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

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

Ali A. Ibrahim

## **Abstract**

This paper briefly discusses the significance of corporate governance for the Islamic financial services industry. Furthermore, it predicts that the Islamic financial services industry is likely to converge to modern governance practices. The paper also argues that the industry needs to have a homogenous and specialized regional securities market to realize its true potential.

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

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## **Abstract**

This paper briefly discusses the significance of corporate governance for the Islamic financial services industry. Furthermore, it predicts that the Islamic financial services industry is likely to converge to modern governance practices. The paper also argues that the industry needs to have a homogenous and specialized regional securities market to realize its true potential.

## **INTRODUCTION**

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

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

Generally, the Islamic finance scholars have discussed corporate governance from the perspective of transactional validity—that primarily revolves around avoidance of interest and related moral hazards—for the Islamic financial services industry (the “IFS Industry”). The issues such as regulatory concerns over agency problem, investor protection and the contemporary debate over convergence or divergence of corporate governance have not received much attention from the Islamic finance scholars. Appropriate response to such issues is crucial for the IFS Industry not only for its global competitiveness, but also, as discussed below, to ensure proper *Shari’a*-compliance.

This paper presents a new perspective to existing scholarly debate to corporate governance and IFS Industry, and seeks to briefly highlight aspects of the contemporary corporate governance debate<sup>1</sup> in its analysis with *Shari’a*, and how the IFS Industry could increase its potential. This paper argues that convergence in Muslim countries to the modern corporate governance practices insofar as they seek to increase corporate accountability and transparency, further investor protection and reduce agency costs may be consistent with *Shari’a*, and such convergence is highly likely. However, convergence to modern transactional practices may not be consistent with *Shari’a* primarily because all the modern transactions, despite their efficient role in the financial markets, may not be able to pass the test of validity under *Shari’a*. Hence, more transactional divergence will lead to more transactional innovation in the IFS Industry. The paper further argues that the Islamic finance scholarship should analyze the modern governance practices separately from the transactional aspect. Finally, the paper argues that establishment of an exclusive homogenous securities market is essential for the IFS Industry, and briefly highlights some benefits of such a market.

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<sup>1</sup> See generally Ali Adnan Ibrahim, Developing Governance and Regulation for Emerging Capital and Securities Markets, (May 19, 2006) (unpublished LL.M. supervised research paper, Washington University) (available at <http://lsr.nellco.org/cgi/viewcontent.cgi?article=1001&context=georgetown/gps>) (surveying the issues involved and analyzing the contemporary scholarship and highlighting well-informed legal reforms as opposed to unwise transplanted).

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Accordingly, the discussion in this paper is organized to present (i) a glimpse of literature on agency problem and convergence or divergence of corporate governance, (ii) corporate governance and the IFS industry and (iii) the need for and role of an IFS Securities Market.

## **I. AGENCY PROBLEM AND CONVERGENCE OR DIVERGENCE OF CORPORATE GOVERNANCE**

Today, financial globalization enables international investors to share the risk better and allows the capital to flow toward the most productive markets, and provides respective countries to reap the benefits of their comparative advantages.<sup>2</sup> This, however, requires a structure of corporate governance that not only recognizes property rights but also provides effective enforcement to safeguard them. As discussed below, such safeguards emanate primarily from the laws and regulatory and judicial enforcement mechanisms. Furthermore, confirming prior studies that development in debt and equity markets and financial development contribute to and promote economic growth, the empirical studies found a link between the legal system and economic development.<sup>3</sup>

### *Agency Problems: Self-Dealing and Investor Protection*

In general, the foundations of the market systems include compelling transparency, prohibiting insider-dealing and policing self-dealing.<sup>4</sup> “Corporate governance deals with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment”<sup>5</sup> and it also “deals with the agency problem: separation of

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<sup>2</sup> Rene M. Stulz, *The Limits of Financial Globalization*, 60 J. FIN. 1595, 1595 (2005).

