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## **Ethics: Inherent In Islamic Finance Through Shari'a law; Resisted In American Business Despite Sarbanes-Oxley**

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## NOTE

### ETHICS: INHERENT IN ISLAMIC FINANCE THROUGH SHARI'A LAW; RESISTED IN AMERICAN BUSINESS DESPITE SARBANES-OXLEY

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#### I. INTRODUCTION

Ethics are inherent in Islamic finance and are accepted by those wishing to enter the marketplace of Islamic finance; however, in America where ethics have only recently been integrated through Sarbanes-Oxley into our existing system of business, ethical compliance is met with resistance. Islamic financing is based on a system of ethics derived from the principles of the Quran.<sup>1</sup> These ethical principles are applied to the financial industry through Shari'a law.<sup>2</sup> Shari'a law governs all business transactions of devout Muslims who must be in compliance with Shari'a law in order to observe the principles of Islam articulated in the Quran.<sup>3</sup> As wealth has increased in the hands of

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1. HSBC Amanah, *The Concept*, available at [http://www.hsbcamanah.com/hsbc/amanah\\_banking/the-concept](http://www.hsbcamanah.com/hsbc/amanah_banking/the-concept) (last visited Feb. 1, 2007) [hereinafter HSBC Amanah, *The Concept*]. Quran is also seen spelled "Koran" or "Qur'an."

2. *Id.* Shari'a is spelled in a variety of ways. I have chosen to use this spelling since it is the spelling used in the text of the Accounting and Auditing Organization for Islamic Financial Institutions ("AAOIFI") standards. Other spellings include Shariah, Shari'ah, and Sharia.

3. Jerry Useem, *Banking on Allah, devout Muslims don't pay or receive interest. So how can their financial system work?*, available at [http://money.cnn.com/magazines/fortune/fortune\\_archive/2002/06/10/324525/index.htm](http://money.cnn.com/magazines/fortune/fortune_archive/2002/06/10/324525/index.htm); see also, HSBC Amanah, *The Concept*, *supra* note 1.

Shari'a compliant Muslims, so has the opportunity and demand to create Shari'a compliant investments.<sup>4</sup> Regulatory standards have been created by the Accounting and Auditing Organization for Islamic Financial Institutions ("AAOIFI") to standardize the governance of every Islamic business product and service.<sup>5</sup> Any institution offering a Shari'a investment product must conform to the ethical principles of Shari'a law set forth in the Accounting, Auditing, and Governance Standards for Islamic Financial Institutions created by the AAOIFI.<sup>6</sup> The principles of Shari'a are enforced and monitored by Shari'a scholars through the issuance of a "fatwa," a religious blessing, certifying Shari'a compliance, at which point the investment product is deemed a Shari'a product.<sup>7</sup>

In response to corporate governance failures such as Enron, the United States took the first stride towards adopting a similar, ethical business model.<sup>8</sup> The Sarbanes-Oxley Act of 2002 heightened disclosure requirements and raised the level of accountability.<sup>9</sup> Sarbanes-Oxley introduces ethical principles to the United States corporate environment through the application of many rules.<sup>10</sup> Currently, however, there is a backlash against Sarbanes-Oxley as it is perceived as being too costly,<sup>11</sup> demonstrating the continued chasm between ethics and corporate law in America.

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4. Julian Walker, *Islamic Growth Means Challenges*, 1 (2005), available at <http://www.shariahcap.com/news/images/Arab%20Financial%20Forum%20Islamic%20Growth%20Means%20Challenges%20Nov05.doc>.

5. HSBC Amanah, *Frequently Asked Questions*, available at [http://www.hsbcamanah.com/hsbc/amanah\\_banking/faqs#14](http://www.hsbcamanah.com/hsbc/amanah_banking/faqs#14) (last visited Feb. 1, 2007) [hereinafter HSBC Amanah, *Frequently Asked Questions*], at *Is it true that there are only a handful of Shariah scholars in Islamic banking?*.

6. Sheikh Nizam Yaquby, *Sharia Requirements for Conventional Banks*, available at [http://www.islamic-banking.com/aom/shariah/sn\\_yaqubi.php](http://www.islamic-banking.com/aom/shariah/sn_yaqubi.php).

7. JULIE FISHMAN-LAPIN, ISLAMIC INVESTING, STAMFORD ADVOCATE (Apr. 23, 2006), <http://www.shariahfund.com/news/images/The%20advocateIslamic%20Investing%20April%2023rd%202006.pdf>.

8. *See generally*, Adrian Michaels, *US Companies Not Ready for Governance Rules Sarbanes-Oxley*, FIN. TIMES, LONDON ED., July 13, 2004, at 31.

9. *Id.*

10. *See generally* Annette L. Nazareth, *Keeping SarbOx Is Crucial; Some U.S. Critics Call It Burdensome, But Other Nations are Adopting Similar Laws*, BUSINESS WEEK, Nov. 13, 2006.

11. Jonathan D. Glater, *Here It Comes: The Sarbanes-Oxley Backlash*, N.Y. TIMES, Apr. 17, 2005 at 5.

## II. ETHICS IN ISLAMIC FINANCE

Islamic finance flows from the principle that religion cannot be divorced from any aspect of life, including business.<sup>12</sup> Shari'a law governing Islamic finance is derived from the guidance from God found in the Quran and the Sunnah (teachings) of the Prophet Muhammad.<sup>13</sup> This necessitates tailoring conventional financial practices to fit within religious rules stemming from as far back as the time of Muhammad in 632 AD.<sup>14</sup> Therefore, the industry of Islamic banking is quite distinct from the modern and secular investing practices of the West. This distinction creates an opportunity for Western financial institutions to create Shari'a compliant products and expand into this burgeoning marketplace.<sup>15</sup>

*A. Growing Demand*

There is an increasing population of people looking for financial products consistent with their religious beliefs.<sup>16</sup> The increase of money in the Middle East reflecting the growth of the oil industry has had a positive impact on the Islamic banking industry.<sup>17</sup> The wealth in the Middle East has created a demand on the Islamic banking industry and an incentive for American companies to provide different investment options to meet this demand.<sup>18</sup> In order to capitalize on this demand and serve the market, American investment firms must create AAOIFI

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12. See generally ACCOUNTING, AUDITING AND GOVERNANCE STANDARDS FOR ISLAMIC FINANCIAL INSTITUTIONS (The Accounting and Auditing Organization for Islamic Financial Institutions ed., June 2004). (The foregoing source does not contain consecutive pages. It is formatted in a way such that the first page of each section begins at 1. As a result, cites to this source will follow the following format: [name of source], [name of section], [page number].

13. *Id.* at Introduction p. XXVI. See also HSBC Amanah, *The Concept*, *supra* note 1. Shari'a is interpreted to mean "the path." Shari'a scholars refer to the Quran and teachings of Muhammad and apply them to issues of today.

