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Matthias Casper

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Abstract

Islamic Finance has been growing at annual double-digit rates for about 40 years although even in conservative Islamic countries the Sharia with its prohibition of interest (*ribâ*) is not directly applicable law. Islamic Finance is voluntary and encompasses all kinds of financial services that are conducted without breaching the rules of the Sharia, although the contract itself is subject to a secular (national) jurisdiction. The paper analyses the coexistence of secular and religious law in the context of Islamic Finance and focuses on Sharia Supervisory Boards. These Boards, generally composed of three Sharia Scholars, proof to investors that their business conducts of an Islamic financial institution or at least their financial products are Sharia-compliant. Metaphorically speaking, Sharia Supervisory Boards have become a "transformational conduit" between the religious laws and the investor, who has chosen to adhere to its principles, although there is no obligation for him to do so in a secular jurisdiction.

The article analyses the most important functions of Sharia Supervisory Boards (SSB) as there are: the certification, the supervisory and the advisory function. Afterwards it will be shown, that Sharia Supervisory Boards can be embedded into the European understanding of Corporate Governance, if the management of the Islamic financial institution remains independent. Other questions in the context of Corporate Governance like the independence of the SSB from the Management or conflicts of interests by dual mandates in a SSB will be discussed as well. Besides the external SSB Islamic financial institutions set up an internal sharia review (Sharia Compliance Department). It will be discussed whether this internal body can be integrated into the regular Compliance Department.

Since there is no uniform interpretation of the Sharia, there is a risk that the Sharia-conformity of a product will be contested (Sharia Risk). Therefore will be analyzed whether it is appropriate if either the investor or the bank/issuer are required to bear the entire risk of non-compliance unilaterally by themselves. It will be discussed if prospectus liability is applicable and indemnification clauses are valid.

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I. Introduction

According to one of the Hadith, the prophet said: "Gold for gold, silver for silver, wheat for wheat, barley for barley, dates for dates, and salt for salt - like for like, and hand-to-hand. Whoever pays more or takes more has indulged in *ribâ*. The taker and the giver are alike [in guilt].[1]. Read in conjunction with the Koranic verse that Allah permits commerce but prohibits usury (*ribâ*) (Sura 2, vers 275), the prohibition of *ribâ* has been a subject of controversies for centuries. However, this paper does not aim to discuss the logic behind the prohibition of *ribâ*, because it remains a fact that to this day, millions of Muslims worldwide obey the prohibition of charging interest.[2] Therefore, they are looking for financial products that are Sharia-compliant. This means investment forms that are compatible with the principles of the divine law. In reaction to this, the so-called Islamic Banking has been growing at annual double-digit rates for about 40 years. Worldwide, an entire Islamic financial sector has developed, even in *diaspora* countries such as Great Britain.

The question that comes to mind is whether Islamic prohibition of interest applies in secular countries such as Great Britain. This question is, however, misleading. Even in conservative Islamic countries *Sharia* law is not directly applicable law. Especially the areas of civil and commercial law are usually governed by public, i.e. 'state made', law, which usually does not prohibit interest. Islamic Banking is voluntary in all countries but Iran and Sudan. Therefore, Islamic Finance can be defined as follows: It encompasses all kinds of financial services that are conducted without breaching the rules of the *Sharia,* although the contract itself is subject to a secular (national) jurisdiction.[3] There are no known examples where Islamic religious law was chosen as the governing law of a contract.

Regarding the coexistence of secular and religious law in the context of Islamic Finance, one can distinguish three models:

(1) Exceptionally, a state will declare religious laws to be directly applicable (e.g. in Sudan or Iran) or to be – like in Pakistan – examination criteria for all statutes enacted by the state. (2) The second model can be found in many Arab Gulf States. The Kingdom of Bahrain, one of the most important financial hubs for Islamic Finance, stands *pars pro toto*. These countries are characterized by a dualism of conventional banks and Islamic banks. The regulatory law currently puts Islamic banks in a separate category, which is supposed to safeguard that so-called *Islamic full-service-banks* comply with the objectives and principles of Islamic law. For conventional banks that offer both Islamic and regular financial products (so-called

[1] Narrated in major Hadith collections. For references see e.g. *Lohlker*, Das islamische Recht im Wandel, Münster 1999, p. 30.
[2] For the discussion on *ribâ* see e.g. *Saeed*, Islamic Banking and interest, Leiden 1999, pp. 41.
[3] *Casper*, in: Jansen/Oestmann, Gewohnheit. Gebot. Gesetz, Tübingen 2011, pp. 301, 305.