<sup>3</sup> Rafael La Porta et al., *Law and Finance*, J. POL. ECO. 1113, 1152 (1998). (Although there were inconsistencies found in data gathering and coding techniques, the study remains a pioneering work. See generally Holger Spamann, *On the Insignificance and/or Endogeneity of La Porta et al.'s 'Anti-Director Rights Index' under Consistent Coding*, (Har. Law Sch. Program on Corp. Governance, Discussion Paper No. 7 of 2006), available at [http://www.law.harvard.edu/programs/olin\\_center/fellows\\_papers/pdf/Spamann\\_7.pdf](http://www.law.harvard.edu/programs/olin_center/fellows_papers/pdf/Spamann_7.pdf)).

<sup>4</sup> William W. Bratton & Joseph A. McCahery, *Comparative Corporate Governance and the Theory of the Firm: the Case Against Global Cross Reference*, 38 COLUM. J. TRANSNAT'L L. 213, 296-97 (1999).

<sup>5</sup> Adrei Shleifer et al., *A Survey of Corporate Governance*, J. FIN. 737, 773 (1997).

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management and finance.”<sup>6</sup> Investor protections and market development go hand in hand in the real world, and if “protections are absent, one-sided deals flourish and outside equity capital either becomes more expensive or dries up altogether.”<sup>7</sup>

To counter the agency problem, one of the arguments is that small investors can only be attracted to the business of financing companies if legal protections against expropriation by managers and large investors are available.<sup>8</sup> Greater protections for shareholders strongly predict the stock market development.<sup>9</sup> Effective regulation of self-dealing is the fundamental element of shareholder protection<sup>10</sup> that also results in dispersion of ownership.<sup>11</sup>

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

### *Convergence or Divergence of Corporate Governance*

Many scholars have proposed reform agendas for developing securities markets in the economies in transition. The most debated approach is to introduce U.S. laws to such economies to develop a U.S.-style securities market, and doing so would be essential to

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<sup>6</sup> *Id.*

<sup>7</sup> Bratton & McCahery, *supra* note 4, at 297.

<sup>8</sup> Adnrei Shleifer et al., *supra* note 5, at 737, 769.

<sup>9</sup> Simeon Djankov et al., *The Law and Economics of Self-Dealing* (Nat’l Bureau of Econ. Research, Working Paper No. 11883), available at <http://papers.nber.org/papers/w11883>, (quoting from p. 34).

<sup>10</sup> *Id.* (quoting from p. 35).

<sup>11</sup> Rafael La Porta et al., *Corporate Ownership Around the World*, 54 J. FIN. 471, 496 (1999).

<sup>12</sup> Simeon Djankov et al., *supra* note 9, (quoting from p. 37).

<sup>13</sup> Simeon Djankov et al., *supra* note 9, (quoting from p. 38).

<sup>14</sup> Bernard S. Black, *The Legal and Institutional Preconditions for Strong Securities Markets*, 48 UCLA L. REV. 781, 783 (2001).

<sup>15</sup> Simeon Djankov et al., *supra* note 9, (quoting from p. 2).

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trigger economic growth.<sup>16</sup> While some scholars strongly suggest convergence of the corporate governance regimes to the U.S. model is a good way forward, others argue against this notion, highlighting the peculiar institutional make-up of the U.S. securities market that cannot be exported merely by changing the laws on the book.<sup>17</sup> The scholars arguing against the convergence also highlight significant and distinct socio-economic and political features of each society that may not only resist the transplanted reforms but such features may also persist. Among these scholars, some have further suggested that recognizing the deep-rooted local culture is important before embarking upon reform initiatives.<sup>18</sup>

For the transition economies, there is a desire to catch up with the western standards, often leading to the wholesale transfer of commercial laws to the transition economies.<sup>19</sup> This practice generally refers to an argument that laws matter for developing strong capital and securities markets, or the “law matters thesis.”<sup>20</sup> Many scholars suggest that convergence of this nature limits channels of corporate evolution.<sup>21</sup> Reforming corporate governance is a matter of comparative institutional analysis.<sup>22</sup> Indiscriminate mixing of legal rules may result in a dysfunctional or unbalanced system lacking certainty. The

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<sup>16</sup> Troy A. Paredes, *A Systems Approach to Corporate Governance Reform: Why Importing U.S. Corporate Law Isn't the Answer*, 45 WM. & MARY L. REV. 1055 (2004). (Quoting the works of Rafael, La Porta et al.)