14. Fishman-Lapin, *supra* note 7.

15. WALKER, *supra* note 4, at 1. See also Yaquby, *supra* note 6.

16. HSBC Amanah, *Frequently Asked Questions*, *supra* note 5.

17. HSBC Amanah, *The Industry*, available at [http://www.hsbcamanah.com/hsbc/amanah\\_banking/the-industry](http://www.hsbcamanah.com/hsbc/amanah_banking/the-industry) (last visited Feb. 2, 2007) [hereinafter HSBC Amanah, *The Industry*].

18. WALKER, *supra* note 4, at 1. See also Yaquby, *supra* note 6.

compliant products.

Recently, the Middle East, itself, has served the Islamic market by offering many new investment products.<sup>19</sup> The Islamic financial movement began in 1973 with the creation of the Islamic Development Bank.<sup>20</sup> The 1970's oil boom put money in the hands of many Muslim nations that wanted to adhere to their Islamic values.<sup>21</sup> Since then, the Islamic banking industry has grown about 10% to 15% per year.<sup>22</sup> In the past year or two, the high price of oil has shifted an enormous amount of wealth to the Middle East.<sup>23</sup> Current estimates show that the oil exporters' current-account surplus could reach \$400 billion.<sup>24</sup> In addition to this current amount of wealth, it is predicted that the demand for oil and gas will increase by 50% in the next thirty years and that the Middle East is going to meet this demand.<sup>25</sup> Further, there are also over 1.5 billion Muslims in the world today,<sup>26</sup> making up 20% of the world's population.<sup>27</sup> The United States alone is home to seven million Muslim-Americans.<sup>28</sup> Currently, the worldwide Islamic banking industry consists of over 300 institutions holding several billion dollars.<sup>29</sup> This represents a huge potential market in which financial institutions in the United States can offer diversified-alternative-Islamic-compliant financial instruments. American banks are just beginning to enter this market and offer Shari'a compliant investment opportunities.<sup>30</sup> The development of viable Shari'a alternatives to conventional Western

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19. Interview by Paul McNamara with Eric Myers, *Islamic Finance On the Alternative Investment Market*, ISLAMIC BUSINESS & FINANCE, Dec. 2005, at 41.

20. Useem, *supra* note 3. The Islamic Development Bank is basically an interest-free version of the World Bank. *Id.*

21. *Id.*

22. *Id.* See also WALKER, *supra* note 4, at 1; HSBC Amanah, *The Industry*, *supra* note 17.

23. WALKER, *supra* note 4, at 1.

24. *Id.* \$400 Billion is more than four times as much as their account surplus in 2002. *Id.*

25. *Id.*

26. HSBC Amanah, *Frequently Asked Questions*, *supra* note 5, at *Why is there a need for a separate brand for HSBC Amanah?*

27. Karen Iley and Mona Megalli, *Western Banks Eye Billion Dollar Islamic Market*, REUTERS NEWS, Aug. 8, 2002.

28. Useem, *supra* note 3.

29. HSBC Amanah, *The Concept*, *supra* note 1. In 2002 it was estimated that \$100 billion was invested in Islamic compliant products. See also Iley and Megalli, *supra* note 27.

30. WALKER, *supra* note 4, at 2. See also McNamara, *supra* note 19, at 41.

investments will allow for Muslim participation in the worldwide markets.<sup>31</sup>

### B. Distinct From Conventional Financial Structures

Islamic financial models are unique in that ethics are intertwined with their operations.<sup>32</sup> Islamic governance takes into account the social implications of a business transaction and thereby serves the greater community interests.<sup>33</sup> One of the main tenets upon which Islamic banking law rests is the prohibition on interest or “riba”.<sup>34</sup> The concept is meant to outlaw all forms of wrongdoing and give the financier an interest in the venture.<sup>35</sup> Not only does the doctrine of “riba” prevent the exploitation of someone in a weak bargaining position, but it also forbids “all forms of gain or profit which were unearned in the sense that they resulted from speculative or risky transactions and could not be precisely calculated in advance by the contracting parties.”<sup>36</sup> The prohibition of interest is meant to design an economy and society based on risk-sharing, fair dealing, and equity.<sup>37</sup> In Islamic law, the justification that interest is the cost of using money or that a loan is an investment is rejected in favor of ethics.<sup>38</sup>

Islamic economic theory criticizes the conventional financial industry for speculation, consumerism, volatility, “unnecessary products,” large corporations, and usury.<sup>39</sup> These traditional capitalistic

31. See FISHMAN-LAPIN, *supra* note 7.

32. See *generally* ACCOUNTING, AUDITING AND GOVERNANCE STANDARDS FOR ISLAMIC FINANCIAL INSTITUTIONS, *supra* note 12.

33. HSBC Amanah, *Frequently Asked Questions*, *supra* note 5, at *What is the purpose of Islamic financial providers?*

34. *Id.* at *What constitutes Riba?* The prohibition is based on religious beliefs of the teachings of Prophet Mohammad set forth in the Quran. “Any amount, big or small, over the principal, in a contract of loan or debt is ‘riba’ by the Quran, regardless of whether the loan is taken for the purpose of consumption or for some production activity.” *Id.*

35. *Id.* at *Why has Riba been prohibited by Islam?*

36. Michael J.T. McMillen, *Islamic Shari’ah-Compliant Project Finance: Collateral Security and Financing Structure Case Studies*, republished from 24 FORDHAM INT’L L.J. 1184, 1184 n.2 (2001).

37. Useem, *supra* note 3.

38. See ACCOUNTING, AUDITING AND GOVERNANCE STANDARDS FOR ISLAMIC FINANCIAL INSTITUTIONS, *supra* note 12, at Accounting p. 26.

39. Useem, *supra* note 3.

means of profit-making are not compatible with Islamic values.<sup>40</sup> Islamic law therefore creates a culture where people only spend what they have, a theory in direct opposition to consumer driven models.<sup>41</sup> Investment regulations are implemented to avoid “sinful” activity. Currency hedging, futures contracts, day trading, and credit cards are all prohibited under Islamic law.<sup>42</sup> In addition, companies with excessive debt, interest-bearing securities and accounts-receivables in their assets are screened out.<sup>43</sup> Islamic law further prohibits support of industries such as alcohol, gambling, pork-related products, tobacco, weapons, conventional financial services and other “immoral” activities.<sup>44</sup> In response to this investment criterion, a Dow Jones Islamic Index was created in 1999 to screen out stocks that did not comply with these beliefs.<sup>45</sup> The index tracks securities that are approved by the Shari’a Supervisory Board of the Dow Jones.<sup>46</sup> The screen eliminates businesses that make 5% or more of their revenue from activities deemed “sinful” and prohibited under Shari’a.<sup>47</sup> When a company makes less than the 5% level of revenue from a sinful activity, a compliant investor can invest in the company, but must donate to charity the same proportion of his dividends as the company’s revenue from a “sinful” activity.<sup>48</sup> Risk mitigation is essential to producing structures that comply with Islamic finance.<sup>49</sup> Therefore, since the stock market is

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40. *Id.*

41. *Id.*

42. *Id.*

43. *Id.* The cutoff of debt-to-market-capitalization and cash and interest-bearing securities is a ratio of 33%, and a 45% cut-off is applied to the accounts-receivable-to-assets ratio. *Id.*

44. *Id.* See generally Iley and Megalli, *supra* note 27. See also Dow Jones Islamic Fund, available at [http://www.investaaa.com/cgi-bin/client\\_product.cgi?member=55&product\\_id=525](http://www.investaaa.com/cgi-bin/client_product.cgi?member=55&product_id=525) (last visited Feb. 6, 2007).

