations control the quality of a product or services, the nature of the market, or require market players such as advisers and intermediaries comply with certain standards.

[1088] ibid 18.
[1089] ibid 2.
[1090] ibid.
[1091] ibid 4.
[1092] T. Daintith, 'A Regulatory Space Agency' (1989) 9 Oxford Journal of Legal Studies 534, 534.

The objectives of regulation in a particular regulatory system should be considered in a distributive sense as they are about the distribution of rights and wealth among stakeholders.[1093] In this regard, the protection of investors' rights requires a risk-based approach under which professional and retail clients are protected from ex ante and ex post market failures. Under the FSMA 2000, the FSA was required to discharge its functions in a way that to secure the appropriate degree of protection for consumers; 'having regard to the different risks involved in different investments and transactions, the differences in expertise in between customers, the need for advice and accurate information and the general principle that consumers should take responsibility for their decisions.'[1094] In this regard, providing investors with adequate and accurate information is the fundamental requirement for regulatory objective of customer protection. In this context, accurate information supports proper advice giving through enhancing transparency in the system. Also, it enhances customers' confidence and leads to more competition and innovation in the market. Although, the Financial Services Act (2012) established new regulatory objectives[1095], information and advice are the main elements for a robust regulatory system. In this regard, to meet the Financial Conduct Authority strategic objective, namely to ensure that markets are functioning well, it must secure investors' right by providing them with accurate and fit for purpose information and advice. Further, a sound investors' protection system enhances integrity (soundness, stability and resilience) of the market and supports prevention and combat against crimes and market abuses.

[1093] Robert Baldwin, Martin Cave and Martin Lodge, *Understanding Regulation: Theory, Strategy' and Practice* (2nd edn, OUP 2011) 25.
[1094] Financial Services and Markets Act 2000, s.5.
[1095] According to the new Act the Prudential Regulatory Authority must promote the safety and soundness of authorised persons by the Prudential Regulation Authority (PRA-authorised persons) by ensuring that the business of such persons does not adversely affect the stability of the UK financial system. see Financial Services Act 2012, s.6.

The concept of regulation implies the importance of certainty as the essence of rule of law and a means to reach better outcome in its economic sense. In fact, certainty and discretion in a regulatory system support the distributive function of regulation by providing legitimacy and efficacy. In this regard, certainty provides predictability and consistency with other policies through building a defined system for the application and enforcement of regulation.[1096] Further, it builds a proper ground for the evolvement of regulatory rules, procedures and mechanisms through supporting efficient path dependence in a regulatory system. In an economic sense, certainty results in wealth maximization and accordingly efficient economic activity as it supports certain property rights and the domain of legal activities in a way that enhances confidence in markets.[1097] In contrast, discretion allows a regulatory agency or authority (formal or informal) to act according to its 'own value judgement within the parameters of legally acceptable options.'[1098] It encourages flexibility in a regulatory system as it permits tailored solutions for problems.[1099] From a classical point of view over the rule of law, certainty and discretion are regarded as opposites. In Lord Bingham's words: 'questions of legal right and liability should ordinarily be resolved by application of the law and not the exercise of discretion.'[1100] However, changes in economic systems and the rise of capitalism changed this dogmatic perception over certainty and discretion. Now it is believed that certainty as a regulatory objective can be achieved through flexible and innovative mechanisms provided by discretion. In other words, to prevent arbitrary decisions taken by authorities, rule of law requires

[1096] Daniel Kalderimis, Chris Nixon and Tim Smith, 'Certainty and Discretion in New Zealand Regulation' (paper prepared for the NZ Law Foundation Regulatory Reform Project, 2013) http://www.regulatorytoolkit.ac.nz/topics-of-regulatory-interest/reducing-uncertainty-consumers accessed 2 June 2015.
[1097] ibid.
[1098] ibid.
[1099] ibid.
[1100] Tom Bingham, *The Rule of Law* (Penguin 2010) 48.

discretionary power to be constrained by law and the principles of rationality, proportionality, consistency, non-discrimination, transparency and due process.[1101] In fact, a proactive and durable regulation requires flexibility provided by discretion of official bodies such as administers, courts and enforcement agencies, and also by decisions of unofficial regulators such as practitioners and scholars.

In this regard, it is discussed that a proactive and complete regulatory system is comprised of rules and principles as they support each other in different aspects of regulation. Certainty mainly is considered as the inevitable result of the applications of rules, and flexibility as the result of the application of principles. In this regard, despite their differences in characteristic and nature, they both in their formation and mandate 'define opposite ends of a continuum: 'principle' is to 'rule' as 'plan' is to 'blueprint', the latter being merely a more detailed form of the former in each case.'[1102] However, despite similar objectives and functions, some scholars favour differences in the form and mandate of rule and principle. In Raz words: 'a court can establish a new rule in a single judgement that becomes a precedent. Principles are not made into law by a single judgment; they evolve rather like a custom and are binding only if they have considerable authoritative support in a line of judgments. Like customary law, judicially adopted principles need not be formulated very precisely in the judgements that count as authority for their existence. All that has to be shown is that they underlie a series of courts' decisions, that they were in fact a reason operating in a series of cases.'[1103] Further, since 'rules prescribe

[1101] Julia Black, 'Managing Discretion' (ARLIC Conference Papers – Penalties: Policy, Principles and Practise in Government Regulation, June 2001) http://www.lse.ac.uk/collections/law/staff%20publications%20full%20text/black/alrc%20managing%20discretion.pdf accessed 2 Jun 2015.
[1102] Robert E. Goodin, *Political Theory and Public Policy* (University of Chicago Press 1982) 63.
[1103] Joseph Raz, 'Legal Principles and the Limits of Law' (1972) 81 (5) Yale Law Journal 823, 848.

relatively specific acts; principles prescribe highly unspecific actions',[1104] their implementation in a regulatory system should be examined individually.