<sup>17</sup> To quote a few, see generally Katharina Pistor et al., *Law and Finance in Transition Economies*, 8 ECON. OF TRANSITION 325 (2000); Bernard S. Black et al., *Final Report and Legal Reform Recommendations to the Ministry of Justice of the Republic of Korea*, 26 J. CORP. L. 546 (2001); Bernard S. Black, *The Legal and Institutional Preconditions for Strong Securities Markets*, 48 UCLA L. REV. 781 (2001); Cally Jordan, *The Conundrum of Corporate Governance*, 30 BROOK. J. INT'L L. 983 (2005); Troy A. Paredes, *A Systems Approach to Corporate Governance Reform: Why Importing U.S. Corporate Law Isn't the Answer*, 45 WM. & MARY L. REV. 1055 (2004); William W. Bratton & Joseph A. McCahery, *Comparative Corporate Governance and the Theory of the Firm: the Case Against Global Cross Reference*, 38 COLUM. J. TRANSNAT'L L. 213 (1999).

<sup>18</sup> Amir N. Licht, *The Mother of All Path Dependencies Toward a Cross-Cultural Theory of Corporate Governance Systems*, 26 DEL. J. CORP. L. 147, 203 (2001).

<sup>19</sup> Katharina Pistor et al., *Law and Finance in Transition Economies*, 8 ECON. OF TRANSITION 325, 327 (2000).

<sup>20</sup> Paredes, *supra* note 16.

<sup>21</sup> John C. Coffee, Jr., *The Future as History: The Prospects for Global Convergence in Corporate Governance and Its Implications*, 93 NW. U. L. REV. 641, 646 (1999).

<sup>22</sup> Paredes, *supra* note 16, at 1155.

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scholars have expressed serious doubt for the success of transplanted reforms without developing “complimentary institutions”<sup>23</sup> or “institutions.”<sup>24</sup>

As for the law matters thesis, its essence “is about strong shareholder property rights, as reflected in the control that shareholders are allocated over the enterprise and the legal limits that constrain managerial and directorial discretion, all pointing in the direction of ensuring that shareholders do not have their wealth expropriated.”<sup>25</sup> The law matters thesis, therefore, suggests that minority shareholders will emerge pursuant to laws safeguarding their property rights. To this extent, the law matters thesis addresses the core issue, but transplanting foreign laws into an alien legal system does not appear to be the best way to achieve this goal. The legal systems in the developing economies often have customary or religious preference and such customary or religious undercurrents may react negatively to the wholesale transplantation of the laws.

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

## **II. CORPORATE GOVERNANCE AND ISLAMIC FINANCIAL SERVICES INDUSTRY**

Generally, the developed financial markets work in a manner that encourages and supports entrepreneurial initiative by making available easy access to, and supply of, finance. The developed financial markets represent a set of institutions that complement each other and, thus, support the financial superstructure of an economy. For instance, the legal system, including the courts and lawyers, and the financial intermediaries work

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<sup>23</sup> Ronald J. Gilson, *Globalizing Corporate Governance: Convergence of Form or Function*, 49 AM. J. COMP. L. 329 (2001).

<sup>24</sup> See Paredes, *supra* note 16.

<sup>25</sup> Paredes, *The Importance of Corporate Law: Some Thoughts on Developing Equity Markets in Developing Economies*, TRANSNAT’L LAW. (forthcoming 2006) (manuscript is on file with author).

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in a sophisticated harmony to complement the efficient market. Unprecedented growth of the US securities markets is a more specific example of the coordination between the legal system and the market institutions.<sup>26</sup>

### *Continuing Growth and the Challenges Facing IFS*

Recent scholars have emphasized resolving moral hazard issues facing the IFS Industry to enhance and ensure *Shari'a*-compliant governance.<sup>27</sup> The emergence of moral hazard debate highlights the hybrid nature IFS Industry. That is, the prevalence of religious and secular norms in the IFS Industry.

