

***Shari'ah's* Black Box: Civil Liability and Criminal
Exposure Surrounding *Shari'ah*-Compliant Finance**

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I. Introduction:

The legal practitioner, motivated by the exorbitant fees awarded specialists who have acquired expertise in a novel, complex, and highly profitable financial structure, often loses sight of the fundamental threshold issues for such legal structures: whether the transaction or business model complies with existing civil and criminal statutory and regulatory frameworks, and whether the transaction exposes the client to unique and elevated civil liability, criminal exposure, or regulatory intervention.¹

Unfortunately, the history of the legal and accounting professions in guiding clients through the hazards of novel and complex transactions has been poor. Perhaps nowhere is this more evident than in the professional treatment of *Sharia*'ah-compliant finance ("SCF"), the practice of investing in conformity with Islamic law. In just the past three decades, financial institutions and finance-driven businesses have entered into countless SCF transactions, facilitated by their attorneys, accountants, and financial advisors.² Due in part to the dependence of the SCF industry on a small group of *Shari*'ah authorities associated with international terrorism, these transactions could potentially expose the parties involved to significant civil and criminal liability in areas as diverse as securities fraud, antitrust, and racketeering. The lesson professionals should have learned from the lessons of the past -- but appear not to have, given what can only be described as the blind exuberance driving SCF -- is that huge profits and explosive growth, massive public relations and marketing efforts, and popular appeal in the financial industry do not establish even a minimal baseline for legal compliance.

Whether a new financial product or an innovative structure for an existing business is compliant with the civil, criminal, and regulatory frameworks imposed on a lightning fast and fully reticulated finance-driven economy is no longer a question for a single professional. Careful analysis and due diligence across several disciplines conducted in a fully-informed, interactive environment is not a luxury of the prudent but a necessity for all but the reckless.

This Article examines *Shari*'ah-compliant finance in light of existing U.S. law. It highlights and examines areas of civil liability and criminal exposure unique to SCF

¹ The post-Enron "Sarbanes-Oxley" world is the recent result of this failure. *See, e.g.*, Harvey J. Goldschmid, Comm'r, Sec. & Exch. Comm'n, Post-Enron America: An SEC Perspective, Address at the Third Annual A.A. Sommer, Jr. Corporate Securities & Financial Law Lecture (Dec. 2, 2002), available at <http://www.sec.gov/news/speech/spch120202hjjg.htm> (last visited Jan. 24, 2008).

² Beyond the Enron-era, the financial world is in the midst of the "sub-prime mortgage securitization" industry meltdown, *see, e.g.*, Ben S. Bernanke, Chairman, Fed. Reserve, The Recent Financial Turmoil and its Economic and Policy Consequences, Address at the Economic Club of New York (Oct. 15, 2007), available at <http://www.federalreserve.gov/newsevents/speech/bernanke20071015a.htm> (last visited Jan. 24, 2008), which is already being compared to the debacle of the Savings & Loan crisis, *see, e.g.*, Amy Waldman, *Move Over, Charles Keating - Causes Of The Savings And Loan Scandal*, WASHINGTON MONTHLY, May 1995, available at http://findarticles.com/p/articles/mi_m1316/is_n5_v27/ai_16947718 (last visited Jan. 24, 2008).

investments and transactions³ in the U.S. as they have been developed and utilized by various financial institutions and facilitated and promoted by legal, accounting, and financial professionals.⁴ Part I provides an introduction to SCF and explains why it should be subject to special scrutiny by lawyers, accountants, and other professional advisers. Part II discusses the role of the professional in SCF transactions and suggests an analytical framework for approaching the legal issues surrounding SCF in the U.S. This framework divides the world of potential liability into two groups: liability arising out of elements endogenous to SCF, involving issues about what *Shari'ah* actually is and requires; and liability arising out of elements exogenous to SCF, such as the impact of Western-adaptions of *Shari'ah* principles. Part III focuses in detail on the former, while Part IV examines legal concerns related to the latter.