45. Useem, *supra* note 3. For example, the Dow Jones Islamic Index would screen out: Marriott, since it serves pork in its hotel restaurants; Citigroup, because of the interest element to their company; and AOL Time Warner, because of the “unwholesome” music and entertainment they support.

46. Dow Jones Islamic Fund, *supra* note 46.

47. Useem, *supra* note 3.

48. *Id.* This donation of dividends to charity is known as “portfolio purification.” *Id.*

49. United Nations Conference on Trade and Development, *Islamic Finance and Structured Commodity Finance Techniques: Where the Twain Can Meet* at 3 (May 29, 2006), available at <http://www.unctad.org/TEMPLATES/Page.asp?intItemID=3830&lang=1#> (follow the link to article).

inherently risky, stock market transactions are only permitted when the ethical elements of Islamic law are adhered to.<sup>50</sup> Although based on Islamic principles, such a screening process, which excludes firms that are particularly risky, may be attractive to any conservative investor, not only to Muslims who are interested in accountability and the social responsibility of the company.<sup>51</sup> The Dow Jones Islamic Fund integrates the ethical principles of Shari'a law into modern equity investing.<sup>52</sup>

### C. Sharing the Profits and Losses

The theoretical model of Islamic banking is based on the sharing of both profit and loss.<sup>53</sup> The assumption being that direct investment into ventures leads to more prudent lending.<sup>54</sup> Investors are more interested in the outcome when the success or failure of the venture determines the amount of profit or loss.<sup>55</sup> The concept is that a financier of a venture should not be guaranteed a profit without sharing in the risk.<sup>56</sup> If the entrepreneur, who puts in the hard work is not guaranteed a positive return, why should someone profit who is not putting any work in at all?<sup>57</sup> In practice, this means that an Islamic bank provides the capital to a firm, and then shares with its clients the profits and losses of the return on this investment.<sup>58</sup> Although this is the theoretical model of Islamic banking, profit-loss sharing models of financing actually constitutes

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50. Useem, *supra* note 3.

51. William Rutledge, Executive Vice President, Federal Reserve Bank of New York, Regulation and Supervision of Islamic Banking in the United States (Apr. 19, 2005), available at <http://www.newyorkfed.org/newsevents/speeches/2005/rut050422.html>.

52. Dow Jones Islamic Fund, *supra* note 44, at *Overview*.

53. Humayon A. Dar and John R. Presley, *Lack of Profit Loss Sharing in Islamic Banking: Management and Control Imbalances*, at 4 (Department of Economics, Loughborough University, Working Paper No. 00/24), available at <http://www.lboro.ac.uk/departments/ec/Researchpapers/2000/00-24/erp00-24.pdf> (last visited Feb. 6, 2007).

54. Useem, *supra* note 3.

55. *Id.*

56. HSBC Amanah, *Frequently Asked Questions*, *supra* note 5, at *Why has riba been prohibited by Islam?*

57. *Id.* The discussion on risk sharing, fair dealing, and equity represents fairness in terms of finance and social justice. See also Useem, *supra* note 3.

58. Dar and Presley, *supra* note 53, at 17.



only about 20% of Islamic compliant investments.<sup>59</sup>

The reason for the minimal use of the profit and loss sharing model is because entrepreneurs are not likely to share their profits when optimistic, and capitalists are of course hesitant to bear risk knowing that the opportunity signals the improbability of its success.<sup>60</sup> Those entrepreneurs, who are confident in their venture's success, are more likely to secure financing that is fixed-interest in order to maximize their own returns.<sup>61</sup> Whereas those entrepreneurs who anticipate their venture will fail may welcome the idea of sharing the loss.<sup>62</sup> Profit and loss sharing is a risky investing vehicle because banks lack the right to monitor the operations of the firms in which they are invested.<sup>63</sup> The concept of control-rights is at the heart of who should be earning a profit or incurring risk or loss.<sup>64</sup> Without the conventional guarantee of return, profit and loss sharing represents a risk; however, the theory of fairness makes profit and loss sharing the ideal concept of investment in Islamic law.<sup>65</sup>

Profit and loss sharing, although present in the United States through venture capitalism, is not a conventional means of banking or deposit. Western banking is based on the premise of depositing the principle without risk, as opposed to profit and loss sharing where the initial deposit is gambled.<sup>66</sup> With profit and loss sharing, the return on the investment is based on the profits earned from the investment, rather than a set rate.<sup>67</sup> Therefore, where profit loss sharing is substituted for conventional savings account, then the guarantee of fixed-interest income is eliminated, and the principle investment is jeopardized.<sup>68</sup> This theoretical model also differs from conventional venture capitalism in that the customer does not have any input into the decisions on what the principle is invested in.<sup>69</sup> In the venture capitalist framework in

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59. This is an estimate based on 1996 figures according to the International Association of Islamic Banks. *Id.*

60. Dar and Presley, *supra* note 53, at 5.

61. Useem, *supra* note 3.

62. *Id.*

63. Dar and Presley, *supra* note 53, at 17.

64. *Id.* at 7.

65. Useem, *supra* note 3.

66. Rutledge, *supra* note 51.

67. *Id.*

68. *Id.*

69. Useem, *supra* note 3.

America, management and control of the venture are essential.<sup>70</sup> Muslims are not likely to use profit and loss sharing as a means of banking as Americans do in conventional banks, where there is a fixed return on the principal.<sup>71</sup> Since this model has yet to be realized, a significant opportunity exists for those willing to offer Shari'a compliant banking products.<sup>72</sup>

#### D. AAOIFI Standards

Financial institutions that are interested in the opportunity to serve the Islamic market must comply with AAOIFI standards.<sup>73</sup> In 1991, the Islamic banking industry decided that the existing standards did not provide sufficient guidance.<sup>74</sup> The AAOIFI took on the tasks of setting and enforcing the industry standards.<sup>75</sup> The AAOIFI was instituted in order for scholars on Shari'a law to create standards of financing that complied with the religious laws.<sup>76</sup> At the heart of the AAOIFI standards is the key concept in Islamic jurisprudence of "collective personal reasoning," referred to as "ijtihad," as opposed to "individual personal reasoning."<sup>77</sup> AAOIFI standards are meant to help companies understand and supervise Islamic finance and fit it within their own regulatory scheme.<sup>78</sup> In addition, since compliance with Shari'a law is required of all Muslims in their banking transactions, it is believed that accepted financial standards that create disclosure and access to information will increase user confidence and therefore increase investment.<sup>79</sup> The AAOIFI set forth the objectives of financial accounting in order to create the disclosure requirements.<sup>80</sup> Some of the

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70. Dar and Presley, *supra* note 53, at 6.