The continued and future success of the IFS Industry depends not only on its compliance with *Shari'a* but also on its global competitiveness. Reaching beyond the “core group of religious depositors”<sup>28</sup> appears inevitable and requires “ambitious innovation.”<sup>29</sup> Other initiatives to be taken include “developing doctrines governing the creation and regulation of an Islamic public financial market.”<sup>30</sup> For further growth, scholars consider international and regional cooperation to be vital to enhance efficiency of the IFS Industry.<sup>31</sup> The development of supporting market institutions and standardization appears equally essential. As these institutions emerge and develop, standardization is likely to follow.

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<sup>26</sup> See generally Paredes, *supra* note 16.

<sup>27</sup> See Ibrahim Warde, *Corporate Governance and Islamic Moral Hazard*, in ISLAMIC FINANCE: CURRENT LEGAL AND REGULATORY ISSUES, HARVARD UNIVERSITY, 15-25 (Har. Law. Sch. Islamic Finance Project ed. 2005).

<sup>28</sup> FRANK E. VOGEL & SAMUEL L. HAYES, III, ISLAMIC LAW AND FINANCE: RELIGION RISK AND RETURN, 293 (1998).

<sup>29</sup> *Id.*, at 295.

<sup>30</sup> *Id.*, at 293.

<sup>31</sup> Ahmad Mohamed Ali, *The Emerging Islamic Financial Architecture: The Way Ahead*, in PROCEEDINGS OF THE FIFTH HARVARD UNIVERSITY FORUM ON ISLAMIC FINANCE, 147, 155 (Har. Law. Sch. Islamic Finance Project ed. 2002).

### *Defining Corporate Governance in Shari'a*

According to *Shari'a* scholars, the objective of corporate governance “is to ensure ‘fairness’ to all stakeholders to be attained through greater transparency and accountability.”<sup>32</sup> Agreeing on the content of the definition, the definition, however, does not help us understand how corporate governance of a *Shari'a* compliant business is different from its secular counterpart. The secular governance practices are not relevant for the transactions that a firm would do in the ordinary course of business (except for the related party, self-dealing etc. transactions). But *Shari'a* would first look at the transactional structure to see whether the transaction involves elements that invalidate the gains or profits. Corporate law, in the secular context, does perform a similar function and to ensure that the corporate transaction do not transgress upon the corporate charter and cross the line that the law has drawn. A general absence of codification that declares a non-*Shari'a* practice or transaction to be illegal *ipso facto* broadens the role of *Shari'a* governance to even the review a firm’s transactional conformity.

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

Corporate governance may have two-tier implications for its scope within *Shari'a*. Since *Shari'a* is concerned not only with the substance but also with the form of the business,<sup>33</sup> we may, for the understanding of this discussion, term the objectives of a firm’s business to be the substance, and the ways to conduct the business as its form. While scholars

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<sup>32</sup> See generally M. Umer Chapra & Habib Admad, *Corporate Governance in Islamic Financial Institutions* (IRTI Publication Management System, Jeddah, Saudi Arabia, available at <http://www.irtipms.org/PubDetE.asp?pub=93>).

<sup>33</sup> See generally, MAHMOUD A. EL-GAMAL, *ISLAMIC FINANCE: LAW ECONOMICS AND PRACTICE* (2006).

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have focused mainly on the substance of a *Shari'a*-compliant business, guidance as to the use of contemporary corporate governance best practices in the IFS industry is not specifically available. More specifically, the question would be whether the modern corporate governance practices are consistent with *Shari'a* and, if so, whether a convergence to the modern regime is likely within the IFS Industry.