After examining the multitude of liability issues surrounding *Shari'ah*-compliant financing, this Article concludes that SCF exposes the financial institutions and other businesses which attempt to exploit this new industry to a host of disclosure, due diligence, and compliance issues, all of which elevate the civil liability and criminal exposure such companies otherwise factor into their business risk profiles.⁵ Moreover, very little of this increased civil liability and criminal exposure has been recognized, analyzed, or guarded against in any meaningful way.⁶

³ The distinction made throughout between a SCF “investment” and “transaction” is intended and important in this context. SCF expresses itself in fundamentally two ways: (a) “the investment” refers to the kind of investment or business *Shari'ah* is understood to permit (i.e., equity versus debt with interest; asset-based versus intangibles such as derivatives or hedging transactions based upon future contingencies; and commerce in permitted versus prohibited industries) and (b) “the transaction” refers to the way in which a permitted investment or business transaction is structured typically through the use of nominate contracts (i.e., an “interest-free” loan may be structured as a cost-plus sale or sale/lease back). See *infra* notes 124-126.

⁴ This memorandum uses the term “facilitator” (or in some cases “professional facilitator”) to mean the range of legal, accounting, and financial advisor professionals who are intimately involved in the promotion and structuring of SCF investments and transactions. An example of this burgeoning cottage industry can be gleaned by looking at the promotional material for the myriad of professional and business conferences dedicated to SCF. See, e.g., *Upcoming Event, Arab Bankers Ass'n of N. Am.*, available at http://www.arabbankers.org/shared/layouts/section.jsp?_event=view&_id=120130_U127360_132301 (last visited Jan. 24, 2008).

⁵ While it is not the purpose of this memorandum to detail the legal risks for the professional facilitators, there is substantial legal exposure for the legal, accounting, and financial professionals who provide the knowledge and expertise to develop the financial and legal instrumentalities of SCF. While “scheme liability” under a Rule 10b-5 private right of action has been put to rest by *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 128 S. Ct. 761 (2008), to the extent that the lawyers get involved in drafting the “representations”, liability will still apply. See LOUIS LOSS & JOEL SELIGMAN, *FUNDAMENTALS OF SECURITIES REGULATION* 1329-1332 (2004) (for a discussion on “primary liability” for lawyers under Rule 10b-5); *id.* at 1465-1469 (for a discussion of the “duty to report evidence of a material violation” under Part 205 to Title 17 of the Code of Federal Regulations promulgated by the SEC pursuant to Section 307 of the Sarbanes-Oxley Act of 2002).

⁶ This conclusion has been reached by a thorough review of the published proprietary and non-proprietary information disseminated by many of the financial institutions and the professional

Several traits of the SCF industry are particularly problematic. First, and most troubling, is the *Shari'ah* “black box” syndrome: U.S. financial institutions and businesses involved in SCF risk grave consequences by willfully ignoring the endogenous elements of *Shari'ah*. Ignoring what *Shari'ah* is -- both in theory and in practice -- and its intimate connection to Islamic terror and holy war against the non-Muslim world amounts to corporate recklessness. Moreover, placing *Shari'ah* in a black box and treating its prohibitions as if they were benign secular and objective “screens” ignores the duty of disclosure of the most important elements of *Shari'ah*: its purposes and its ultimate methods. Based on the materiality standards of contemporary securities and fraud laws, it is clear that a reasonable post-9/11 investor would consider *Shari'ah*'s connection to the Law of *Jihad*, and several *Shari'ah* authorities' advocacy of violence and connection to terrorism, as material to their investment decision.

Second, insofar as U.S. financial institutions participate in and cooperate with the *Shari'ah* authorities' efforts to establish the rules and regulations for the SCF industry, antitrust issues such as rules collusion are likely to present additional issues of exposure for those embracing this new industry. And lastly, the current structure of the SCF industry in which two dozen of the most influential *Shari'ah* authorities control the way funds go in and out of the largest financial enterprises in the world creates the paradigmatic pattern of predicate racketeering activity any aggressive prosecutor or plaintiff's lawyer looks for in a RICO cause of action

As a result of these troubling characteristics of *Shari'ah*-compliant finance, U.S. financial institutions and businesses have a duty to conduct reasonable due diligence to be certain that their respective *Shari'ah* authorities are neither advocating crimes in the name of *Shari'ah* nor promoting the material support of terror, either through legal rulings or through the funneling of “purification” funds to terrorists. Failure to conduct such due diligence can lead to catastrophic civil and criminal liability.