71. *Id.* at 8.

72. Useem, *supra* note 3.

73. ACCOUNTING, AUDITING AND GOVERNANCE STANDARDS FOR ISLAMIC FINANCIAL INSTITUTIONS, *supra* note 12, at Introduction p. v. Dr. Mohammad Nedel Alchaar is the Secretary-General of the AAOIFI.

74. *Id.*

75. *Id.*

76. *Id.* at Introduction p. xxvi.

77. Yaquby, *supra* note 6.

78. Rutledge, *supra* note 51.

79. ACCOUNTING, AUDITING AND GOVERNANCE STANDARDS FOR ISLAMIC FINANCIAL INSTITUTIONS, *supra* note 12, at Introduction p. xxvi.

80. *Id.* at Accounting p. 4.

AAOIFI mandates include:

- (1) Develop the accounting, auditing and banking practices thought relating to the activities of Islamic financial institutions;
- (2) Disseminate the accounting and auditing thought relating to the activities of Islamic financial institutions and its application through training, seminars, publication of periodical newsletters, preparation of research and other means;
- (3) Prepare, promulgate and interpret accounting and auditing standards for Islamic financial institutions in order to harmonize the accounting practices adopted by these institutions in the preparation of their financial statements, as well as to harmonize the auditing procedures adopted in auditing the financial statements prepared by Islamic financial institutions;
- (4) Review and amend the accounting and auditing standards for Islamic financial institutions to cope with developments in the accounting and auditing thought and practices; and
- (5) Approach the concerned regulatory bodies, Islamic financial institutions, other financial institutions that offer Islamic financial services, and accounting and auditing firms in order to implement the accounting and auditing standards, as well as the statements and guidelines on the banking, investment and insurance practices of Islamic financial institutions that are published by AAOIFI.<sup>81</sup>

The main standard developed through the AAOIFI is the communication and disclosure of relevant financial information to the public.<sup>82</sup> The regulatory framework seeks to increase the number of products available to Muslims and investments made by Muslims by outlining the standards, and deeming that, when they are met, compliance is assured.<sup>83</sup>

Each conventional institution that offers Islamic financial services is required to “appoint a Shari’a supervisory board, which shall present a

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81. *Id.* at Introduction p. x.

82. *Id.* at Accounting p. 7.

83. *See id.*

Shari'a report, and to implement the Governance standards issued by AAOIFI that relate to the Shari'a supervisory board."<sup>84</sup> This board is focused on insuring that all transactions comply with Shari'a law.<sup>85</sup> The board is required to disclose any financial transactions that are not compliant with Shari'a law and to make all disclosures relevant to assist an investor in evaluating risks inherent in the assets and the liquidity of the investment.<sup>86</sup> This requires directing and reviewing the activities of the Islamic products.<sup>87</sup> The supervisory board's decisions are binding on the institution.<sup>88</sup>

Another major role that Shari'a scholars play is the issuance of Fatwas, a religious blessing that certifies compliance with Shari'a law.<sup>89</sup> Without this blessing, compliance is not deemed to be met.<sup>90</sup> The issuance of a Fatwa signifies that the transaction is "halal," meaning that it comports with Shari'a law.<sup>91</sup> Building a relationship between Shari'a scholars and the company is a crucial component of compliance to ensure continual oversight.<sup>92</sup> Trust and teamwork between the Shari'a board and the company is fundamental to the development of an investment.<sup>93</sup>

As a part of the corporate governance regulations, the AAOIFI issues standards for auditing practices.<sup>94</sup> It states:

The objective of an audit of financial statements is to enable the auditor to express an opinion as to whether the financial statements are prepared, in all material respects, in accordance with the Shari'a Rules and Principles, the accounting standards of the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), and relevant national accounting standards and practices in the court

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84. *Id.* at Accounting p. 494.

85. *Id.* at Governance p. 5.

86. *Id.* at Accounting p. 500.

87. *Id.* at Governance p. 5.

88. *Id.*

89. FISHMAN-LAPIN, *supra* note 7.

90. *Id.*

91. United Nations Conference on Trade and Development, *supra* note 49, at 5.

92. FISHMAN-LAPIN, *supra* note 7.

93. Clare Woodcraft, *Shariah Compliant Hedging- Thinking Out of the Box*, Shariah Capital, Jan. 15, 2003, available at <http://www.shariahunds.com/news/pop-up.php?cat=show&id=68> (last visited Feb. 6, 2007).

94. ACCOUNTING, AUDITING AND GOVERNANCE STANDARDS FOR ISLAMIC FINANCIAL INSTITUTIONS, *supra* note 12, at Auditing p. 4.

in which the financial institution operates.<sup>95</sup>

Auditors' reports are expected to "give a true and fair view."<sup>96</sup> These governance standards are based on principles of professional conduct.<sup>97</sup> The general principles of an audit are (1) righteousness, (2) integrity, (3) trustworthiness, (4) fairness, (5) honesty, (6) independence, (7) objectivity, (8) professional competence, (9) due care, (10) confidentiality, (11) professional behavior, and (12) technical standards.<sup>98</sup> In addition, an internal review is to be conducted to determine compliance with Shari'a rules.<sup>99</sup>

### E. Islamic Compliance

Compliance with these auditing and accounting standards is very costly because of the extent of monitoring and disclosure.<sup>100</sup> In addition, developing investment strategies that comply with Islamic banking principles is distinct from the strategies used for conventional investments.<sup>101</sup> Western banks generally invest in fixed income, interest-bearing securities.<sup>102</sup> Such investments are prohibited by Shari'a law.<sup>103</sup> Unlike the fundamental principle in conventional banking for "project finance" which prefers the use of debt in order to leverage the project,<sup>104</sup> Islamic financing prefers equity over debt.<sup>105</sup> Under Islamic financing, conventional debt has been replaced with asset-backed debt financing.<sup>106</sup> For instance, a savings account that is compliant with Shari'a law invests money directly into ventures instead of merely earning fixed interest.<sup>107</sup> Profits can be made, but they cannot be derived from the investment of money alone.<sup>108</sup> The principle behind

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95. *Id.*

96. *Id.*

97. *Id.*

98. *Id.*

99. *Id.* at Governance p. 23.