Islamic Windows), this framework aims to ensure that at least the Islamic products are in compliance with the Sharia.

However, this task is not exercised by the regular supervisory authority or another governmental agency. Instead, this supervisory function is delegated to the financial institution itself. The financial institution is obliged to establish a *Sharia Supervisory Board* (also shortened as *Sharia Board*), which has the duty to supervise the bank and confirm that its products and operations are in compliance with the precepts of the Sharia.[4] Sharia Boards are composed of Islamic legal scholars (so-called Sharia scholars) versed in economic and financial matters. They are paid but not employed by the company. The establishment of Sharia Boards has thus become a statutory duty, making them an integral part of the Islamic Finance architecture today.

(3) The situation is again different in countries with a predominantly non-Muslim population, such as the member states of the European Union.[5] These countries are not interested whether an Islamic bank operates in a Sharia-compliant way or not. Islamic banks in these countries may establish Sharia Boards but there is no legal obligation. If they do choose to offer Islamic financial products, however, they may find it necessary to provide proof to their investors that their business conduct or at least their financial products are Sharia-compliant – for marketing purposes and beyond. Metaphorically speaking, Sharia Boards have become a “transformational conduit” between the religious laws and the investor who has chosen to adhere to its principles, although there is no obligation for him to do so in a secular country. The prime example for this model is Great Britain with its five Islamic banks. Germany may follow as soon as Islamic banks have gained a foothold here. A decision of the German Federal Financial Supervisory Authority (BaFin) on the application of Kuveyt Türk to establish the first fully Sharia-compliant bank in Germany is expected soon. Until now, there has been little demand for Islamic Finance among German Muslims.

This short overview has shown that the Sharia Board and the Sharia Compliance Departments within the financial institutions play an important role. Problems with Sharia Boards and Sharia Compliance Departments in the context of Corporate Governance. In a first step, the functions of a SSB will be explained and the differences to a Sharia Compliance Department. After a short presentation of the rules set forth by the AAOIFI and the IFSB for good governance of a Sharia Board, the focus will be on the question whether these rules are compatible with a “European” understanding of good Corporate Governance of financial institutions. It is important to highlight that when ‘European Corporate Governance’ is mentioned in this paper,

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[4] For example, according to the Central Bank of Bahrain Rulebook Vol. 2 Part A, HC 9.2.1 Islamic banks are required to “establish an independent Sharî‘a Supervision Committee complying with AAOIFI's governance standards for Islamic Financial Institutions No. 1 and No. 2”, available on http://cbb.gov.bh.

[5] For an overview of regulatory issues with regard to Islamic Finance in various EU countries, see *Khan, M. F. / Porzio, M.*, Islamic Bankig and Finance in the European Union, Cheltenham 2010.

reference is not made to a European Corporate Governance Codex, a subject which has been brought up in the recent Green Book on Corporate Governance from April 2011 and the Green Book on Corporate Governance for Financial Institutes from 2010. Instead, the term European Corporate Governance is used in the sense of the common understanding of Corporate Governance in most member states of the European Union, especially in Germany or the UK.

In a last step, the paper concentrates on the integration of internal Sharia Compliance into the context of European Corporate Governance.

II. Definition and Function of Sharia Boards

1. Overview

It is self-evident that the large number of Sharia Board worldwide makes a uniform understanding of Sharia-compliant banking transactions impossible. There are two non-governmental-organizations that mainly contribute to a standardization of Islamic Finance. Besides the *Accounting and Auditing Organization for Islamic Financial Institutions* (AAOIFI), domiciled in Bahrain, the *Islamic Financial Services Board* (IFSB)[6] domiciled in Malaysia plays an important role with Kuala Lumpur being the second biggest center for Islamic Finance worldwide. Although none of these two big standard-setting organizations explicitly admits to following one of the four Sunni schools of law[7], these schools play an important role in deciding whether a financial product is Sharia-compliant.[8]

These organizations have enacted a large number of standards, similar to the German Corporate Governance Codex, which Islamic banks may not be legally obliged to follow but which are usually complied with by the banks. Therefore, the standards are typical for soft-law. There is an exception, however, for some states from the aforementioned 'model 2'-category. The regulatory law in Malaysia and Bahrain refers to some of these standards and therefore requires Islamic banks to follow their principles.