This analysis is a first of its kind in the published literature. To date, there has been no focused effort to identify and analyze the implications for civil liability and criminal exposure for U.S. financial institutions and other businesses engaged in any of the various manifestations of SCF from a legal and regulatory framework. While some of the SCF professional and scholarly writings address broad regulatory concerns⁷, economic

facilitators (i.e., the law firms, accounting firms, and financial advisors who promote SCF as a business model and marketing niche) and of the published academic and trade journals which have treated SCF in some detail over the past decade. Some of this material will be referenced throughout this memorandum as its relevance to disclosure, due diligence, compliance, industry standards, and best practices are examined.

⁷ See, e.g., ISLAMIC FINANCE: THE REGULATORY CHALLENGE (Simon Archer & Rifaat Ahmed Abdel Karim eds., 2007); Ayman H Abdel-Khaleq, *Offering Islamic funds in the US and Europe*, INTERNATIONAL FINANCIAL LAW REVIEW, available at <http://www.iflr.com/?Page=17&ISS=16434&SID=515350> (last visited Jan. 24, 2008).

risks⁸, and transactional⁹ and market-related hurdles¹⁰, scant attention has been paid to the specific civil and criminal liability implications of SCF. Necessarily, this is an introductory and preliminary effort.¹¹ Each specific area identified in this Article requires and deserves a detailed treatment by academics and legal professionals, including government attorneys involved in financial regulation and compliance, policy specialists, and---most importantly---practitioners advising their clients on the advisability and the logistics of SCF.

II. Overview of Shari’ah-Compliant Finance:

A. What is SCF?

According to the disclosures and representations of the financial institutions currently promoting SCF¹², *Shari’ah* compliance means that a particular investment or financial transaction has been conducted or structured in a way considered “legal” or “authorized”¹³ pursuant to Islamic law.¹⁴ Compliance with *Shari’ah* is achieved by having a *Shari’ah* authority – either an individual or group of individuals possessing

⁸ See, e.g., THE POLITICS OF ISLAMIC FINANCE (Clement M. Henry & Rodney Wilson eds., 2004); see also IBRAHIM WARDE, ISLAMIC FINANCE IN THE GLOBAL ECONOMY (2000).

⁹ Michael J.T. McMillen, *Symposium: Islamic Business and Commercial Law: Contractual Enforceability Issues: Sukuk and Capital Markets Development*, 7 CHI. J. INT’L L. 427 (2007).

¹⁰ See, e.g., THE POLITICS OF ISLAMIC FINANCE (Clement M. Henry & Rodney Wilson eds., 2004); Jane Pollard & Michael Samers, *Islamic Banking And Finance: Postcolonial Political Economy And The Decentering Of Economic Geography*, 32 TRANSACTIONS OF THE INSTITUTE OF BRITISH GEOGRAPHERS 313 (2007), available at <http://www.blackwell-synergy.com/doi/pdf/10.1111/j.1475-5661.2007.00255.x?cookieSet=1> (last visited Jan. 24, 2008).

¹¹ This memorandum does not address in any meaningful way SCF insurance. This is due in large part to the complex nature of the business of insurance and its regulation and the relatively untested models for *Shari’ah* compliant insurance schemes from within the SCF industry itself.

¹² A good yet basic recitation of SCF by a U.S. Muslim academic who was the “Scholar-in-Residence: U.S. Department of Treasury” on SCF is in Mahmoud Amin El-Gamal, *A Basic Guide to Contemporary Islamic Banking and Finance* (June 2000), available at <http://www.nubank.com/islamic/primer.pdf> (last visited Jan. 24, 2008).