However, in practice the distinction between rule-based and principle-based systems is not clear and most regulatory systems particularly in financial services, such as the 2007 FSA endorse a hybrid approach[1105] since rules and principles support and elaborate each other in various areas. In this regard, the relationship between principles and rules was discussed in *R (on the application of British Bankers Association) v Financial Services Authority and Financial Ombudsman Service*[1106] and in Quseley J words: 'the principles are best understood as the ever present substrata to which the specific rules are added. The principles always have to be complied with. The specific rules do not supplant them and cannot be used to contradict them. They are but specific applications of them to the particular requirements they cover. The general notion that the specific rules can exhaust the application of principles is inappropriate. It cannot be an error of law for the principles of to augment specific rules.'[1107]

To have a comprehensive perception over the concept of regulation and its mechanisms, we should examine it in different senses. Generally we have three perceptions over the concept and domain of regulation. The first approach refers to regulation as a specific set of commands. The second approach studies regulation as deliberate state influence; and the third approach considers regulation as all forms of social and economic influences.[1108] Regulation as a specific set of commands deals with rules. It is described as direct or command-and-control regulation and

[1104] ibid 838.
[1105] Philip Rawlings, Andromachi Georgosouli and Costanza Russo, 'Regulation of Financial Services: Aims and Methods' (April 2014) Queen Mary Centre for Commercial Law Studies, University of London 40, http://www.ccls.qmul.ac.uk/docs/research/138683.pdf accessed 2 June 2015.
[1106] [2011] EWHC 999 at 162
[1107] Ibid.
[1108] Kalderimis (n 1096) 3.

reflects a traditional style for regulation under which generally is about the 'promulgation of a binding set of rules to be applied by a body devoted to this purpose.'[1109] In this regard, the major tasks of a regulator (mainly the government) as the agents are perceived to be rule-making, enforcement and the application of sanctions.[1110] Generally, the type of rule is the result of function, character, status and the structure of the rule. Further, the main issue in command-and-control concept of regulation is the ideal degree of precision of a rule in terms of its transparency, accessibility and congruence.[1111] The precision of rules in some industries such as financial services and health sectors is more important since they bear high responsibility for public interest and welfare values. In this context, a central regulation provides more adequate monitoring and enforcement mechanisms as 'the behaviour expected of regulates can be specified with considerable clarity (for instance, through the provision of national minimum standards), making it relatively straightforward to identify breaches of the legal standard and to enforce the law.'[1112] Further, regulators and regulated industries are provided with precise concept of operational and regulatory obligations.[1113] However, since command-and-control regulatory system lacks the comprehensive and accurate knowledge of industry, it cannot produce effective rules to resolve the industry specific problems. In other words, changes in the structure of markets and contingencies in their operation require regulatory mechanisms with incentivizing and controlling qualities as a rule-based centralized regulation cannot incentivize the industry to be innovative in terms of the structure and operation of products.

[1109] ibid; the term command-and-control crept into the language of policymakers through the writings of neo-classical economists who used it to reflect negative aspects of direct government intervention. See, Neil Gunningham and Peter Grabosky, *Smart Regulation: Designing Environmental Policy* (OUP 1998) 39.
[1110] Robert Baldwin, Colin D. Scott and Christopher Hood, *A Reader on Regulation* (OUP 1998) 14.
[1111] ibid.

Regulation as deliberate state influence refers to regulation in a broad sense under which state resorts to command or non-command actions to influence business or social behaviour. Further, it includes other methods of influence such as economic incentives and franchises.[1114] Regulation as all forms of social and economic influences refers to all means whether formed and applied by state or other sources such as markets, corporations and professional bodies with deliberate or incidental regulatory effects.[1115]

9.3 Issues in the Regulation of Shari'ah Boards

Integrity is the essential part of distributive perception over regulation. Its moral root reflects the importance of probity in the discharge of contractual or customary responsibilities to others. In this regard, those act as steward are responsible to safeguard others' property against reasonably foreseeable risks that may present a threat to the integrity of the property in question.[1116] Integrity is recognized as a key intangible, strategic asset[1117] in the success of the company since it boosts its reputation and accordingly its competitive power. In fact, the reputation of a commercial entity is influenced by its moral capability and the performance of its leadership. Integrity in this context involves the conduct or the absence of conduct implying dishonesty and the lack of fairness in stewardship.[1118] In this regard, integrity capacity as 'an individual or collective capability for repeated process alignment of moral awareness,

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[1112] Neil Gunningham and Darren Sinclair, 'Instruments for Environmental Protection' in Gunnigham (n 1109) 41.
[1113] ibid.
[1114] Baldwin (n 1093) 3.
[1115] ibid.
[1116] Rider (n 559) 160.
[1117] Joseph A. Petrick and John F. Quinn, 'The Challenge of Leadership Accountability for Integrity Capacity as a Strategic Asset' (Nov. 2001) 34 Journal of Business Ethics 331.
[1118] ibid.

deliberation, character and conduct that demonstrates balanced judgement, enhances sustained moral development and promotes supportive systems for moral decision making',[1119] supports the unity of purpose and action when faces the complex and conflicting values.[1120] Further, it supports long-term sustainable competitive advantage of a company through 'exploiting an enduring core of relevant capability differentials cultivated by responsible management of tangible and intangible internal skills and assets.'[1121] In this regard, the protection of integrity is not only an obligation on the shoulders of management, also any person or body whose misconduct may affect the reputation of company. In this context, obligation bears a broad concept including moral, professional or legal duties to act or assure the integrity of the business. In this regard, under secular law, companies also can be held liable same as individuals for their misconducts and resulted harms.