These principles will be looked at later when discussing whether they are compatible with a European understanding of Corporate Governance.

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[6] The IFSB expresses its self-understanding on its homepage: „The Islamic Financial Services Board (IFSB) is an international standard-setting organization that promotes and enhances the soundness and stability of the Islamic financial services industry by issuing global prudential standards and guiding principles for the industry".

[7] The schools of law which are named after their founders are the *Hanafi*, *Shafi`i*, *Hanbali* and *Maliki* schools. For a detailed overview on the emergence and nature of these schools see e.g. *Hallaq*, An Introduction to Islamic Law, Cambridge 2009, pp. 31.

[8] For more Details see *Casper*, Corporate Finance Law, 2012, 170, 172.

2. Functions

The Sharia Board most important function is that of certification. This refers to the function of supervising the conformity of financial products with the Sharia law (see above I.). Normally, there are three Sharia scholars on the board which then examines the financial product. The process is often not very transparent. After examination, the SSB issues a *Fatwa* (legal opinion), in which the board confirms or negates compliance with the Sharia. A *Fatwa* is not considered a source of Islamic law.[9] Depending on the authority of the respective legal scholar, it can, however, be binding for devout Muslims. A popular example will be presented further below. Furthermore, the *Fatwas*, which are usually written in or at least translated into English, will often be published on the internet, thereby making them available to a wider public. However, the reasoning and arguments are usually not disclosed in the Fatwa. Consequently, Sharia Board requires further analysis.

The certification function is accompanied by a supervisory function, which is especially important for Islamic banks. This function is already discernible from the name: *Sharia Supervisory Board* (SSB). In the case of an Islamic bank, the board will monitor the entire business organization to ensure that it is in accordance with the principles of Islamic law. In this context, the AAOIFI Sharia standards – and some of the Sharia related principles of the IFSB – play an important role. For example, an Islamic bank is not allowed to invest in companies with unlawful (under religious law) business objectives. This includes alcohol or pork manufacturers or the publishers of certain dirty magazines. Some Sharia scholars even prohibit investments in any kind of entertainment media[10] because, as they state, „there is always something indecent with it."

But it is not the task of the SSB to monitor the liquidity management or profitability of a business. This is the task of the regular Supervisory Board or the Board of Directors of the bank.

The third function of the Sharia Boards is usually called the advisory function. This term is correct insofar as the management often seeks the advice of the Sharia Board before introducing a new product to the market, developing a new financial product, establishing new funds or developing a new investment policy. To this extent, the Sharia Board indeed exercises a certain advisory function. Nevertheless, just as the regular Supervisory Board, the Sharia Board only meets two to four times a year. Therefore, it is de facto unavailable for ongoing consulting. The advisory function

[9] For the institution of *fatwa* and its applicability see *Hallaq*, The Origins and Evolution of Islamic Law, Cambridge 2005, pp. 62, 88-89; *Rohe*, Das islamische Recht, 2009, S. 74 f.; *Krawietz*, Der Mufti und seine Fatwa, Die Welt des Orients 26 (1995), pp. 161-180.

[10] See e.g. Dow Jones Islamic Market Indexes Rulebook, p. 4, http://www.djindexes.com/mdsidx/downloads/rulebooks/Dow_Jones_Islamic_Market_Indices_Rulebook.pdf (accessed 07 October 2012).

could also come into conflict with the board's certification and supervisory functions. For this reason, the IFSB in particular recommends the establishment of an internal Compliance Department in addition to the Sharia Board.[11] This department is then responsible for the day-to-day questions of compliance with religious principles. Sometimes banks will solely rely on internal consultants. But even though these consultants, often people with a background in finance, will usually be well versed in questions of Islamic law, there is still a great difference to the Sharia Board. The internal consultants are not legal scholars and therefore cannot issue a Fatwa. In practice, Sharia Boards and internal consultants coexist. When it comes to aspects of applicability of legal norms and the role of the "transformational conduit", however, the external Sharia Board is the solely relevant institution. This is why it is important to analyze its compatibility with European Corporate Governance.