¹³ In classical and traditional Islamic law, extant and in use to this day by the recognized *Shari’ah* authorities, there are essentially five categories of normative assessments: obligatory, recommended, permitted, discouraged, and forbidden. ENCYCLOPEDIA OF ISLAMIC LAW: A COMPENDIUM OF THE MAJOR SCHOOLS xxxvii-xxxviii (Laleh Bakhtar ed., 1996).

¹⁴ While *Shari’ah* is often referred to as Islamic law, *Shari’ah* is according to the *Shari’ah* authorities the divine law of Allah which is articulated directly to man through the *Qur’an* and indirectly through the canonical stories of Mohammed’s life as told through the *Hadith*. The jurisprudential rules developed by the *Shari’ah* authorities over time to arrive at finite legal rulings are often referred to as *usul al fiqh* or the roots of the law and *al fiqh* or just *fiqh* is the *corpus* of jurisprudential rules and principles. *Furu’* is the term used for the positive law rulings of individual jurists. For a discussion of this in more detail, see *infra* note 32. For purposes of this memorandum, the word *Shari’ah* is used as a collective term to include all of these elements unless otherwise indicated. This is how most Muslims use the word in the vernacular.

authoritative status in matters relating to SCF¹⁵ – approve the particular investment or type of transaction. Most financial institutions retain¹⁶ a *Shari'ah* advisory board, which typically consists of three or more “*Shari'ah* scholars” who profess to be recognized as authorities in SCF.¹⁷

According to most financial institutions, SCF is achieved by the avoidance of interest¹⁸, risk (typically understood as uncertainty or speculation)¹⁹, and certain types of prohibited

¹⁵ There is no universally recognized degree or examination to acquire the status of an SCF authority. Generally, the discipline in *Shari'ah* related in part to commerce is termed *fiqh al muamalat* and while there are jurists who specialize in this area, the qualifications for such positions are quite varied. While the industry itself is undertaking to create standards and structures for uniformity and transparency, it has not been successful to date. An examination of these issues can be found in Wafik Grais & Matteo Pelligrini, *Corporate Governance and Shariah Compliance in Institutions Offering Islamic Financial Services* (World Bank Policy Research Working Paper No. 4054, 2006), available at http://www-wds.worldbank.org/servlet/WDSContentServer/WDSP/IB/2006/11/08/000016406_20061108095535/Rendered/PDF/wps4054.pdf (last visited Jan. 24, 2008).

¹⁶ The manner in which a *Shari'ah* advisor is employed or contracted for by the financial institution bears on several of the legal complications and risks discussed herein. See *infra* notes 48-51 and accompanying text (discussing criminal *respondeat superior*); see also *supra* note 14 and accompanying text.

¹⁷ The number of *Shari'ah* scholars sufficiently versed in the disciplines necessary to be gainfully employed by a “blue chip” financial institution engaged in SCF is quite limited. It is generally represented that there are only about 20-25 competent *Shari'ah* scholars who have mastered *Shari'ah*, finance, and English well enough to be considered both an SCF scholar and employable. Richard C. Morais, Don't Call It Interest, Forbes.com, <http://www.forbes.com/business/global/2007/0723/104.html> (last visited Jan. 24, 2008). For the general problem of the dearth of qualified *Shari'ah* scholars, see Grais & Pelligrini, *supra* note 15, at [page number here] & n.18.

¹⁸ In Arabic, the term used is *riba*, which literally means “increase.” In the past, there has been debate among *Shari'ah* authorities and Islamic academic scholars over the prohibition against *riba* in financial and commercial transactions. Some scholars point to the fact that the prohibition against interest in the *Qur'an* is not simple interest but usurious interest and specifically a default interest prevalent in pagan pre-Islamic Arabia. Today, the debate is academic because there is broad consensus that interest of all kinds is forbidden by *Shari'ah*. For the consensus view of the prohibition against interest, see FRANK E. VOGEL & SAMUEL L. HAYES, III, ISLAMIC LAW AND FINANCE: RELIGION, RISK, AND RETURN 71-87 (1998). For a contrarian position, see TIMUR KURAN, ISLAM & MAMMON: THE ECONOMIC PREDICAMENTS OF ISLAMISM 14 (2004); see also Alex Alexiev, *Islamic Finance or Financing Islamism?* 6-7 (The Center for Security Policy, Occasional Papers Series No. 29, 2007). For a general discussion of how contemporary SCF has perverted the “intent” of an “authentic” Islamic political economy, see Mahmoud Amin El-Gamal, “Interest” and the Paradox of the Contemporary Islamic Law and Finance, 27 FORDHAM INT'L L.J. 108 (2003); Chibli Mallat, *The Debate on Riba and Interest in Twentieth Century Jurisprudence*, in ISLAMIC LAW AND FINANCE (Chibli Mallat ed., 1988).