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

As for the governance structure, teachings of *Shari'a* enjoin fairness and honesty to the primary principles of any conduct including transactions.<sup>34</sup> Prohibition of fraud, misstatement, misappropriation and other forms of dealings that result in exploitation and deprive someone of her/his property without consent complement the *Shari'a*-compliant financial conduct.<sup>35</sup>

Recent studies emphasize more disclosures and rights to shareholder, and strong enforcement of such rights.<sup>36</sup> Protection of minority interest is therefore considered essential for stronger capital markets. Substantive legal protections to the minority shareholders and their strong enforcement encourage the local and international investors to invest in the emerging securities markets. Safeguarding property rights, ensuring transparency and bringing about effective accountability appear to be the cornerstones of the modern corporate governance regimes.

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<sup>34</sup> See generally MUSHTAQ AHMAD, BUSINESS ETHICS IN ISLAM, 143-147 (1995).

<sup>35</sup> *Id.*

<sup>36</sup> Simeon Djankov et al., *supra* note 9, (quoting from p. 1).

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*Shari'a* has always attached similar or higher importance to such concerns for doing business. Incorporating modern and higher standards of minority protection against expropriation, more disclosures and transparency and effective accountability into the *Shari'a*-based corporate governance regimes will only assist achieving compliance with the *Shari'a* injunctions and business ethics. With this perspective and since *Shari'a* does not specify any upper limit for better regulation, the contemporary drive for accomplishing higher standards in corporate governance do not appear to be inconsistent with *Shari'a*. Accordingly, convergence to the modern corporate governance regimes is highly likely within the IFS Industry. However, a question needs to be explored whether such convergence would be more beneficial if it occurs gradually or quickly.<sup>37</sup>

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

#### *Financial Regulation: Objectives and Emerging Markets*

Non-governmental R&D support and governmental regulation have contributed significantly to the present growth of the IFS Industry. The financial regulation benefited from the non-governmental R&D initiatives that were often sponsored by various public sector agencies of the Muslim countries. However, the financial regulation for IFS Industry largely comprises the prudential banking regulation, and do not form part of

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<sup>37</sup> In this regard, an indigenized analysis by each local/national IFS market appears to be a better way to move forward.

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securities regulation. The future growth of IFS Industry in the securities markets is likely to necessitate bridging this regulatory gap.

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

Objectives for financial services regulation include protection of public investor, elimination of externalities from the failure of intermediaries, redistributive policies, equitable norms and consideration of political economy,<sup>38</sup> and “elimination of financial crime and international terrorism.”<sup>39</sup> There are three fields of financial regulation: corporate governance, securities regulation, and regulation of financial institutions.<sup>40</sup> As for the emerging markets, a combination of market institutions and regulations ensure effective corporate governance.<sup>41</sup> However, overregulation is likely to make raising capital costly.<sup>42</sup>

In the post-globalization scenario, with lowered barriers to capital and instantaneous information flow, securities markets compete and issuers choose the market on which to list their securities,<sup>43</sup> and would be subject to one set of liability standards and

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<sup>38</sup> Howell E. Jackson, *Regulation in Multisectoral Financial Services Industry*, 77 WASH. U.L.Q. 319, 332-339 (1999).

<sup>39</sup> This has been added to the list recently. See Howell E. Jackson, *Variation in the Intensity of Financial Regulation: Preliminary Evidence and Potential Implications* 12-14 (Har. Law Sch. Program on Corp. Governance, Discussion Paper No. 521 of 2005), available at [http://www.law.harvard.edu/programs/olin\\_center/papers/pdf/Jackson\\_521.pdf](http://www.law.harvard.edu/programs/olin_center/papers/pdf/Jackson_521.pdf).

<sup>40</sup> Howell E. Jackson, *Centralization, Competition and Privatization in Financial Regulation*, 2 THEORETICAL INQUIRIES L. 649, 649 (2001).

<sup>41</sup> Bernard S. Black et al., *Final Report and Legal Reform Recommendations to the Ministry of Justice of the Republic of Korea*, 26 J. CORP. L. 546, 546 (2001).

<sup>42</sup> *Id.*

<sup>43</sup> John C. Coffee, Jr., *Racing Toward the Top?: The Impact of Cross-Listing and Stock Market Competition on International Corporate Governance*, 102 COLUM. L. REV. 1757, 1759-60 (2002).