In order for Sharia Boards to fulfill the above mentioned functions, three models exist to integrate the sharia advisor into a financial institution.

(1) Theoretically, one could discuss the integration of sharia scholars into the Managing Board or the Board of Directors. But usually Sharia scholars would not be willing to take upon a full-time job for only one Islamic financial institution. Also, the institute itself will only be interested in receiving the occasional certification or advice from the scholar but not in having a scholar be a permanent board member. Although some of sharia scholars also have a background in finance, they normally do not possess the necessary qualifications for board membership of a financial institution (so-called "fit-and-proper-test").[12]

(2) For this reason, it is quite common for the Sharia scholars to organize themselves in a separate board which then exists alongside the Board of Directors. According to the AAOIFI Governance Standard for Islamic Financial Institutions No. 1 (1997), the Sharia supervisory board should be an independent body of legal scholars specialized in fiqh al-mua'malat (Islamic commercial jurisprudence) (Governance Standard No. 1 sub. 2). Additionally, the principles state that "every Islamic financial institution shall have a Sharia supervisory board to be appointed by the shareholders in their annual general meeting upon the recommendation of the board of directors" (No. 1 sub. 2). And, "[t]he Sharia supervisory board shall consist of at least three members. The Sharia supervisory board may seek the service of consultants who have expertise in business, economics, law, accounting and/or others" (No. 1 sub. 7).

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[11] See IFSB, Guiding Principles on Shariah Governance Systems for Institutions offering Islamic Financial Services, December 2009, Introduction, margin number 5; See also AAOIFI's Governance Standards No. 3: "The Shari'a review function may be located in the Internal Audit function of the bank."

[12] For more details see *Casper*, Festschrift für Klaus Hopt, 2010, pp. 457, 471 et seq.

From a German point of view, an SSB can be qualified as an advisory council (*Beirat*), which is, however, unfamiliar to the German Stock Corporation Act (AktG). Due to sec. 23 subsec. 5 AktG, the majority in the German literature assumes that the establishment of an advisory council is prohibited as there is no room for another supervisory body beside the Supervisory Board (*Aufsichtsrat*).[13] But this discussion – for my understanding – does not apply to the Sharia Supervisory Board. If there is a clear separation between the responsibilities of both organizations, and if the board of directors is still responsible for all decisions regarding the bank, there is no reason to qualify an SSB as an advisory council (*Beirat*). This issues will be further analysed below.

(3) Apart from the external SSBs, there are often internal Sharia Advisors or whole departments called Sharia Compliance Departments as already mentioned above briefly. According to No. 3 of the AAOIFI Governance Standard (1999), there is a duty to establish an internal Sharia compliance system: "The internal Sharia review shall be carried out by an independent division/department or part of the internal audit department, depending on the size of an Islamic financial institution (IFI)" (Governance Standard No. 3 sub. 2). "The internal Sharia review is an integral part of the organs of governance of the IFI and operates under the policies established by the IFI." (No. 3 sub. 3). "The head of the internal Sharia review shall be responsible to the board of directors." (No. 3 sub. 7).

This sounds similar to regular Compliance Departments whose establishment is mandatory for all financial institutions in the EU (see Art. 13 MiFID). But the difference is the same as that between the SSB und the Supervisory Board (*Aufsichtsrat*). The Sharia Compliance Department is exclusively concerned with breaches of Islamic law. In contrast, the regular compliance department has to ensure compliance with all laws and regulations governing the financial institution.

III. SSBs in the Context of European Corporate Governance

In comparative Company Law, Corporate Governance is understood as the objective of ideal and efficient administration of good management and controlling. To this extent, the existence of a religious "guardian council" is a clear alien element. On the other hand, there is no need to throw in the towel when keeping in mind the following aspects. Firstly, a too extensive influence by the Sharia Board has to be

[13] *Mertens,* in: Kölner Kommentar zum AktG Vor § 76 Rn. 28; *Habersack,* in: Münchener Kommentar zum AktG § 95 Rn. 6; *Hoffmann-Becking,* in: Münchener Handbuch zum Gesellschaftsrecht, tome 3: AG, 3rd ed. 2007, § 29 Rn. 19a.

avoided as the bank's Executive Board must bear the ultimate responsibility for corporate actions[14] and it must remain independent from the SSB.