¹⁹ The *Qur'an* forbids gambling or *maysir*; the *Sunna* includes *gharar* or risk in the prohibition. Since all business includes an element of risk, the jurisprudential task for the *Shari'ah* authorities is to take the specific examples found in the canonical literature, such as “Do not buy fish in the sea, for it is *gharar*,” and to translate that into principles, then rules and finally into finite rulings

industries (relating to activities considered *haram* or forbidden, such as the pork and alcohol-beverage industries, pornography, gambling, and interest-based financing).²⁰ In addition, SCF also includes a focus on “purification”, which has two separate elements. One is a form of obligatory charitable contribution called *zakat*, where the act of supporting the less fortunate is considered a spiritual purification²¹; the other is the purification of a *Shari’ah*-compliant investment or financial transaction that has been tainted with forbidden revenue, whether from interest, illicit speculation, or a forbidden commercial enterprise such as the pork industry.²² In the latter meaning of purification, the forbidden funds must be disgorged by donating the money to an acceptable charity, but this charitable gift will not count towards a Muslim investor’s *zakat* requirement.²³

A rudimentary understanding of *Shari’ah* is required to grasp the implications of SCF relative to U.S. law. To begin, *Shari’ah*, or the ‘proper way’, is considered the divine will of Allah as articulated in two canonical sources. The first is the *Qur’an*, which is considered the perfect expression of Allah’s will for man. Every word is perfect and unalterable except and unless altered by some subsequent word of Allah.²⁴ While most of

and contract forms which are considered *halal* or permitted. See generally VOGEL & HAYES, *supra* note 18, at 87-95.

²⁰ While there is general agreement about most of these industries as absolutely forbidden, some such as the tobacco business and military and defense industries are typically forbidden in SCF in Western countries but not considered an absolute *Shari’ah* prohibition. For an exploration into the *Shari’ah* motives for forbidding defense industry investments in the West, see *infra* notes 50, 73-76 and accompanying text.

²¹ *Zakah* (sometimes referred to as *zakat*), which literally means purification, is a form of religious tax for assisting the less fortunate and those that “struggle for Allah.” The amount is between 2.5% and 20%, depending upon the source of the wealth, but it is typically on the lower end (2.5%) of the scale. The amounts also vary based upon which of the four Sunni schools of jurisprudence one follows. Shi’a Muslims also follow their own jurisprudence which also accounts for some of the variation. For a fuller discussion of this religious tax and its use to support those who “struggle for Allah” or fight against non-Muslims in holy war (i.e., *Jihad*), see John D.G. Waszak, *The Obstacles to Suppressing Radical Islamic Terrorist Financing*, 37 CASE W. RES. J. INT’L L. 673 (2005).

²² See the extended discussion on purification by a well-known American *Shari’ah* authority, in Yusuf Talal DeLorenzo, *Shari’ah Supervision of Islamic Mutual Funds*, available at <http://www.djindexes.com/mdsidx/downloads/delorenzo.pdf> (last visited Jan. 24, 2008).

²³ Yusuf Talal DeLorenzo, *Dow Jones Universtiy Questions and Answers*, Question 32, available at <http://www.central-mosque.com/fiqh/dow.htm> (last visited Jan. 24, 2008).