100. *See* FISHMAN-LAPIN, *supra* note 7.

101. *See id.*

102. Rutledge, *supra* note 51.

103. *Id.*

104. McMillen, *supra* note 36, at 1184.

105. HSBC Amanah, *The Concept*, *supra* note 1.

106. HSBC Amanah, *The Concept*, *supra* note 1.

107. Useem, *supra* note 3. This account is called a "mudarabah account." *Id.*

108. *Id.*

this is that money has to be doing work in order for profits to be made.<sup>109</sup> Innovation, cost, and relationships with Islamic scholars are thus necessary to create new models.<sup>110</sup>

Shari'a law requires a different strategy for embarking upon a business transaction than the ordinary profit-maximizing approach. In an Islamic transaction, an intermediary will buy the item that the purchaser wants from the seller.<sup>111</sup> The purchaser simultaneously agrees to pay the bank in monthly installments for a price that is greater than the price the bank paid (the mark-up value).<sup>112</sup> Ironically, this mark-up value is usually similar to the prevailing interest rate.<sup>113</sup> The crucial element of this transaction is that the bank took possession of the item for a period of time (even if only an instant).<sup>114</sup> In addition, if the bank collects fees because of late payment, the late fee must be donated to a charity.<sup>115</sup> In one example in the United States, in order to avoid a leveraged buy-out, Crescent Capital Investments, the American subsidiary to First Islamic,<sup>116</sup> purchased Loehmann's Department Stores' assets and leased them back to the company.<sup>117</sup> Models have been developed that are both acceptable under Shari'a law and conventional regulations.

Similar maneuvers are required with home ownership because of the prohibition against using traditional interest-based mortgages to buy a home.<sup>118</sup> A Muslim previously had two options for homeownership: either perpetually "rent" a house, or buy the house outright.<sup>119</sup> A new method has emerged where a lease-to-own contract is formed, whereby the buyer pays monthly installments of the principal plus "rent" to an institution that purchased the home from the seller.<sup>120</sup> Predictably, the

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109. *Id.*

110. Yaquby, *supra* note 6.

111. Useem, *supra* note 3. This type of transaction is called a "marabaha." *Id.*

112. *Id.*

113. *Id.*

114. *Id.*

115. *Id.*

116. Barney Gimbel, *Loehmann's New Order Keeps the Faith*, CNNMoney.com, Feb. 7, 2005.

117. *Id.*

118. See Lornett Turnbull, *Faith and Finance Collide for Muslim Home Buyers*, THE SEATTLE TIMES, Mar. 21, 2005 at A1.

119. *Id.*

120. *Id.*

amount of monthly “rent” is typically based on the prevailing market interest rate. Through these installments of “rent,” equity is built up in the home, and an ownership interest thus accumulates to the “renter.”<sup>121</sup> As one might imagine, this looks very much like a conventional mortgage; but Shari’a law remains observed by the details of the arrangement.<sup>122</sup> Indeed, for purposes of Shari’a compliance the arrangement is an interest-free mortgage; yet at the same time the “rent” is based on, and expressed as, a conventional interest rate.<sup>123</sup> Compliance with Shari’a law, however, is not as easy as simply circumventing its rules.<sup>124</sup> Many warn, for example, that “calling fornication ‘making love’ doesn’t make it any different;”<sup>125</sup> similarly, “selling pork and labeling it beef” is not compliant.<sup>126</sup> Although there is a huge market opportunity to offer the Islamic community the same diversity in investment opportunity as conventional systems have, it is a tremendous undertaking to achieve compliance. It is estimated that the Middle East investment market is somewhere between \$250 and \$500 billion.<sup>127</sup> These numbers represent a great incentive for the creation of Islamic compliant products, into which this wealth could potentially be invested.<sup>128</sup> Although daunting, the barriers to entry and the standards that are required for compliance is worth it.<sup>129</sup>

The United States government has been open to new types of financing that allows for the United States to service the Islamic investment industry;<sup>130</sup> however, not only do United States companies have to comply with Shari’a law, but their undertakings must still be approved by the United States regulatory system.<sup>131</sup> The United States has been flexible in allowing new types of investing, rationalizing that

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121. *Id.*

122. *Id.* There are Muslims who do not believe that the lease-to-own model of mortgage is compliant with Shari’a law because it is in fact interest, even though it is called something else. *Id.*

123. *Id.*

124. Useem, *supra* note 3.

125. *Id.* Shaykh Nizam Yaquby is a Shari’a scholar who warns against crossing the line. He thinks rounding the edges is dangerous and is “playing semantics with God.” *Id.*

126. Turnbull, *supra* note 118. (quoting Jeff Siddiqui, a Muslim real estate agent).

127. FISHMAN-LAPIN, *supra* note 7.

128. *See id.*

129. *See id.*

130. Rutledge, *supra* note 51.

131. *Id.*

the inherent structure is the same as conventional investment products.<sup>132</sup> In 1997, the United Bank of Kuwait proposed that the United States Office of the Comptroller of the Currency permit a bank to purchase property on behalf of a buyer and hold legal title to it.<sup>133</sup> When payment of the final lease installment is made, legal ownership is transferred to the buyer.<sup>134</sup> Subsequently in 1999, the United Bank of Kuwait proposed to allow the bank to acquire assets and resell them to buyers on an installment basis that allowed the bank to mark-up the price.<sup>135</sup> Both proposals were permitted in the United States based on the rationale that the buy and sell transaction was, effectively, a single transaction because they occurred simultaneously.<sup>136</sup> Under Shari'a law, compliance was justified because the transaction was viewed as two separate transactions.<sup>137</sup> Such a transaction was rationalized in two different ways to fulfill the needs of two disparate cultures.<sup>138</sup> The form of the transaction becomes less important when it is reviewed by the United States in light of the reasons for the additional transaction.<sup>139</sup> The United States considered the proposals equivalent to secured loans and riskless transactions.<sup>140</sup> This flexibility demonstrates that the United States government perceives the value of investment from the Muslim community worth the additional cost of compliance associated with Shari'a law.<sup>141</sup>

It should be noted, however, that some scholars hold that it is not possible for a conventional bank to offer truly Islamic products since the conventional bank's charters and statutes are not Shari'a compliant.<sup>142</sup> Such a situation presents the possibility that the funds are drawn from earnings that are not Shari'a compliant.<sup>143</sup> If the basic charters of the

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132. *Id.*

133. *Id.*

134. *Id.*

135. *Id.*

136. *Id.*

137. *See id.*

138. *Id.*

139. *Id.*

140. *Id.*

141. *Id.*

142. Yaquby, *supra* note 6. Many of these scholars' critiques are premised on the rationale that conventional institutions are only trying to exploit Muslim beliefs in order to unfairly compete with Islamic financial institutions. *Id.*