Secondly – and more importantly – the Sharia Board must meet three requirements in order to fulfill its certification and supervisory function while at the same time complying with our requirements for good corporate governance: (1) the board's independence from the corporate management, (2) the members' expertise and (3) the avoidance of conflicts of interest due to being dependent on the Company or due to dual mandates.

1. Independence of the Board of Directors (or the Managing Board)

From the German legal perspective, the ultimate responsibility of the Executive Board is a basic principle of company law as well as of regulatory law.[15] Hence, the Sharia Board's decisions cannot be binding for the company. Even if its decisions may be factually binding, legally the ultimate decision has to be made by the Executive Board of the respective bank, which bears the sole responsibility for a company's business policy.

Casting a quick glance at the Arabic countries, a different image becomes apparent. The English translation of Art. 58(a) sentence 2 of the Jordanian Banking Code reads as follows: „The board shall comprise not less than three members and its opinion shall be binding on the Islamic bank." The AAOIFI Principles on Corporate Governance – which are binding for example in Bahrain – use a very similar phrasing.[16] A different approach can again be found in Great Britain. English regulatory law allows freedom of legal arrangement and does not prescribe the establishment of a Sharia Board. But the Financial Services Authority (FSA) demands proof from Islamic institutions that, if a Sharia Board is installed, it only exercises an advisory function and does not interfere with the management of the institution. In an explanatory paper it is stated as follows: „The key point from the FSA's perspective is that firms can successfully show that the role and responsibilities of their SSB are advisory and that it does not interfere with the management of the firm."[17] It then goes on to state that this principle has worked for the existing Islamic banks in Great Britain. This is the path that the German regulatory law should also follow as long as no specific regulations for Islamic financial institutions exist. It would ensure that the general principles of banking regulation are adhered to.

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[14] For a more detailed analysis see *Casper*, Festschrift Hopt, 2010, pp. 457, 472; *Sorge*, ZBB 2011, 363, 365 f.

[15] See for example *Sorge*, ZBB 2010, 363, 365 f. with further references.

[16] AAOIFI, Governance Standard for Islamic Financial Institutions No. 1, sec. 2.

[17] FSA, Islamic Finance in the UK: Regulation and Challenges, November 2007, www.fsa.gov.uk/pubs/other/islamic_finance.pdf, p. 13.

Even if there will be no specific rules in German regulatory law on Islamic financial institutions in the near future, an Islamic financial institution located in Germany needs to take precautionary measures to avoid that the decisions of the SSB become formally or factually binding. First of all, clear rules regarding the duties and responsibilities of the SSB are important. It should be clear that the SSB has no direct influence on the decisions of the Managing Board. If the SSB objects to specific financial products or work processes within the financial institution and regards them as non-sharia-compliant, it should highlight different ways to solve the problem so that the Managing Board can choose between different alternatives.[18] In this context, one could resort to the principles set forth by the German Federal Court of Justice as to when consulting by an auditor is still deemed acceptable within the boundaries of sec. 319 subsec. 3 no. 5 Commercial Code (HGB). According to the Federal Court of Justice, the auditor may present alternatives on how to proceed to the Managing Board but he may not make the ultimate decisions himself.

2. Independence of the SSB

From the German and the European perspective, it does not seem to be problematic that the two trendsetters in Islamic Finance, the AAOIFI and the IFSB, demand that Sharia Boards should be independent from the financial institution and should not be subject to instructions from the company.[19] However, it has to be rejected that the Sharia Board should be committed to the common good at the same time. This would privilege Sharia-compliant investment products over their conventional counterparts.

Nevertheless, there are no legal obstacles hindering the Sharia Board from acting not only in the interest of the bank but also in that of the investor. It could be said that the investor's interest to receive a Sharia-compliant investment product is not merely an insignificant "sentimental value". Rather, private autonomy also means that one can choose financial products that are compliant with personal ideals and beliefs. The assumption that the Sharia Board also acts in accordance with the interest of the investor is consistent with the aforementioned view that the Sharia Board assumes the function of a "transformational conduit" between religious laws and the investor.

According to the principles of AAOIFI, the members of a Sharia Board should be elected by the general assembly (Governance Standard No. 1 sub. 3). From the angle of German Corporate Governance, this is acceptable but not necessary. Due to the qualification of the SSB as an advisory board that reports to the Managing Board or

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[18] For more Details see *Sorge*, ZBB 2010, 363, 367 f.