²⁴ For a thorough discussion from a “moderate” *Shari’ah* authority on the full theological and jurisprudential analysis of *Shari’ah*, see MOHAMMAD HASHIM KAMALI, *PRINCIPLES OF ISLAMIC JURISPRUDENCE* (2003). For the specific discussion of “abrogation”, which is the juridical view of latter *Qur’anic* verses which contradict earlier ones, see *id.* at 202-227. For an analytical and objective analysis of Islamic jurisprudence and its implications for Muslim-non-Muslim relations, see Stephen Collins Coughlin, “To Our Great Detriment”: Ignoring What Extremists Say About Jihad (with appendices) 83-133 (July 2007) (unpublished thesis, National Defense Intelligence College).

the *Qur'an*'s 6,236 verses²⁵ are not considered legal text, there are 80 to 500 verses²⁶ considered instructional or sources for normative law. But the *Qur'an* is only one source of Allah's instruction for *Shari'ah*. The *Hadith*²⁷, or stories of Mohammed's life and behavior, are also considered legal and binding authority for how a Muslim must live. The *Hadith* were collected by various authors in the early period after Mohammed's death. Over time, Islamic legal scholars vetted the authors for trustworthiness and their *Hadith* for authenticity, and there is now a general consensus across all Sunni schools that there are six canonical *Hadith*.²⁸ The legal or instructional portions of the *Hadith* together make up the *Sunna*.²⁹ While the *Shari'ah* authorities from the Shi'a Muslim

²⁵ Because the original Arabic *Qur'an* is not formally numbered and there are no periods in classical Arabic setting off one verse from another, Islamic canon typically breaks the 114 *suras* or chapters into 6,236 *ayat* or verses, but other counts are also used.

²⁶ There is also a healthy debate over which verses in the *Qur'an* are actually legal sources (*ayat al-ahkam*) such that laws are directly or indirectly derived from them. According to most scholars, the debate centers on the context of the appearance of a verse which has within it a connection to normative or instructional language. Some include all such verses while others only count those verses which are clearly "legal" in that they address authorized or prohibited behavior. See, e.g., KAMALI, *supra* note 24, at 25-27.

²⁷ *Hadith* is singular for 'tradition'. *Ahadith* is the plural. This memorandum uses *Hadith* as the collective body of traditions.

²⁸ The *Hadith* were not formally collected between 100 to 200 years after the death of Mohammed. See generally THE ISLAMIC SCHOOL OF LAW: EVOLUTION, DEVOLUTION, AND PROGRESS viii-xii (Peri Bearman, Rudolph Peters & Frank E. Vogel eds., 2005) ; see also Coughlin, *supra* note 24, at n.90:

Individuals associated with Muhammad in his lifetime were called "companions."

Among the numerous companions, the seven most prolific commentators on his life were Abu Hurairah 'Abdur Rahman bin Sakhar Dasi (5,374 Hadith), Abdullah bin Umar bin Khattab (2,630), Anas bin Malik (2,286), Aisha (2,210), Abdullah bin Abbas (1,660), Jabir bin Abdullah Ahsan (1,540), and Sa'ad bin Malik Abu Saeed Khudhri (1,540). The compiled Hadith of these companions did not survive in their original creations but were passed down and collected by numerous Hadith collectors of varying quality and repute. Six scholars stand out among Hadith collectors for the reputed accuracy and authenticity in the selection of Hadith they chose to include as a part of their collections. In precedent order, the six "correct" collections of the Sunni, also called the "Six Canonical Collections" (the Sahih Sittah), are the works of Bukhari, Muslim, Abu Dawud, Tirmidhi, Ibn Maja and Nasa'i. Hence, if a story concerning Muhammad is related through one of the six "correct" collections and it reliably cites one of the seven companions, a presumption emerges, verging on irrefutable, that the texts cited are accurate for the points being made - as matters of both Islamic theology and law. Because those accounts are presumed reliable, the Sunna arising from them cannot be construed to contradict the Qur'an but rather are to be understood as doctrinally authoritative explanations of the Quranic verses they support: "Whatever the Messenger gives you, then take it and whatever he prohibits you, then stay away from it." (Qur'an 59:7)