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enforcement remedies.<sup>44</sup> Taking advantage of this trend, issuers, particularly from transition economies, may raise equity capital from the market of their choice.<sup>45</sup> In this regard, listing at, for instance, the London Stock Exchange or in the US will subject the IFS firms to higher standards to corporate governance regimes and, thus, making them attractive for investment.

In addition to the legislative and regulatory measure, the stock exchanges, as frontline regulators, may improve corporate governance practices by protecting investors and maintaining the integrity of securities market.<sup>46</sup> Well-regulated stock exchanges may, therefore, make raising finance comparatively convenient in the emerging economies.

But, on listing abroad by some of the IFS firms, neither the IFS Industry in general may benefit nor the financial markets in the Muslim countries can take the advantage of the foreign investment. In the absence of sufficient legal and regulatory infrastructure<sup>47</sup> the transition economies cannot offer sophisticated and internationally competitive securities market. Owing to the lack of competitiveness of the emerging markets, the foreign investor from the developed economies might stay home.<sup>48</sup> On the other hand, the lack of international competitiveness may prompt the issuers from the emerging markets to opt out of their home jurisdictions in favor of any developed market, making it more difficult for the emerging markets to develop such competitiveness.

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<sup>44</sup> Hal S. Scott, *Internationalization of Primary Public Securities Markets*, 63 SMU LAW & CONTEMP. PROBS. 71, 71 (2000). (suggesting against the sufficient investor demand, and recommending Optimal Standardized Issuance to reduce the cost of issuance and promote healthy competition in the primary market).

<sup>45</sup> Coffee, *supra* note 43, at 1759-60.

<sup>46</sup> Robert Todd Lang et al., *Special Study on Market Structure, Listing Standards, and Corporate Governance*, 57 BUS. LAW. 1487, 1558 (2002) (suggesting that the stock exchanges should do this with the help of the stakeholders).

<sup>47</sup> This includes the use of technology for more optimal arrangements at the level of primary market. *See generally* Scott, *supra* note 44, at 71, 104.

<sup>48</sup> Frederick Tung, *Lost in Translation: From U.S. Corporate Charter Competition to Issuer Choice in International Securities Regulation*, 39 Ga. L. Rev. 525, 532 (2005).

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A. Specialized Markets

Scholars have highlighted the likelihood that different markets should specialize in trading securities of a particular type of firms.<sup>49</sup> This phenomenon may be developed in the emerging markets where firms eyeing for particular incentives invest in specialized industrial sectors. Given the nature of incentives in various sectors by the transition economies, the emerging markets may develop specialized trading expertise in the securities of a particular sector or industry. A specialized IFS securities market could therefore be the one that Muslim countries can develop.

B. Integration and Regionalization

The prediction of specialized stock exchanges serving different clienteles of listed corporations<sup>50</sup> may also occur at the regional level in the emerging markets. The divergence of investment opportunities in the transition economies may also lead to competition to attract foreign investment. Depending on the success of the foreign investment policies in specific industrial sectors, regional securities markets may develop to attract listing in the specialized sectors. Empirical evidence in this regard remains to be explored.

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

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<sup>49</sup> Coffee, *supra* note 21, at 652.

<sup>50</sup> Coffee, *supra* note 43, at 1830.

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The law of one price provides another possibility for the emerging markets to have integrated arrangements.<sup>51</sup> Before achieving regionalization or integration, the emerging markets may also consider harmonization, multi-jurisdictional disclosure system and an offshore free-zone to increase their competitiveness.<sup>52</sup>

Scholars have recommended regional cooperation among the emerging securities markets, focusing specifically on Latin America,<sup>53</sup> Sub-Saharan Africa<sup>54</sup> and Eastern Europe.<sup>55</sup> Likewise, the Middle-Eastern economies<sup>56</sup> are on their way to a regional securities market. Furthermore, to launch a world-class financial center in the Middle East, Dubai established the Dubai International Financing Center, a free-trade zone with an independent regulatory authority to oversee the activities related to the Center.<sup>57</sup> In addition to international sponsorship, a culturally sensitive regulatory framework and

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<sup>51</sup> Amir N. Licht, *David's Dilemma: A Case Study of Securities Regulation in a Small Open Market*, 2 THEORETICAL INQUIRIES L. 673, 687 (2001). (arguing, *inter alia*, that the law of one price curbs arbitrage profits—underpriced buying and overpriced selling).