143. *Id.*



bank do not comply with Shari'a law, then funds, branches, and windows cannot be deemed compliant.<sup>144</sup> Still, most current Shari'a scholars think that it is acceptable if other services provided by the institution are not Islamic compliant.<sup>145</sup> These scholars feel that it is sufficient for compliance to be met when funds are completely segregated, a Shari'a supervisory board exists, a commitment to Islamic financial concepts is present, and compliance with the AAOIFI is adhered to.<sup>146</sup> In addition, commingled funds containing both compliant and non-compliant earnings can be purified and then used for Shari'a-permissible investments.<sup>147</sup> Perhaps this is part of the notion that the Islamic economy cannot isolate itself from the rest of the world.<sup>148</sup> Some goes so far as to posit that if the Prophet Mohammed were alive today, he would find some accommodation to participate in the global economy.<sup>149</sup> Proponents also argue that allowing traditional institutions to offer compliant products creates more competition which will only lead to more diligence and care in the quality of the products offered by everyone in the Islamic market.<sup>150</sup>

The international reaction to the emergence of this industry is a strong move towards compliance with the standards in order to serve the Islamic investment market.<sup>151</sup> As exemplified by Mr. Eric Meyers<sup>152</sup> who devoted five years to the development of Shariah Capital, a hedge fund that is in compliance with Islamic law.<sup>153</sup> Conventional hedge funds are based on the elements of risk and speculation and use the concept of "short-selling" to make high profits.<sup>154</sup> Mr. Meyers encountered problems arising from the Quran's prohibition against selling something that you do not own, and its prohibition against risk

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144. *Id.*

145. HSBC Amanah, *Frequently Asked Question, supra* note 5, at *How can a conventional bank, which is primarily interest-based, offer banking services?* This is the belief of the Shari'a supervisory board of HSBC. *Id.*

146. Yaquby, *supra* note 6.

147. *Id.*

148. Useem, *supra* note 3.

149. *Id.*

150. *Id.*

151. WALKER, *supra* note 4, at 2.

152. FISHMAN-LAPIN, *supra* note 7.

153. *Id.*

154. *Id.* Short selling is a strategy that allows hedge funds to post high returns even when the market is down.

and speculation.<sup>155</sup> Therefore, in order for a hedge fund to be compliant with Islamic principles, an alternate financial model needed to be created. Shariah Capital adapts by screening out and monitoring for compliant, publicly-traded companies using real-time screening software, while still keeping with the short-selling concept behind hedge funds.<sup>156</sup> The database software allows for access to all deals transacted and any intermediary involved.<sup>157</sup> This availability of information is important for the disclosure to the fund manager and Shari'a scholars, who are able to monitor continued compliance and make sure transactions are pure.<sup>158</sup> Shariah Capital also targets only conservative risk parameters, as opposed to loose risk parameters.<sup>159</sup> Fundamental strategies have not been changed, yet compliance has been met.<sup>160</sup> In addition, Mr. Meyers has created a web portal that brings together Western companies with Middle Eastern investors.<sup>161</sup> This exists purely to provide access to information concerning these opportunities, not to act as a broker.<sup>162</sup> Mr. Meyers exemplifies someone who saw the ability to serve the Islamic market by offering Shari'a compliant products to be worth the cost of compliance with regulations.

### III. SARBANES-OXLEY AND ETHICS IN AMERICAN BUSINESS

The regulations, as set forth by the AAOIFI, were created and published with the purpose of expanding the market of acceptable Islamic compliant products.<sup>163</sup> More compliant products mean more Muslim investment.<sup>164</sup> Expansion is only possible if companies are aware of what compliance requires. The atmosphere in which AAOIFI

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155. *Id.*

156. *Id.*

157. Woodcraft, *supra* note 93.

158. *Id.*

159. *Id.*

160. FISHMAN-LAPIN, *supra* note 7.

161. *Bridging Innovation and Investment Capital*, Islamic Business & Finance, Jan. 2006, at 43 (referring to the Web portal as "Arabian access" which provides a featured report of companies on this Web site). The purpose is to "bring unique companies to the attention of investors known for their ability to identify undervalued or undiscovered opportunities." *Id.*

162. *Id.*

163. Useem, *supra* note 3.

164. United Nations Conference on Trade and Development, *supra* note 49, at 4.

regulations were standardized is distinguished from the corporate climate during the time when Sarbanes-Oxley was implemented. Sarbanes-Oxley was a response to the corporate and accounting scandals within the United States financial system.<sup>165</sup> The collapse of Enron and other massive accounting frauds demonstrated that the standards of business needed to be amended and heightened.<sup>166</sup> An overarching principle of Sarbanes-Oxley was to create regulations that would increase public investor trust and confidence that the laws were being followed.<sup>167</sup> Sarbanes-Oxley denotes itself as “[a]n Act to protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws, and for other purposes.”<sup>168</sup> Although both Sarbanes-Oxley and the AAOIFI regulations seek to infuse business with ethics, in the case of Sarbanes-Oxley it is into pre-existing business models.

In the Islamic investing market, financial institutions zealously comply with the AAOIFI and its intrinsic ethics in order to become a valid member of the market place. These companies are submissive to the requirements set forth by the AAOIFI and do not challenge the purpose behind the laws. In contrast, financial institutions in the United States attempt to evade compliance with the requirements of Sarbanes-Oxley.<sup>169</sup> Already enjoying the fruits of the marketplace, United States companies see compliance with new regulations as an additional burden and cost.<sup>170</sup> The ethics of Sarbanes-Oxley are not otherwise intrinsic in American corporate culture. Indeed, the ethical component of Sarbanes-Oxley is seen as superfluous to achieving the Act’s regulatory objectives. Assuming the responsibility of compliance with the historic rules of a developing market (Islamic) is considerably more acceptable for new participants than is the burden of compliance with new regulations (United States) imposed upon an already-existing market. Rigid ethical regulations are difficult to implement in a business world that has long existed without them.

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165. Michaels, *supra* note 8 at 31.

166. *Id.*

167. Nazareth, *supra* note 10, at 134.

168. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified as amended in scattered sections of 15 U.S.C.).

169. See Glater, *supra* note 11.

170. See Cory L. Braddock, *Penny Wise, Pound Foolish: Why Investors Would Be Foolish To Pay a Penny or a Pound for the Protection Provided by Sarbanes-Oxley*, 2006 BYU L. REV. 175, 176 (2006).