[19] IFSB Principle 3.1. (ref. 11) margin number 40 ff.; margin number 29 stresses, however, the responsibility towards shareholder interests; see AAOIFI Standards (ref. 16) No. 1 sec. 2, No. 5, sec. 2-7 with more emphasis on the independence. See also *Abd Jabbar*, Company Lawyer 2009, 243, 244.

the Board of Directors, it would also be thinkable that the Board of Directors or the Managing Board elects the members of the SSB together with the Supervisory Board.

3. Qualification and Conflict of Interests

At first glance, the Sharia Board members' expertise seems to be a trivial requirement. The devil, however, is in the details. First of all, a member should not only have a sound understanding of Islamic law but should also have an adequate knowledge in finance. The latter is easy to assess, as one could require a degree in economics or finance or corresponding work experience. In contrast, there is no standardized education for scholars of Islamic law (*Sharia scholars*).

Consequently, there are only a very small number of qualified scholars with a sufficient background in economics or finance.

With qualified scholars being in short supply, one can observe a strong concentration on certain individuals. According to a survey by funds@work, *Nizam Yaqubi*, one of the most popular scholars, is a member in 85 (!) Sharia Boards at the same time.[20] If the same people sit on the boards of different, competing companies, this obviously implies a risk of conflicts of interests. Therefore, there are many reasons for new regulatory principles aimed at avoiding such an extensive accumulation of mandates. From the German perspective, one could refer to the rules for the Supervisory Board (sec. 100 subsec. 2 AktG) whereupon an individual is not allowed to hold more than 10 mandates in different Supervisory Boards. At the "Deutscher Juristentag" in September 2012 in Munich a plea was made to reduce this number to six.[21] Of course, the discussion regarding sec. 100 AktG does not hold the same weight with regard to Sharia Boards as the work load of the members of an SSB is not as extensive. However, 85 mandates are not acceptable under any circumstances. More importantly, a clear rule is needed to avoid conflicts of interest. If a scholar within the SSB is only concerned with the certification of Islamic financial products or the business process of an Islamic financial institution, it is not necessary to ban a membership in the board of a competing Islamic financial institution. But if the advisory function of the SSB plays an important role, there should be rules of incompatibility for the membership in SSBs of institutes that are in direct competition. The advisory function should primarily be fulfilled by the internal Sharia Compliance Department or Officer and not – at least not primarily – by the external SSB.

[20] See report by funds@work, The Small World of Islamic Finance - Shariah Scholars and Governance, 19 January 2011, http://www.funds-at-work.com/uploads/media/Sharia-Network_by_Funds_at_Work_AG.pdf_03.pdf.

[21] Beschlüsse der wirtschaftsrechtlichen Abteilung des 69. DJT Nr. 18, available under www.djt.de.

IV. Internal Sharia Compliance Systems in the Context of European Corporate Governance

The discussion on regular Corporate Compliance and Corporate Governance is still in the early stages.[22] One main question is whether non-financial listed stock corporations have the duty to establish a Compliance Department to prevent breaches of law.[23] But this question is not important in our context, because all Islamic Financial Institutions located in the EU indubitably have such an obligation to establish a Compliance Department, as governed by Art. 13 MiFID or section 33 German Securities Exchange Act (WpHG). Although the law speaks of “compliance functions” this can be understood as a duty to provide for a specific Compliance Department that reports directly to the Managing Board.

The question must be whether the principles of the AAOIFI on internal compliance are compatible with our understanding of compliance systems and whether the Sharia compliance function can be integrated into an existing regular Compliance Department.