<sup>52</sup> Scott, *supra* note 44, at 78 and 92. (arguing against the viability of harmonization and multi-jurisdictional disclosure system for international securities market—but recommending establishing offshore free-zone).

<sup>53</sup> Les Riordan, *Three Proposals for a Latin American Stock Exchange, Private Offshore Market, or a Computerized Financial Information Service*, 27 U. MIAMI INTER-AM. L. REV. 585 (1996).

<sup>54</sup> Evelyn Bradley, *A regional Stock Exchange: Hope for Sub-Saharan Africa Stock Markets*, 8 MSU-DCL J. INT'L L. 305 (1999); *also see* for a criticism of the strategy in this regard Charles R. P. Pouncy, *Stock Markets in Sub-Saharan Africa: Western Legal Institutions as a Component of the Neo-Colonial Project*, 23 U. PA. J. INT'L ECON. L. 85 (2002); *see*, for a general economic cooperative initiatives in Africa, Claire Moore Dickerson, *Harmonizing Business Laws in Africa: OHADA Calls the Tune*, 44 COLUM. J. TRANSNAT'L L. 17 (2005).

<sup>55</sup> William C. Philbrick, *The Paving of Wall Street in Eastern Europe: Establishing Infrastructure for Stock Markets in the Formerly Centrally Planned Economies*, 25 LAW & POL'Y INT'L BUS. 565 (1994).

<sup>56</sup> Paul A. Mackey et al., *Internal Securities and Capital Markets*, 39 INT'L LAW. 373, 373 (2005); These economies are also committed to reforming their capital markets and continue to look for the right guideline for the reforms. For instance, the Director General of “Dubai International Finance Centre” announced the establishment of a “Regional Institute of Corporate Governance to serve at improving the regional securities and financial markets. Dr. Omar Bin Sulaiman maintained:

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

For complete coverage of the above announcement, *see* <http://www.ameinfo.com/73238.html> (last visited Jan. 14, 2005).

<sup>57</sup> Paul Mackey et al., *supra* note 56, at 373-374.

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regional cooperation could promote the success of securities market in a developing country.<sup>58</sup>

Specialization, regional cooperation and an integration of securities market may be achieved by establishing the securities market exclusively for the IFS Industry.

### III. ISLAMIC FINANCIAL SERVICES SECURITIES EXCHANGE

The establishment of an IFS securities exchange will ensure a specialized provision of services and uniformity of transaction costs. Being a homogeneous market place, the securities listed at the exchange will not be affected by the liquidity and other constraints faced by any single stock exchange—that impact upon all the listed securities. The homogeneous nature of the IFS securities exchange will facilitate consistent growth with the IFS Industry. At the IFS exchange, the entrepreneurs and the suppliers of finance would be able to transact in accordance with the principles of Islamic finance.

Facilitated by Information Technology, the IFC securities exchange could be connected to the specialized secondary market open to the investors world-wide. However, a sophisticated cross jurisdictional dispute resolution mechanism would need to be in place to avoid any legal uncertainty with regard to the functioning of the exchange. The IFS securities exchange, which may be incorporated by the stock exchanges that list the IFS products or, in the alternate, set up by any willing number of the regional exchanges. The IFS Securities Exchange will serve to provide capital source within the IFS product region, in line with the investment policies of various Muslim countries. Governmental support also appears essential in this regard.<sup>59</sup> Collaboration with the international organization will provide the requisite expertise required to develop the foundational regime.

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<sup>58</sup> Jason Gottlieb, *Launching the Phnom Penh Stock Exchange, Toward a Legal Framework for Launching a Stock Exchange in an Underdeveloped Country*, 14 COLUM. J. ASIAN L. 235, 275 (2000).

<sup>59</sup> Governmental support was regarded essential also for the Sub-Saharan African regional stock market. See generally Bradley, *supra* note 54.