The regulation of any profession and delimitation of responsibilities is a common legal practice in many jurisdictions. In this regard, certainty in the definition of duties, responsibilities and obligations is an essential element to form an effective and efficient regulatory system. In the context of Islamic finance, the regulation of Shari'ah boards does not demonstrate a straightforward task. Despite the existence of consensus in the industry over the general duties of Shari'ah boards, their exact responsibilities vary from institution to institution. Further, the lack of harmonization in the interpretation of Shari'ah led to uncertainty in its concept and the content of Shari'ah boards' duties. This is compounded by uncertainty in the application of some Islamic law principles in the secular legal systems too. As discusses before, although the issue of legality

[1119] J. A. Petrick and J. F. Quinn, 'The Integrity Capacity Construct and Moral Progress in Business' (2000) 23 (1) Journal of Business Ethics 3; see also Petrick and Quinn (n 1117).
[1120] Petrick and Quinn (n 1117) 332.
[1121] ibid; see also J. Barney, 'Looking Inside for Competitive Advantage' (1995) 9 (4) Academy of Management Executive 49.

in Shari'ah is irrelevant in non-Islamic jurisdictions, it is possible the application of the common law illegality leads to uncertainty of obligations' status and their enforceability.[1122]

Although uncertainty in obligations and duties constitutes the main issue and impediment in the regulation of Shari'ah boards' conducts, the lack of the concept of professionalism can be considered as additional barrier.

9.4 Professionalism and Shari'ah Boards' Functions

The regulation of professional services is an important part of the application of the modern concept of rule of law. 'Profession' or professional conduct as a form of human conduct is claimed to be of significance for the well-being of human in modern society as its specialization in knowledge and ethics enhances competition and the economic performance of markets.[1123] A Profession as an occupational group provides solution for the anomie arising from the division of labour in the industrial society.[1124]As Durkheim says: 'once the group formed, a moral life appears naturally carrying the mark of the particular conditions in which it has developed. For it is impossible for men to live together, associating in industry, without requiring a sentiment of the whole formed by their union, without attaching themselves to that whole, preoccupying themselves with its interests, and taking account of it in their conduct."[1125] Further, on the importance of morality as part of a profession he says: "what we specially see in the occupational

[1122] Rider (n 559) 149.
[1123] John Lawrence, *Argument for Action: Ethics and Professional Conduct* (Ashgate 1999) 53-56.
[1124] ibid 63.
[1125] Durkheim, 'Preface to the Second Edition 1902', in *Division of Labor in Society* (the free press 1974) 14-15 quoted in Lawrence (n 1123) 63.

group is a moral power capable of containing individual ego, of maintaining a spirited sentiment of common solidarity in the consciousness of all workers…'[1126]

There has been several definitions for profession. In this regard, it is discussed that profession is about formally rational abstract utilitarian knowledge.[1127] A broader view defines it as a vocation founded upon specialized education to serve others objectively.[1128] In other words, profession refers to a declaration of belief by a person to uphold the rule of law by obeying the regulations of a professional associations.[1129] Further, according to the Directive 2005/36/EC on Recognition of Professional Qualifications: 'those practised on the basis of relevant professional qualifications in a personal, responsible and professionally independent capacity by those providing intellectual and conceptual services in the interest of the client and the public.' In other words, a profession is about the systemic governance of an occupation through the establishment and development of formal education and qualification order controlled by a regulatory body with power to discipline members. The idea of profession is associated with the notions of status, and functional privilege which require recognition from society.[1130] In this regard, as provided definitions reflect, the existence of certain objective standards for the establishment of a profession is necessary. Further, a profession is intellectual in character and derived from learning based on an orderly educational process.[1131] The mentioned characteristics reflect the importance of a systematic theory, recognized authority by clients, the existence of a system of

[1126] ibid.
[1127] Keith M. MacDonald, *The Sociology of the Professions* (Sage 1999) 1.
[1128] Sidney Webb and Beatrice Webb, New Statesman, 21 April 1917 quoted in Lawrence (n 1123).
[1129] Daniel R. Coquillette, 'Professionalism: The Deep Theory' (1994) 72 North Carolina Law Review 1271, 1272.
[1130] Lawrence (n 1123) 72.
[1131] ibid.

sanction and approval, a code of ethics and a professional culture sustained by formal associations.[1132]

A profession as a system is concerned with the definition of duty and setting technical, disciplinary and regulatory rules of an occupation with regard to the social, economic and cultural aspects of a jurisdiction and also in harmony with other professions' functions. In this regard, the concept of profession implies a process to pursue, develop and maintain the interest of the occupational group in terms of their ideology and practice (professionalization).[1133] Consequently, the professional group as an association has autonomy 'in constructing its occupational identity, promoting its image with clients and customers, and in bargaining with the state to secure and maintain its (sometimes self) regulatory responsibilities. In these instances the occupation is using the discourse partly in its own occupational and practitioner interests but sometimes also as a way of promoting and protecting the public interest.'[1134] In this regard, the professions in the modern world affect the interests and well-being of individuals and society by their intellectual dominance. Further, their critical role in the pursuit of the public interest[1135] has created a strong sense of ethical responsibility for them.[1136] In other words, the value of human-well-being is the foundation for the interpretation of professions' ethical responsibility to pursue the public interest.[1137]

[1132] Ernest Greenwood, 'Attributes of a Profession' (1957) 2 (3) Social Work 45.
[1133] Julia Evetts, 'Professionalism in Turbulent Times: Changes, Challenges and Opportunities' (Propel International Conference Stirling, May 2012) 3.
[1134] ibid p.5
[1135] The concept of public interest refers to the collective realization of individual interests for pursuing mutual advantage. See Bruce Jennings, Daniel Callahan and Susan M. Wolf, 'The Professions: Public Interest and Common Good' (1978) 17 (1) The Hastings Center Report 3.
[1136] ibid.
[1137] Lawrence (n 1123) 123.