According to the AAOIFI Standards “the internal Sharia review shall be carried out by an independent division/department or part of the internal audit department, depending on the size of an Islamic financial institution (IFI). It shall be established within an IFI to examine and evaluate the extent of compliance with Islamic Sharia rules and principles, fatwas, guidelines, and instructions issued by the IFI’s Sharia supervisory board” (No 3. sub 2 part 1).” The first question that arises in this context is that of the independence of the Sharia Compliance Department. This requirement is already well known in the context of Corporate Compliance for financial institutions. In section 33(1) cl. 2 no. 1 of the WpHG, three requirements for the Compliance Department (called “compliance function” in the WpHG) within an investment services companies are listed: independence, effectiveness and permanence. But ever since the Circular Note on Compliance (MaComp)[24] by the Federal Financial Supervisory Authority (BaFin) it has been accepted that the members of the Compliance Department are independent from everyone but the Management Managing Board, which is responsible for the whole enterprise including compliance to all legal duties and therefore also the Compliance Department. To put it metaphorically: The Chief Compliance Officer is not a Janus-faced body who is obliged to protect both the interests of the company and those of the public – or in our context those of Allah. In other words, the Compliance

[22] For an overview see e.g. *Casper,* in: du Plessis/Großfeld/Luttermann/Saenger/Sandrock/Casper, German Corporate Governance in International and European Context, 2nd ed. 2011, pp. 359.
[23] Denying *Casper* (supra note 22), pp. 363.
[24] Circular 4/2010 (WA) – *Mindestanforderungen an die Compliance-Funktion und die weiteren Verhaltens-, Organisations- und Transparenzpflichten nach §§ 31 et seq WpHG für Wertpapierdienstleistungsunternehmen (MaComp)* from 7 June 2010, available under http://www.bafin.de/cln_179/nn_722758/SharedDocs/Veroeffentlichungen/DE/Service/Rundschreiben/2010/rs__1004__wa__*MaComp*.html.

Department does not constitute a branch of the police department or the prosecutor within the company.

From this point of view, another rule within the AAOIFI Governance Standards may be problematical: "The primary objective of the internal Sharia review is to ensure that the management of an IFI discharges their responsibilities in relation to the implementation of the Shari'a rules and principles as determined by the IFI's SSB." (No. 3 sub 2 part 2). "They shall have direct and regular communications with all levels of management, SSB and external auditors, which shall enhance the organizational status of the internal Sharia reviewers." (No. 3 sub 7). But on the other hand the principles of the AAOIFI clarify that: "The head of the internal Shari'a review shall be responsible to the board of directors." (No. 3 sub 7). And later on it is pointed out: "The head of the internal Shari'a review shall discuss conclusions and recommendations with appropriate levels of management before issuing a final written report." (No. 3 sub 20). This report has to be written four times a year and is addressed to the SSB as well.

This confirms that, even according to the principles of the AAOIFI, the internal Sharia Compliance Department falls under the responsibility of the Board of Directors or the two boards in the two-tier system. Compliance is a management task and not a public matter. The Sharia Compliance Department cannot be an extended arm of the SSB. The internal department does not automatically report potential breaches of Islamic law directly to the SSB. If these basic principles are accepted, there is no reason why the Sharia Compliance Department could not be integrated into the regular Compliance Department. But it would be helpful if guidelines for the Compliance Department clearly set out the differences between the actions required by breaches of public and religious law, because the consequences are quite different.

V. Sharia Compliance and Sharia Risk

In a last step, the so called "Sharia risk" shall be analyzed. In early 2008 a very controversial debate arose on the question whether the issuer of a Sukuk (also called Islamic Bond) was allowed to guarantee the return of the invested capital. The originators behind the Special Purpose Vehicles (or external guarantors such as banks) had previously relieved the investors from any risks regarding the invested money. It was promised to the investors that they would get their invested money back at the end of the transaction. This practice was eventually permitted by many Sharia Boards.

In spring 2008, Sheikh Mohammed Taqi Usmani, who is the chairman of the Sharia Board of AAOIFI, entered the discussion and issued a Fatwa (legal opinion) in which he rejected these Sukuk-constructions which were equity-like in theory but in fact had debt-like features. In his opinion, there were no "entrepreneurial risks" for the investor. This was regarded as a violation of the principle of profit and loss sharing. As a reaction, the AAOIFI quickly updated its standards and also prohibited such constructions. The sale of the respective Sukuks on the secondary market became difficult and as a result, their price made a deep plunge.

What is the legal implication of such a scenario? Or to put it more precisely: Is there prospectus liability if the Sharia-conformity of a product is not given, either from the very beginning or later during the life-cycle of the Sukuk?[25]

The constellation, in which the lack of Sharia-conformity was certain ex ante or at least clearly foreseeable at the time of issuing the Sukuk, is clear. Prospectus liability is triggered in this constellation.