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Modern business institutions, including the securities markets, do not conflict with *Shari'a per se*. Rather, if their role facilitates curbing and alleviation of poverty and promotes economic welfare by enhancing the purchasing power in an economy, such institutions serve a noble purpose.<sup>60</sup> Arguments that the stock exchanges favor the rich and encourage monopoly by the corporations and discourage the small enterprise,<sup>61</sup> and present a place for the insider trading and excessive transaction costs may be defended. While agreeing that insider trading is a form of exploitation—and no financial market can prosper in its presence—it is essentially a regulatory issue and a better regulatory response can effectively counter such practice. Furthermore, the transaction costs (in particular, the service charges for financial intermediation) represent someone's labor and expertise, which attach credibility to an issue and maximizes chances of success in the market, and the agreed price for service or labor appears in accordance with *Shari'a*. However, there may be discouraging effects of excessive transaction costs on small enterprises. But that too would be an economic policy and regulatory issue, and not the one that could affect the transaction costs' legitimacy in *Shari'a*. As a measure to promote the small enterprise, a suggestion for a specialized market or a stock market for small businesses appears apt.<sup>62</sup>

For an Islamic stock market, transactional transparency and absence of market manipulations, short selling, insider trading, contra deals and excessive financial exposure are essential, because scholars view such practices as immoral or unethical.<sup>63</sup> Transactional transparency and compliance with *Shari'a* also applies to the market participants and, as argued, include the fair intentions to carry out the transaction.<sup>64</sup>

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<sup>60</sup> AHMAD, *supra* note 34.

<sup>61</sup> LEADING ISSUES IN ISLAMIC BANKING AND FINANCE 143-151 (Saad Al-Harran ed., 1995).

<sup>62</sup> *Id.*

<sup>63</sup> Datuk Dr. Syed Othman Alhabshi, Toward an Islamic Capital Market, *available at* <http://vlib.unitarklj1.edu.my/staff-publications/datuk/Nst19feb93.pdf> (last visited on Apr. 20, 2006).

<sup>64</sup> *Id.*

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The establishment of IFS securities exchange may also seem closer to the objectives of *Shari'a* for its potential to spread the financial benefits to a greater number of population in a society.

## CONCLUSIONS

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

The IFS Industry is successfully crossing the conceptual barriers and will, hopefully, attain the market efficiency that comes essentially with the continuation of a business entity, despite the fact that continued business entities did not exist in Muslim countries.<sup>65</sup> The scholars have provided guidelines for organizing limited liability business organizations including the form of a modern corporation.<sup>66</sup> However, the role of a corporation in society still needs further examination in light of *Shari'a*. The question of whether a corporation serves the society from its profits or serves solely the interests of its shareholders needs scholarly response. A socially responsible corporation may yield lesser profit to the shareholders and this feature is likely to affect its competitiveness. Without fully resolving such issues, the Islamic financial markets are far from a reality.

The Findings of the Islamic Capital Task Force noted that Islamic capital market is a part of global securities markets and its regulation is needed to nurture and support its growth, and that for its regulation should comply with IOSCO's Objectives Principles.<sup>67</sup> The findings noted absence of any international body providing directions on the Islamic

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<sup>65</sup> Timur Kuran, *The Absence of the Corporation in Islamic Law: Origins and Persistence*, available at <http://ssrn.com/abstract=585687> (last visited on March 30, 2006).

<sup>66</sup> IMRAN AHSAN KHAN NYAZEE, *ISLAMIC LAW OF BUSINESS ORGANIZATIONS: CORPORATIONS* (1998).

<sup>67</sup> International Organization for Securities Commissions, Report of the Islamic Capital Market Task Force (July 2004), available at <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD170.pdf>.

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capital markets issues and emphasized convergence of divergent *Shari'a* interpretations.<sup>68</sup> However, efforts to streamline the divergence are under way and it remains to be empirically examined if any particular school of *Shari'a* interpretation is becoming more popular and what might be the possible repercussions for such preferences, if such preferences exist.

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<sup>68</sup> *Id.*