Although, the discourse from above of the professional group such as organizational objectives and clients' priorities, may influence professional services and thereby limiting the exercise of discretion by them, they cannot abolish the authority and independence of the profession in terms of establishing technical and accountability rules. In other words, from an ethical point of view, clients' priorities and organizational objectives influence 'deep theory' of professionalism. 'Deep theory' here refers to the ultimate motivation for obeying rules and encompasses three categories: goal-based, rights-based and duty-based.[1138] In this regard, the goal-based category of deep theory is focused on the outcomes and ends of clients irrespective of the means.[1139] Its emphasis is on the instrumental function of law to achieve particular personal ends and consequently believes in moral relativism as its ethical model.[1140] On the other hand, the focus of right-based approach is on human freedom through the application of principles of justice. In contrast, the duty-based deep theory is focused on the moral aspects of a profession under which goals do not justify means.[1141] According to this approach, dignity and probity and not sole economic and social objectives are crucial motives for a professional to serve clients. In fact, persevering dignity as a value[1142]is the priority in the duty-based approach. Dignity as an inherent nobility is about self-respect by which professions enhance independent judgement and objectivity. Further, it helps to keep predictability in professions through improving order in their systematic rules and operations. In this regard, rules in the duty-based perception of professions

[1138] Coquillette (n 1129) 1273.
[1139] ibid.
[1140] ibid.
[1141] ibid.
[1142] Values or 'goods' are in human existence. They are conceptions of the desirable (positive values) or undesirable (negative values) to provide order and predictability in our social environment. Values tend to occur in systems and are subject to change as they are inevitably related to the conditions people experience. However, some values such as dignity are highly abstract and their priority and dominance is not dependent to people experience. In contrast, the dominance of other values at lesser level of

in the forms of principles, policies and regulations attempt to coordinate actions for inherent professional values and goals such as independence and fairness in connection with clients' purposes. In this context, effective and efficient rules are made by accepted professional authorities that their nature of power is based on moral and technical precepts.

In the context of Islamic finance, the lack of the concept of profession for Shari'ah board membership is an impediment for establishment a regulatory system with regard to Shari'ah board's functions. In this regard, the first issue is uncertainty and ambiguity in the concept and scope of knowledge. The concept of Shari'ah in terms of Shari'ah financing encompasses a broad idea over commercial transactions (*fiqh al-muamalat*) which is mainly based on individual interpretations made by Islamic scholars. In other words, the concept of Shari'ah is contingent on the definitions and interpretations resulted from the authority of Shari'ah jurists in specific contexts. Professional knowledge in the modern world reflects a systematic concept which is based on the established theory, skills and training system which are known through a specific professional association. In fact, the reason for the existence of credential system resulted from the formalization of professional education, is to meet the need for some degree of predictability and uniformity in the market.[1143]In this regard, Islamic finance industry has not presented a systematic concept for Shari'ah as the professional knowledge since there has been no consensus over its concept. This issue is more severe in jurisdictions like the UK, there has been no professional association to accomplish this responsibility. Professional associations reinforce professions credibility through the internalization of professional and ethical norms, continuous monitoring the quality of services, setting standards and sanctions, for instance by the removal of

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abstraction such as a good job is determined by its extensiveness in the total activity of the system, its duration and the intensity with which it is sought and maintained. See Lawrence (n 1123) 7.

[1143] Lawrence (n 1123) 80.

licence or bringing criminal charges for misconducts.[1144] Although at micro level, some advisory institutions such as Islamic finance council in the UK, and at macro level international standard setting organizations such as AAOIFI provide Shari'ah training services, they are not professional associations since they have no formal and legal status to control the conducts of Shari'ah boards' members. Further, the services of those institutions are not based on the professional conception of knowledge since they only teach the current structure of Islamic finance transactions and products. Professional knowledge requires regular development and the amendment of rules according to market incidents. In other words, there is path dependency in the form and essence of a profession that reflects a historical preference over the usage of those rules in terms of efficiency and effectiveness. Further, the path dependence in a profession reflects a professional culture shaped in a long time. To establish an effective regulatory system, the professional culture helps to perceive the peculiarities of a profession in terms of required incentives or deterrents. In this context, the concept of Shari'ah does not reflect path dependency as the Islamic finance industry contract-based innovation and product engineering is established based on classical *fiqh* opinions. Further, this contract-based approach in innovation has been also an impediment in the formation of a professional culture as it prevents the formation of rules of professional conduct in a reasonable processes.

9.5 Conclusion

This chapter examined the importance of professionalism in the regulation of Shari'ah boards' functions. Regulation as a governance mechanism controls the interactions between market actors and also facilitates the achievement of private and public goals through its conducting

[1144] ibid 82.

rules. In the context of Islamic finance, the lack of the concept of professionalism for the membership in Shari'ah boards in terms of education, knowledge and professional association has led to the ambiguity over their responsibilities and liabilities. Further, the lack of a professional association to monitor the functions of Shari'ah board's members in terms of their ethical and technical responsibilities resulted in the absence of professional culture in their discharge of duties. In this regard, to establish an effective regulatory system, it is imperative to develop the concept of Shari'ah and accordingly present clear process for the functions of Shari'ah board's members.

Chapter Ten

Conclusion

This study sought to investigate the role of Shari'ah boards in the context of Islamic finance and determine their position in English common law. This is followed from the contention that although Shari'ah boards are regarded as the Shari'ah compliance gatekeepers of Islamic finance industry, there is no consensus among practitioners and academics over their specific roles. Further, in the context of corporate law there is no legal position for Shari'ah boards' membership, as a result their role in the governance of Islamic financial institution is not clear. In fact the lack of a precise legal position for Shari'ah boards in the context of Islamic finance is the result of contention over the concepts of law and law-making in Islam as there is no agreed definition for Shari'ah. Accordingly as the result of ambiguity over the concept of *Shari'ah*, the notion of Shari'ah compliance as the ultimate goal of Islamic finance industry suffers from uncertainty in meaning.