A. Governance Standards in the United States

The United States' adoption of Sarbanes-Oxley shares many similarities with the regulations for Islamic banking set forth by the AAOIFI.<sup>171</sup> The use of supervisory boards to review the appropriateness of proposed investments has been adopted by conventional American institutions.<sup>172</sup> Shari'a law has seen the wisdom in this for decades as a means of maintaining compliance with their ethical principles.<sup>173</sup> The board that supervises Shari'a compliance is made up of scholars qualified to make religious rulings (fatawa) on transactions.<sup>174</sup> Such rulings are binding on the financial institution and trump managerial authority.<sup>175</sup> Western institutions have adopted the idea of a supervisory board for not just legal compliance oversight but also separate, internal standards of business ethics.<sup>176</sup> This demonstrates how corporate governance in the United States attempts to integrate ethics into the United States corporate structure.

The United States adopted auditing standards requiring disclosure requirements similar to the AAOIFI standards. Recognizing the insufficiency of its standards after the Enron, WorldCom, and Tyco troubles, the United States created and adopted the Sarbanes-Oxley Act of 2002.<sup>177</sup> The United States was forced to respond since investor confidence declined and the environment of corporate fraud was publicized.<sup>178</sup> Sarbanes-Oxley Act, although similar in requirements to the standards created by the AAOIFI, consists of rules designed to deal with specific problems that the scandals exposed.<sup>179</sup>

The motive of Sarbanes-Oxley is to protect investors by allowing them access to more information that is better regulated to ensure

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171. Rutledge, *supra* note 51.

172. *Id.*

173. *Id.*

174. HSBC Amanah, *Frequently Asked Question*, *supra* note 5, at § B (noting that more than 15 scholars sit on the Shari'a board for the AAOIFI). *See also* Yaquby, *supra* note 6.

175. Yaquby, *supra* note 6.

176. Rutledge, *supra* note 51.

177. Braddock, *supra* note 170, at 175 (noting that Sarbanes-Oxley is also referred to as the Public Company Accounting Reform and Investor Protection Act of 2002).

178. *Id.*

179. Andrew Parker, *Top Regulator's Tough Sympathy*, FIN. TIMES, LONDON ED., Nov. 3, 2005, at 14.

accuracy.<sup>180</sup> Sarbanes-Oxley created regulations applicable to publicly-traded companies in order to avoid financial failure.<sup>181</sup> Title I of the Act creates a Public Company Accounting Oversight Board (PCAOB) to oversee the auditing of the company.<sup>182</sup> This independent board inspects public accounting firms.<sup>183</sup> This board's allegiance is to upholding Sarbanes-Oxley just as Shari'a boards' allegiance is with Shari'a Law. Title III of the Act amends Section 10A of the Securities and Exchange Act of 1934 by strengthening the requirements of a company's audit committee.<sup>184</sup> Title III mandates certification of financial reports by the principle executive, making him/her responsible for internal controls and procedure disclosure.<sup>185</sup> Title IV of the Act amends Section 13 of the Securities Exchange Act of 1934 by adding disclosure requirements requiring management to prepare an internal control report.<sup>186</sup> In addition, the auditor must opine on management's assessment.<sup>187</sup> This allows investors to be knowledgeable of the company's internal controls.<sup>188</sup> The Securities and Exchange Commission (SEC) is required to review the financial reports.<sup>189</sup> Title IV is also comparable to the internal disclosure requirements of the AAOIFI regulations. Title II amends Section 10A of the Securities and Exchange Act of 1934 by adding requirements which establish the independence of the auditor.<sup>190</sup> Title II prevents auditors from providing any additional consultation to the company and prohibits communications between management and the auditor.<sup>191</sup> Title II differs from the AAOIFI standards, which encourages relationships between Shari'a advisors and the management.

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180. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified as amended in scattered sections of 15 U.S.C.).

181. Braddock, *supra* note 170, at 177.

182. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, §§ 101-09, 116 Stat. 745, 750-72 (codified as amended in scattered sections of 15 U.S.C.).

183. Nazareth, *supra* note 10.

184. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, §§ 301-08, 116 Stat. 745, 775-85 (codified as amended in scattered sections of 15 U.S.C.).

185. Braddock, *supra* note 170, at 179.

186. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, §§ 401-09, 116 Stat. 745, 785-91 (codified as amended in scattered sections of 15 U.S.C.).

187. Nazareth, *supra* note 10.

188. Parker, *supra* note 179.

189. 15 U.S.C. § 7261(c)(1) (2002).

190. 15 U.S.C. § 78j-1(g)-(i) (2002).

191. 15 U.S.C. § 78j-1(g)(1)-(9) (2002). *See also*, Braddock, *supra* note 170, at 178.

B. Comparing Sarbanes-Oxley's Standards with the AAOIFI's

The purposes of the Shari'a supervisory board and the PCAOB created by Sarbanes-Oxley are very similar; however, the relationship between the board and the company, respectively, are unique. The mandates of the Shari'a board are to assure compliance with the Shari'a law and also encourage development of compliant products that work within the ethical framework set forth by the regulations. This relationship creates many judgments to be made by the board and communications between the board and the management. This system of open communication and oversight is distinct from the PCAOB board's role. The PCAOB board is excluded from the company's management and is meant to merely implement the rules set forth by the SEC.<sup>192</sup> This environment discourages a relationship and reduces judgments made by this independent committee.

The goals of Sarbanes-Oxley are comparable to the objectives set forth in the AAOIFI. The primary purpose of Sarbanes-Oxley is to have independent people reviewing and monitoring the company.<sup>193</sup> Increasing disclosure requirements with an independent board is meant to eradicate inaccuracies and occurrences of fraud by mandating that auditors' allegiance be to creditors and stockholders.<sup>194</sup> Sarbanes-Oxley tries to eliminate the conflict of interest between the auditor and the management to disclose the truth.<sup>195</sup> Sarbanes-Oxley is meant to increase reliability, and to build investor confidence and ethical business.<sup>196</sup> Investor confidence is a key element of the United States market, an element that cannot be ignored considering America has the largest percentage of individual participation globally.<sup>197</sup>

Maintaining investor confidence was also the main goal in publishing the AAOIFI.<sup>198</sup> Despite the structural similarities and comparable goals, compliance with Sarbanes-Oxley is resisted<sup>199</sup>

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192. 15 U.S.C. § 78j-1 (2002).

193. Nazareth, *supra* note 10.

194. Braddock, *supra* note 170, at 182.

195. *Id.* at 183 (describing Section 301 of the Sarbanes-Oxley Act as an attempt to eliminate the conflict of interest between the management and the auditor).

196. Michaels, *supra* note 8.

197. Nazareth, *supra* note 10.

198. ACCOUNTING, AUDITING AND GOVERNANCE STANDARDS FOR ISLAMIC FINANCIAL INSTITUTIONS, *supra* note 12, at Introduction p. XXVI.