²⁹ The debate over the role the *Hadith* should play as the secondary basis for *Shari'ah* is in fact the debate between the traditionalists who follow the millennium-old doctrine of the Islamic legal schools versus the progressives, typically in academia. The former account for the "*Shari'ah* authorities" and the latter for university professors who wish to distance themselves and Islam from the quite bellicose legal-military doctrines derived from the *Hadith*. The subject is fascinating and rich with drama but not one this memorandum can take up. The interested reader

world also accept the *Hadith* as authoritative, they differ on the selection of the authors accepted as authoritative based mostly upon theological grounds.³⁰ For all *Shari'ah* authorities, however, the *Qur'an* is considered the direct revelation of Allah's will and therefore primary, while the *Sunna* is the indirect expression of that will and secondary. Both sources are considered absolutely infallible and authoritative.

In order to divine the detailed laws, norms, and customs for a Muslim in all matters of life, the *Shari'ah* authorities over time developed schools of jurisprudence to guide their interpretations of the *Qur'an* and *Sunna*. While there is broad agreement among the schools about the jurisprudential rules, important distinctions between the schools result in different legal interpretations and rulings, albeit typically differences of degree, not of principle.³¹ The rules of interpretation and their application to finite factual settings in the form of legal rulings are collectively termed *al fiqh* (literally "understanding"). *Usul al fiqh*, or the "sources of the law", is what is normally referred to as jurisprudence. Technically, *Shari'ah* is the overarching divine law and *fiqh* is the way *Shari'ah* authorities have interpreted that divine law in finite ways.³² It is important to note,

should begin with Coughlin, *supra* note 24, at 83 et seq., and then turn to one of the founders of the academic study of *Shari'ah* and Islamic jurisprudence, Joseph Schacht. Must reading would be JOSEPH SCHACHT, AN INTRODUCTION TO ISLAMIC LAW (1982), and JOSEPH SCHACHT, MUHAMMADAN JURISPRUDENCE (1950). Revisionists abound and two interesting versions are WAEL B. HALLAQ, A HISTORY OF ISLAMIC LEGAL THEORIES (1997) and WAEL B. HALLAQ, THE ORIGINS AND EVOLUTION OF ISLAMIC LAW (2005) on the one hand; and M. MUSTAFA AL-AZAMI, ON SCHACHT'S ORIGINS OF MUHAMMADAN JURISPRUDENCE (1996) on the other hand. Useful also would be KAMALI, *supra* note 24.

³⁰ Shi'a Islam differs from Sunni Islam theologically on who they consider to be legitimate successors to Mohammad's reign as leader of the Muslim *Umma* or nation. This has jurisprudential consequences because Shi'a Muslims, who await the return of the Fourth Imam or Caliph following Mohammed, consider their Imams who have followed in the Fourth Imam's footsteps to be his stand-in until his return and as such they share his infallibility. Thus, the leading contemporary Shi'a Imams are considered by their followers as inerrant and their legal rulings take on the perfection one would expect from inerrant beings. See Coughlin, *supra* note 24, at [page number here] n.52 and accompanying text.

³¹ As noted, the *Shari'ah* authorities developed different schools of legal interpretation. These schools are called *maddhahib* (or *maddhab* in the singular form). Early in their development, there were many schisms and new schools but over time, the main body of legal scholarship and almost all *Shari'ah* authorities have long come to recognize only four extant schools among Sunni Muslims and one dominant school (some cite two) among Shi'a Muslims. While there are important jurisprudential and theological differences between the Sunni and Shi'a, see *supra* note 29, and indeed between the schools themselves within the respective Sunni and Shi'a traditions, the specific rulings among all schools on the fundamental issues regarding the purposes of *Shari'ah*, the point of the individual Muslim's life, and the integrity and unity of the Muslim nation as a whole and the methodologies to achieve those ends are remarkably consistent, see generally Coughlin, *supra* note 24.