In this regard, Chapter Two sought to show the structure of Islamic finance industry developed in the last decades. It found that despite the consensus of all *Sunni* and *Shari'ah* schools of thought on the importance of human well-being, wealth creation and accordingly stewardship, there is no agreed perception over their concepts and scopes. The issue of human quality in the interpretation of Shari'ah revealed (the *Quran* and *Sunnah*) and non-revealed (analogy and consensus) sources has got a crucial influence on the development of Islamic finance as it determines the legitimacy of the industry. In this regard, the tradition of intellectual endeavours of Shari'ah jurists in understanding the God's will *(ijtihad)* reflects the strong juristic

characteristic of Shari'ah. In fact, the tradition of issuing *fatwa* as a personal relationship between a questioner and Shari'ah jurist over legal and non-legal issues demonstrates the fatwa-based characteristic of the Islamic finance. This chapter found the adherence to fatwa-issuing tradition in the context of modern financial market is not an efficient approach for the development of Islamic finance as it is too rigid to meet Shari'ah goals (*maghasid al-Shari'ag*). The importance of facility and cost effectiveness in the functions of the modern financial intermediaries are also crucial issues in Islamic finance industry. In fact, adherence to the legalistic approach in the interpretation of principles of Shari'ah with regard to financial transactions (prohibition of *riba*, *gharar* and *maisir*) led to the problem of form over substance as it is only concerned about the legal form not *maghasid al-Shari'ah*. In this regard, the legalistic approach in fatwa ruling led to the use of legal stratagems (*hila*) as they help to avoid legal responsibility. In other words, to alleviate financial predicaments, the industry instead of adherence to an objective-oriented approach in the interpretation of Shari'ah (which is based on expertise) relies on the legalistic approach established based on classical *fiqh* concepts over commercial transactions. This issue has affected the scope of individualism in Islamic law and provides a narrow concept for the freedom of contract in contractual relationships as their legality is only perceived according to the terms of nominated contracts defined in *fiqh*. In this regard, the legalistic approach in the interpretation of Shari'ah, in its collective or individual form, is the predominate approach in shaping the operation of Islamic financial institutions and accordingly providing legitimacy for the industry.

The significance of Shari'ah boards in the development of Islamic finance is studied in Chapter Three. The historical development of Shari'ah boards reflects the evolvement of their role from pure endorsement to auditing. The main concern of the industry was economic objectives such as

the elimination of poverty and the decrease of inequalities as the goals of Shari'ah. In this regard, Shari'ah jurists had no institutionalized place in the industry and after decolonization and accordingly sudden increase in oil prices, competition in the market necessitated the establishment of a formal body for controlling the legitimacy of the industry. In this regard, since there was no systemic effort to engineer Islamic financial products as substitutions for conventional products, the main role of Shari'ah boards was endorsement and they had no auditing role. However, developments in financial markets broadened the scope of Shari'ah boards' role as the industry now considers a supervisory responsibility for them too. Although, Shari'ah supervision is generally regarded as a process of review to check the Shari'ah compliant operation of Islamic financial institutions, there is no agreed definition for it. This fact is the result of ambiguity over the definition of Islamic finance (as no definition is provided by jurisdictions with Islamic banking system) and the concept of Shari'ah. In this regard, although some international organizations such as IFSB provided the industry with some definitions on Shari'ah supervision, the lack of an agreed perception for Shari'ah led to ambiguity over the functions of Shari'ah boards. This chapter found, Shari'ah certification as the main function of Shari'ah boards is subject to the widely divergent opinions and accordingly impeded innovative product engineering in the industry. Further, the industry suffers from the dominant legalistic approach in ijtihad and Shari'ah review which prevents any innovative interpretation and flexibility in the industry. This classical view in *fiqh* forms the current practice in the industry at individual, national and international levels. Even international organizations such as the International Fiqh Academy, which is responsible for the harmonization and integrity of the industry, follows a legalistic approach and accordingly does not recognize any innovative opinion out of the boundaries of classical *fiqh*. This rigid interpretation of Shari'ah has affected

some crucial aspects of the industry such as liquidity and credit risk management as does not approve innovative financial products such as derivatives. In fact, the extent of acceptance of derivatives products by Shari'ah boards reflects the interpretative approach they use in their ijtihad. In this regard, regulatory systems such as in Malaysia may affect Shari'ah boards' interpretative approach. The national development plans of Malaysia led Islamic finance authorities to follow a proactive approach in regulation and accordingly requires Shari'ah boards to adhere to an economic ijtihad which is compatible with development goals. However, product development in the context of Islamic finance follows a process innovation as the structure of Shari'ah-based and Shari'ah-compliant products must be based on the nominate contracts. In other words, Shari'ah boards follow legalistic approach in financial innovation and accordingly seek to actualize the economic effects of conventional products within the boundaries of nominate contracts.

The Chapter Four examines the legal relation between Shari'ah boards and Islamic financial institutions. It found that since the structure and operation of Islamic financial institutions are based on conventional perceptions rooted on the economic function of law and accordingly corporation, the content and form of Shari'ah boards' legal relationships should be addressed according to those perceptions as well. In this regard, the modern corporation is perceived as an economic instrument acts as a nexus of contracts between individual suppliers of various inputs and managers to generate economic profit. This economic rationale and objective affects the operation and accordingly the legal relations of corporation as directors and all other responsible bodies have to pursue principals (shareholders) interests and avoid self-interested conducts. In the context of Islamic law, human well-being is regarded as one of the objectives of Shari'ah and accordingly as the concept of *maslahah*. In other words, the purpose of law in Islam is human

well-being. However, the ethical dimension of Islamic finance presents a broader concept for objectives of Shari'ah and accordingly for Islamic financial institutions. In this regard, Shari'ah assumes a collective responsibility for all to follow the common good of society. In this context, Shari'ah boards' functions bear a social-economic feature as they are responsible for the well-being of society and accordingly their rulings should be based on public interest.