An interesting question to be addressed is whether the issuer could expressly exclude liability with a disclaimer.

Sukuk prospectuses usually contain a recommendation that investors and potential investors should obtain information independently and consult their own Sharia advisors or similar reliable sources with regard to the conformity of the product with Sharia principles. Then the following disclaimer is included: "There is ... a risk that the status of Sharia compliance may change over time. The Company assumes no liability with respect to such changes."

Is such a disclaimer lawful? Addressing this question again leads to the crucial question: Who should bear the risk regarding the correct interpretation of religious laws? On the basis of German prospectus law, it can be suggested that the investors have voluntarily submitted themselves to the religious law which needs to be interpreted and is characterized by a diversity of opinions. Furthermore, the investor often knows and accepts that the prospective profit yield of a Sharia-compliant product might be lower than the market standard. Consequently, it would not be appropriate to shift the Sharia-risk entirely to the bank, issuer or Investment Company. On the other hand, the bank, issuer or mutual fund of course gains a financial advantage from the assumption of the Sharia-compliance of a product. Therefore, it would not be convincing to exempt the bank, issuer or fund from any liability.

As it is often the case, the solution is to be found in the middle. An indemnification clause or disclaimer is acceptable if the classification as Sharia-compliant by the Sharia Board is a legitimate interpretation within the boundaries of Islamic law. Only if there is a clear breach of Islamic law, i.e. in extreme cases, should the bank or issuer be liable for the incorrect prospectus. However, it seems feasible that an

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[25] See *Casper*, Festschrift für U. H. Schneider, 2011, pp. 229, 242 and *Casper,* Die Rechtswissenschaft 2011, 251, 267.

indemnification clause for Islamic financial products, whose religious legitimacy is in dispute among the different schools of law, is only valid if this dispute is pointed out within the prospectus. For example, a prospectus for a certain Islamic financial product could state that the certification as Sharia-compliant by the Sharia Board is based on the views of the Shafi'i school of law but is not necessarily accepted by all Muslim communities.

VI. Conclusion and Summary

As shown above: Sharia Supervisory Boards and European Corporate Governance are not like fire and water. They can be brought in line if the following eight guiding principles are observed.

1. Islamic Finance is voluntary.

2. Islamic Finance is not synonymous with the implementation of religious law. Although an Islamic Financial contract may be constructed in the view of the Islamic Law,[26] the relevant contracts are governed by secular state-made laws but at the same time the financial products are compatible with religious principles. Sharia Boards serve as a "transformational conduit" between religious law and the investor who wishes to adhere to its principles.

3. This objective is achieved through certification by the Sharia Boards. While this is the Board's most important function, it also fulfills a supervisory and an advisory function.

4. Sharia Boards can be embedded into the European understanding of Corporate Governance. For that, the management of the Islamic financial institution has to remain independent. Formal binding decisions of the Sharia Board – like required by the AAOIFI in their Corporate Governance Principles – are not compatible with European Corporate Governance. Only the Board of Directors or the Managing Board is ultimately responsible for the financial institution. The independence of the Sharia Board from the Management on the other hand does not pose a problem with regard to European Corporate Governance.

5. The number of mandates a single Sharia Scholar may hold should be limited. But the goal is not to stipulate a specific number but rather to avoid conflicts

[26] This is a consequence of the private autonomy, for more details see *Casper* Die Rechtswissenschaft 2011, 251, 257 et. seq. – also to the applicability of the frustration of the contract (§ 313 German Civil Code).

of interests, especially if the respective Sharia Board also serves as an advisor to the management.

6. It is preferable if the advisory function is mostly fulfilled by an internal Sharia Compliance Department. The internal Sharia review may be integrated into the regular Compliance Department as long as the Management continues to hold the sole responsibility for the financial institution and the internal Sharia Chief Compliance Officer does not report directly to the Sharia Supervisory Board.

7. Since there is no uniform interpretation of the Sharia, there is a risk that the Sharia-conformity of a product will be contested (Sharia Risk). It is not appropriate if either the investor or the bank/issuer are required to bear the entire risk of non-compliance by themselves.

8. Prospectus liability is confined to extreme cases of obvious breaches of the Sharia principles. An indemnification clause or a disclaimer is acceptable if the classification by the Sharia Board is a legitimate interpretation within the commonly accepted boundaries of Islamic law.