199. *See* Glater, *supra* note 11.

whereas AAOIFI standards are voluntarily embraced. Even after the collapse of Arthur Andersen, Enron, and WorldCom and the revelation of corruption, the response to Sarbanes-Oxley is to avoid compliance because it is too costly.<sup>200</sup> Rather than comply, companies are opting to not be listed on the United States stock exchanges.<sup>201</sup> Publicly-traded small capitalization companies and foreign companies, which are listed on the United States stock exchanges, are considering delisting, and other companies not currently listed are deterred from listing.<sup>202</sup> The United States public offerings dropped by 300% in 2003, the year following the implementation of Sarbanes-Oxley.<sup>203</sup> The reason proffered by these companies for avoiding compliance with Sarbanes-Oxley is that the costs of compliance are too high.<sup>204</sup>

Currently the focus is on the interpretation of Section 404, which creates a major source of additional costs for companies in auditing their internal financial controls.<sup>205</sup> Business representatives are demanding relaxation of the regulations in order to address the enormous costs of compliance.<sup>206</sup> It is argued that Sarbanes-Oxley imposes not only the monetary cost of auditing but also an increased workload to the corporate board, which will decrease attention paid to other business activities as well as lost opportunity costs where funds used for compliance could have been directed towards other productions.<sup>207</sup> It is estimated that companies will use these business interests to try to resist the provisions of Sarbanes-Oxley.<sup>208</sup> In this regard, it is argued that Sarbanes-Oxley was an overreaction to the corporate fraud scandals at the time.<sup>209</sup>

Privately-held companies are not required to meet the same disclosure standards as publicly-held companies.<sup>210</sup> Only publicly-traded companies that list their stock on United States stock market exchanges or securities associations have the more restrictive disclosure

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200. *Id.*

201. Braddock, *supra* note 170, at 176.

202. *Id.*

203. *Id.* at 197.

204. *Id.* at 176.

205. Alan Murray, *Paulson Walks Fine Line Amid Calls for a Less-Intrusive Regulatory Scene*, WALL ST. J., Nov. 29, 2006, at A2.

206. *Id.*

207. Braddock, *supra* note 170, at 190-91.

208. Glater, *supra* note 11.

209. Nazareth, *supra* note 10.

210. Braddock, *supra* note 170, at 176.

standards.<sup>211</sup> Therefore, those companies that have gone private have done so either to avoid the cost of compliance with Sarbanes-Oxley or because they make use of accounting practices that are not in accord with Generally Accepted Accounting Principles (“GAAP”).<sup>212</sup> This means that the companies actually became *less* transparent than before, the exact opposite environment of what Sarbanes-Oxley contemplated.<sup>213</sup> Whether to avoid the cost of adopting heightened regulations or to continue unethical business practices, Sarbanes-Oxley has had the effect of discouraging some companies from maintaining their public status.<sup>214</sup>

Unlike the Islamic system where such regulations are part of the whole business system, Sarbanes-Oxley regulations are both resisted and avoided. American companies are opposed to added costs to comply with requirements when their market base is not growing. Such required standards, however, have proved necessary since about 15% of companies required to comply with Sarbanes-Oxley admitted to material weakness in their controls.<sup>215</sup> This shows that requiring auditors to reach an opinion on the quality of controls, although costly, has been an effective tool in implementing ethics.<sup>216</sup> It is also said that there are also benefits in improved efficiencies, increase in quality of financial reporting, and better ability to detect and prevent inaccuracies.<sup>217</sup> Some even argue that companies’ stock prices have gone up since compliance with Sarbanes-Oxley.<sup>218</sup> Conversely, those companies that delisted from the United States exchanges had a decline in their stock price.<sup>219</sup> Sarbanes-Oxley’s effectiveness for investor protection is further demonstrated in the international implementation of similar models of regulation.<sup>220</sup>

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211. *Id.* at 196.

212. *Id.* at 197.

213. *Id.* at 198.

214. *Id.* at 176.

215. Parker, *supra* note 179.

216. Glater, *supra* note 11.

217. Nazareth, *supra* note 10.

218. *Id.* This statement is based on a study conducted by Lord & Benoit that concluded that companies stock price positively reflected compliance with Section 404. *Id.*

219. Braddock, *supra* note 170, at 197. This is as opposed to those companies that delisted before Sarbanes-Oxley was passed. *Id.*

220. Nazareth, *supra* note 10.



## IV. CONCLUSION

The difference between the implementation of Sarbanes-Oxley and the AAOIFIF standards is that Sarbanes-Oxley is a new standard that is being applied to old practices. The problem is that, after decades of functioning with weaker, perhaps unethical governance practices, Sarbanes-Oxley is an attempt to mandate ethical practices through enforcement of the law. Companies are forced to factor in the cost of compliance with Sarbanes-Oxley as a business expense without the offset of new gains. Hundreds of millions of dollars have to be spent in order to comply with Sarbanes-Oxley.<sup>221</sup> In Islamic finance, those that enter the market and comply with the regulations at cost, do so with intentions that this cost will be offset by the gain from the new market.<sup>222</sup>

Unlike the AAOIFI, which is premised on ethical principles, American corporate law is based on the enforcement of rules. Rules are made so that breaking them is easy to prove after the fact through judicial litigation. Some, including the SEC, have suggested that shifting the accounting standards to a more objectives-oriented approach would better serve the interests of ethical business practice.<sup>223</sup> This sort of principle-based system would put judgment in the hands of the accountants.<sup>224</sup> The idea is to have a regulatory framework based on principles as opposed to rules.<sup>225</sup> In the American environment of litigation, this system has not enjoyed much consideration.<sup>226</sup> The Islamic AAOIFI standards, however, could offer some guidance. Although both systems are premised on the concept of ethics underlying the transaction and corporate environment, the principle of ethics is indistinguishable from the Islamic system; whereas in the American corporate structure, the principle of ethics is distinct. Where ethics do not inherently control business practices, rules rather than principles must govern. Islamic regulations embody ethics as a principle with which business is run, as opposed to Sarbanes-Oxley under which there is a dichotomy between the implementation of the rules and the ethics themselves. In order for the American system to be principles-based,

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221. Michaels, *supra* note 8.

222. See FISHMAN-LAPIN, *supra* note 7.

223. Parker, *supra* note 179.

224. *Id.*

225. Murray, *supra* note 205.

226. Parker, *supra* note 179.

communication between the advisory board and the corporation must be encouraged in order to implement the necessary standards and fulfill the prospective guidance of ethical principles. Transformation from rules to principles would be a positive step. Ethical principles need to be inherent in business practices for the chasm between ethics and corporate law to be eliminated. Merely satisfying the requirements of legislation does not suffice because it encourages a corporate culture that backlashes against the rules.<sup>227</sup> Sarbanes-Oxley mandates a new level of accountability for the American business environment and lays the legal groundwork for the American business system to transform and shift toward a regulatory framework based on principles,<sup>228</sup> as exemplified by the Islamic system of finance.

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227. Kerins, Steve, *Deloitte Exec Gives Lecture at Notre Dame*, THE OBSERVER, Nov. 2, 2006.

228. *Id.*