This chapter explicated Shari'ah boards' legal relation with Islamic financial institutions in terms of fiduciary law. In this regard, their fiduciary relationship implies a trust-like quality which requires the performance of promises. In the context of UK legal system, since there is no defined legal position in statute for Shari'ah boards, their fiduciary characteristics should be explained according to certain factors explained in common law. As is explained in *Lac Minerals Ltd v International Corona Resources Ltd*[1145] and *Hospital Products Ltd v United States Surgical Corp*[1146], the presence of discretion or power given by beneficiary to the fiduciary, vulnerability of the beneficiary, trust, ascendency and confidence result in fiduciary obligations.

The discretionary power of Shari'ah board is explained with regard to their access to critical resources such as confidential information and accordingly their power to affect reputation of Islamic financial institutions. In this regard, the discretionary power of Shari'ah boards in their ex ante and ex post functions bears religious-conventional characteristic as it should be applied according to Shari'ah and conventional perceptions. Due to the lack of an agreed interpretation over Shari'ah principles, there is an uncertainty over the definition of discretionary power of Shari'ah boards in their ex ante and ex post functions. This chapter found that since directors are the ultimate responsible body in the management of corporations, the discretionary power and

[1145] [1990] F.S.R. 441; [1989] 2 S.C.R. 574.
[1146] (1984) 156 C.L.R. 41, HCA.

accordingly duties of Shari'ah board must be explained with regard to the fiduciary duty of directors to promote the success of company provided in the Companies Act 2006. In other words, they are responsible to establish equilibrium between the religious and economic interests of stakeholders through a rationale and reasonable approach in their *ijtihad*. This arguments reveals the vulnerability of stakeholders in terms of knowledge and expertise in Shari'ah and finance. In fact, the issue of information asymmetry in Islamic finance industry is more intense as stakeholders lack Shari'ah knowledge to assess the performance of Shari'ah boards.

Further to the recognition of fiduciary factors, this chapter examined the fiduciary duties and rules which Shari'ah boards must follow. Generally, loyalty as the essence of fiduciary duties requires Shari'ah boards to enhance economic interests of stakeholders and avoid self-dealing in their functions. However, due to the existence of intense legal pluralism in Islamic law, the meaning and scope of loyalty of Shari'ah boards suffer from ambiguity. As a consequence of this ambiguity the protective function of loyalty and other proscriptive rules, namely no conflict of interest, no conflict of duties and no profit rules suffer from ambiguity be weakened. Further, the lack of a solid ground for the concept of fiduciary duties affects Shari'ah boards' accountability and accordingly their liability. In the context of common law, this issue is more problematic as there is no theory of liability in terms of the specificity (civil or criminal) and enforceability in Islamic *fiqh*.

The application of no conflict of interest rule occurs where a person is placed in a position where the proper discharge of a duty to another, he has assumed, conflicts with his own interests. In this regard, one category of this conflict could be unauthorised remuneration within which a Shari'ah boards obtains beyond what is authorised. However, it is argued that since their consultancy fees are irrelevant to the outcome of their decisions, this argument lacks a solid

ground. But, regarding high payments to Shari'ah boards by Islamic financial institutions over Shari'ah compliant products, it is possible due to their interests in Shari'ah board membership, they do not discharge their duties impartially. Further, the conflict of duties rule requires Shari'ah boards' members to avoid multiple employments when there is a possibility of actual conflicts such as inability to come up properly with several Shari'ah auditing positions in various Islamic financial institutions or receiving confidential information from one client which its disclosure or employment may affect negatively its competitive power. The use of confidential information for personal interest also is relevant to fiduciary duties of Shari'ah boards as it may be used in following for self-dealing purposes. Further to the existence of those issues and questions in Shari'ah boards' fiduciary relation with Islamic financial institutions, there is no accountability mechanism to judge over the violation of duties by Shari'ah boards.

The general duties of Shari'ah boards is examined in Chapter Five. This chapter addressed the importance of the classical authority of *madahib* and its influence on the duties of Shari'ah boards in the context of Islamic finance. In this regard, the concept of authority has experienced changes from the absolute ijtihad or intellectual power of a jurist to the complete acceptance of the doctrines of past jurists. In this regard, *taqlid* or imitation forms the nature of authority of Shari'ah boards as their intellectual endeavour is limited by the authority of *madahib* in terms of their doctrines, methodology and opinions. In other words, the authority in the regime of *taqlid* is established in a school as Shari'ah jurists validate their legal opinions through the acceptance of the school methodology and doctrines. This restricted approach in the perception of Shari'ah boards' authority has had positive and negative implications for the industry in terms of development and integrity. In this regard, the legality in Shari'ah boards' duties and accordingly in the interpretation of Shari'ah compliant is the result of *taqlid* regime. This chapter found that

the legality in Islamic law is different from legality in conventional system in terms of the process of law-making and enforcement. While law in a conventional system is the result of an official procedure supported by state, law in Islamic law is the result of an individual process of ijtihad. Further, while the enforcement and liability for the breach of law in conventional system are supported by state, the concept of liability in Islamic law is limited between God and human.

Shari'ah compliance as the cornerstone of the industry defines the main duty of Shari'ah boards in Shari'ah compliance risk management. This chapter found that the inclusive and the broad concept of Shari'ah compliance encompasses monitoring and advising duties of Shari'ah boards. Shari'ah non-compliance risk as an operational risk affects Islamic financial institutions reputation and accordingly results in losses for the industry. In this regard, Shari'ah boards are responsible to supervise the application of Shari'ah in the process of risk management according to their own fatwas. However, the lack of a defined framework for Shari'ah boards' duties resulted in the ambiguity in the concept and scope of Shari'ah compliance risk management. Further, the concept and scope of Shari'ah as an independent mechanism is also affected by uncertainty in Shari'ah boards' duties. In this context, the institution of hisbah as a monitoring and corrective mechanism for the regulation of transactions according to Shari'ah is considered the origin of Shari'ah audit. Although, hisbah at the beginning was not an organized institution in terms of concept and scope, the Ottoman hisbah law reflects the importance of codification for an effective monitoring system. In this regard, although Shari'ah audit is considered as an independent institution to monitor the Shari'ah compliance operation of Islamic financial institution, the dearth of Shari'ah jurists or practitioners with the knowledge of Shari'ah led the Islamic financial institutions to employ Shari'ah boards' members. Further, the lack of a clear framework for Shari'ah audit led to the ambiguity over its concept and scope. This issue is in fact

the result of ambiguity in the concept and scope of Shari'ah compliance and accordingly in Shari'ah boards' duties.

Chapter Six examines the implications of Shari'ah board's fatwas for directors' duty to promote the success of the company in terms of their strategy and control roles. In this regard, board of directors as a collective institution is responsible for value-creation and accordingly the success of company. In the context of Islamic finance, board of directors as a collective decision-making institution must comply with Shari'ah principles reflected in Shari'ah board's fatwas. Although the operation of Islamic financial institutions in the context of UK jurisdiction bears no religious obligation, the contractual provisions require directors to discharge their duties in Shari'ah compliant manner. This reflects legitimacy as the essence of board of director's function. In other words, the board of directors' legitimate discharge of duties in terms of the process of decision-making and the output of Islamic financial institution depends on Shari'ah board's opinions. Also, directors' prescriptive duty to promote the success of the company in the context of Islamic finance should be interpreted with regard to Shari'ah board's fatwas. In this regard, since Shari'ah compliance is a non-legal duty, the dual nature of 'success' in terms of economic and Shari'ah compliant value-creation reflects ambiguity over the fiduciary duties of board of directors. Particularly, the immaterial concept of 'director' in the context of Companies Act 2006 implies the importance of Shari'ah compliance with regard to the duties of all categories of directors. For instance, a shadow director in an Islamic financial institution may be liable for the misconduct of de jure directors which is related to their non-Shari'ah compliant decisions. In this context, also it is possible to consider Shari'ah board's members as Shadow directors when their advisory role and accordingly their influence on directors' decision-making power take non-professional quality. This chapter found that the UK Company law is a

conventional law and there is no record of religious factor in their duties. This fact has affected the strategy-making and controlling functions of board of directors.

The strategy role of directors is affirmed in the Companies Act as the fiduciary duties of directors imply the importance of setting, monitoring and assessment of strategic proposals that affect the long-term performance of the company. In this regard, the interaction between the context, the content and values of the company shapes its strategy. In the context of Islamic finance, Shari'ah boards form the strategy through their specific interpretation over Shari'ah compliance and accordingly over the operation of the company. Although the conventional perception over the role of directors in the management of the company is based on the financial industry, there is no harmonized concept for Shari'ah knowledge required for directors in terms of their strategy role. This issue has affected the concepts of value-creation and success in terms of investment strategy, product development and risk management as they all must be Shari'ah compliant. Shari'ah boards' opinions also affect the monitoring role of directors. In this regard, the operational control of an Islamic financial institution reflects a broad concept as it encompasses the past and present financial operation according to ex ante regulatory standards and Shari'ah board's opinions. Further, the strategic control in terms of long-term goals and values requires directors to evaluate product quality and human resources according to Shari'ah board's opinions.

The legal consequences of the breach of Shari'ah board's fatwas by directors is examined in Chapter Seven. This chapter found that since Shari'ah compliance as the ultimate goal of the industry is mainly interpreted in the application of Shari'ah boards' fatwas, directors as fiduciaries are responsible for their application. The analysis is founded on the importance of investor protection in terms of directors' fiduciary duty of loyalty and non-fiduciary duty of care.

In this regard, the history of common law demonstrates the crucial role of fiduciary duties as accountability mechanisms against directors' misconducts. Although case law reflects the application of both positive and negative approaches in the definition of fiduciary duties, the companies Act 2006 provisions express a comprehensive perception over the duties of directors as they are comprised of prospective and prescriptive rules. In other words, the concept of loyalty as the foundation of all fiduciary duties in the Act is defined in negative (to avoid self-interested conducts) and positive obligations (to perform in the best interest). In this regard, this chapter found that since the concept of directors' duty of loyalty in Islamic finance bears religious and economic factors together, its scope is not clear. In other words, the trust-like relationship between directors and investors requires board of directors to apply Shari'ah board's fatwas and at the same time its positive duty to promote the success of the company demands attention to the economic prosperity of the company. Practically, this issue may result in a contradiction between the Shari'ah compliance and economic interests of Islamic financial institutions as directors are obliged to discharge both. However, the economic consequences of non-Shari'ah compliant decisions of directors reflect the economic effect of fatwas, and as a result directors' duty to apply Shari'ah board's fatwas is not only a contractual obligation, also a statutory one.

This chapter also examined directors' non-Shari'ah compliant decisions in terms of duty of care, skill and diligence. In this regard, this non-fiduciary duty as the statutory statement of common law duty of care indicates the importance of professional knowledge and attentiveness in directorship with regard to business risks. The objective standard of care which is reflected in section 174 of the Companies Act requires directors to exercise reasonable care with regard to their duties. In the context of Islamic finance, the liability of directors for their non-Shari'ah

compliant decisions can be examined in terms of the company articles of association and their service contracts. In this regard, since executive directors due to the nature of their service contracts may be considered office-holders and as a consequence employees, employment law requires them to show reasonable care and skill in their duty. However, duty of reasonable care and skill in Islamic finance reflects no clear concept as there is no specific regulation or case law to explain it. In other words, reasonable care and skill in the context of Islamic finance is not only about the application of Shari'ah board's fatwas, also about expertise in finance and management.

Chapter Eight examines the role of Shari'ah boards in the Shari'ah governance of Islamic financial institutions in terms of good corporate governance. It showed that corporate governance as a system of directorship is concerned with establishing a proper control system under which all internal and external actors contribute to value creation. This concept reflects the economic nature of corporate and the importance of the regulation of power of actors in value creation. In this regard, an effective corporate governance establishes a fair process of decision-making under which rights and responsibilities of stakeholders are defined according to the goals and values of the company. Further, as the result of the influence of ethics in corporate law and also understanding the significance of stability as a public good in financial development, the concept of value-creation got a broad sense under which the interests of all stakeholders must be considered in the process value maximization. In this regard, Islamic law and conventional law shares the similar views on the property rights as they both defend private ownership till it is not harmful for the interests of third parties. In this context, this chapter found that, the role of Shari'ah board in the governance of Islamic financial institution should be defined in relation to other governance bodies such as board of directors and auditors. In other words, the role of

Shari'ah board in Shari'ah governance should be considered with regard to the corporate long-term social and economic value-creation. In this context, they need to establish a cooperative relation, conceptually and instrumentally with other governance bodies in terms of knowledge to reach the company goals.

Although, the term governance in its modern sense is not reflected in Shari'ah, the principles of justice, responsibility and the institution of *Shura* (consultation) support the modern function of governance. In this regard, the role of Shari'ah boards in Shari'ah governance, as a system to align corporate governance to principles of Shari'ah, reflects their permanent control over the operation of company. However, due to the lack of a clear definition and framework for 'due process' in Shari'ah pronouncement, there is no harmonization over the role of Shari'ah boards in Shari'ah compliance and their relation with other Shari'ah units' functions. Further, the lack of transparency in the process of Shari'ah pronouncements leads to uncertainty in Shari'ah board opinions as they can change them easily. This issue raises questions over the efficiency of pronouncements and the increase of fatwa shopping in the industry. Further, the lack of accountability as a corrective means reflects the lack of disciplinary rules with regard to Shari'ah boards' misconducts. Also, the lack of accountability demonstrates the lack of rules of professional conduct required for Shari'ah boards' duties. In this regard, since technical rules define the concept of liability in every profession, the establishment and effectiveness of accountability depend on those rules as they provide clear mandate and concept for Shari'ah boards' duties.

The issue of professionalism and its implication for the regulation of the duties of Shari'ah board's members is examined in Chapter Nine. The regulation of professional services bears public quality as it supports the rule of law in terms of predictability and certainty in

professional's duties. In the context of Islamic finance, the functions of Shari'ah boards' members are not based on the concept of profession and the rules of professional conduct as there is no professional association to define the required technical rules. Further, the concept of Shari'ah in the operation of Islamic finance industry reflects the lack of path dependency and development as its application is based on classical fiqh. This issue implies the absence of professional knowledge in the industry. In other words, the application of Shari'ah in the form of contract-based innovation and product engineering cannot develop as the rules of nominate contracts and *madahib* cannot be changed.

The aim of this study was to examine the role of Shari'ah boards in the context of Islamic finance and investigate their position in law. It was shown that the main role of Shari'ah boards is to provide the industry with legitimacy through the endorsement of financial products and the audit of the operation of Islamic financial institutions. However, due to divergent opinions arising from different interpretations over the concept of Shari'ah, there is no clear definition for Shari'ah compliance as the ultimate goal of the industry. This issue has affected the search for the fiduciary duties of Shari'ah boards. In this regard, the trust-like relationship between Shari'ah boards and Islamic financial institutions reflects the nature of their position as fiduciary. Further, it was shown that, Shari'ah boards' fiduciary duties should be interpreted with regard to directors' prescriptive fiduciary duties defined in the Companies Act 2006 and common law. In other words, fiduciary duties of Shari'ah boards should be clarified according to directors' duty to promote the success of the company. Also the aim of this study was to assess the implications of Shari'ah boards' fatwas for the strategy and control roles of directors. It found that since Shari'ah compliance in directors' duties should be interpreted in terms of Shari'ah boards' fatwas, they are required to consider their opinions in their functions. In this regard, it examined

the fiduciary and non-fiduciary duties of directors in the application of Shari'ah board's opinions and explained the importance of harmonization in the goals and duties of those governance bodies.

The results of this study indicate that the emergence of Shari'ah supervisory boards and their roles should be examined according to the developments of markets. In other words, the responsibilities of Shari'ah boards like other governance bodies should evolve according to the exigencies of markets. In this regard, to enhance stability and predictability of the operation of Islamic financial institutions in terms of Shari'ah boards' fiduciary duties, it is imperative to define a common concept for Shari'ah compliance. This issue requires the harmonization of divergent opinions over the concept of Shari'ah through a centralized approach in the regulation of Shari'ah boards' services. Particularly in the context of UK financial market, the centralized regulation with the support of a professional association responsible for defining the rules of conducts for the functions of Shari'ah boards' members helps to delineate the legal position of Shari'ah boards in terms of their fiduciary duties and liabilities.

This study has examined the general responsibilities of Shari'ah boards and the nature of their position in theory and practice. To clarify the nature of Shari'ah supervisory boards, this study examined their historical root in Shari'ah jurists (*foqaha*) functions and in Islamic fiqh. It described their responsibilities such as auditing and giving advice in terms of the conventional institutions. The remit of this thesis therefore is to reconceptualise the functions of Shari'ah boards in the context of Islamic finance. Further, this study examined common law to find the legal position of Shari'ah boards and their fatwas in the context of the operation of Islamic financial institutions in the UK. Also, it explored the implications of Shari'ah boards' fatwa for the functions of directors on the basis of various judgements in case law.

This study has thrown up many questions in need of further investigation. Regarding the public and private aspects of Shari'ah boards' functions, it is necessary to examine the best form of regulation for the operation of Shari'ah advisory boards in the context of UK financial market. Also, it is imperative to investigate the implications of conventional financial laws for the functions of Shari'ah boards in terms of the interpretation of Shari'ah.

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