³² *Furu'* is the Arabic word most often associated with positive law or the particular rulings in any given case. See VOGEL & HAYES, *supra* note 18, at 23-24; see also M. Cherif Bassiouni & Gamal M. Badr, *The Shari'ah: Sources, Interpretation, and Rule-Making*, 1 UCLA J. ISLAMIC & NEAR E.L. 135 (2002). For a discussion of *furu'* and *usul al-fiqh*, see Wael B. Hallaq, *Usul Al-Fiqh: Beyond Tradition*, 3:2 J. ISLAMIC STUD. 172-202 (1992), reprinted in *Law and Legal Theory*.

however, that the word *Shari'ah* appears only once in the *Qur'an* in this context³³, yet it has gained currency in the Islamic world by virtue of the *Shari'ah* authorities over more than a millennium creating a *corpus juris* (i.e., *al fiqh*) based upon their interpretative understandings of the *Qur'an* and *Sunna*. As such, this Article uses the word *Shari'ah* to mean all of Islamic jurisprudence, doctrine, and legal rulings, much as it is used in the vernacular by the typical *Shari'ah*-adherent Muslim.

Prior to the twentieth century, there was no discipline termed *Shari'ah*-compliant financing or even a *Shari'ah* sub-code regarding commercial transactions.³⁴ There are rulings by *Shari'ah* authorities authorizing certain contract forms dating back hundreds of years, but as late as the 1900s there was still some debate among *Shari'ah* authorities whether the prohibition against interest was absolute or just against usurious interest. When contemporary Islamic political thinkers began to confront the collapse of the Ottoman Empire after the First World War and the intrusion of Western modes of social, political, and commercial life into the heart of the Muslim world, *Shari'ah* authorities followed their lead and began to issue legal rulings to confront this new reality.³⁵ Beginning with the early political-theological writings of men such as Maulana Abul Ala Mawdudi---who argued for an Islamic political resurgence and a unique Islamic political economy---*Shari'ah* authorities followed suit by issuing authoritative legal rulings forbidding interest on deposits and calling for the establishment of "Islamic banks". Over time, these rulings have incorporated prohibitions against transactions considered too uncertain or speculative and also rulings to prevent Muslims from investing in businesses engaged in un-Islamic behavior.³⁶ The development of these rules and the formalization of SCF have matured over the past three decades so that today there are entire university departments in the Middle East, Asia, and even in Western universities dedicated to the

³³ See *Qur'an* 45:18. But see *Qur'an* 5:48, where a variation of the word appears and has the meaning of the 'proper way'; while some might argue that the word appears in yet other variations, the first of these two are the typical verses cited where the word is used in the sense of a legally proper path.

³⁴ The legal verses of the *Qur'an* are typically broken down into those verses dealing with religious rites and worship (*ibadat*) and those dealing with civil relations including commerce, political life, and the Law of *Jihad* (*mu'amalat*). KAMALI, *supra* note 24, at 26. What is confusing to many is that most academics writing on the subject of SCF define *mu'amalat* as civil or commercial relations giving the impression that there is in fact some sub-code of strictly commercial matters devoid of broader implications. See, e.g., Yusuf Talal DeLorenzo & Michael J.T. McMillen, *Law and Islamic Finance: An Interactive Analysis*, in ISLAMIC FINANCE, *supra* note 7, at 142. But cf. VOGEL & HAYES, *supra* note 18, at 301, where the "Glossary" defines *mu'amalat* as "dealings or transactions among human beings; compare 'ibādāt." Thus, while the "glossary" definition is technically correct and properly juxtaposes *mu'amalat* against *ibadat*, the reader who would need such a glossary is not likely to understand that *mu'amalat* is as much the Law of *Jihad* as it is commercial dealings.

³⁵ See generally *supra* note 18. For the "socio-economic" impetus for SCF, see Walid S. Hegazy, *Symposium: Islamic Business And Commercial Law: Contemporary Islamic Finance: From Socioeconomic Idealism To Pure Legalism*, 7 CHI. J. INT'L L. 581 (2007).

³⁶ See generally DeLorenzo & McMillen, *supra* note 34, at 132-197.

study of SCF.³⁷ Most observers connect this recent development to the emphasis of *Shari'ah* in the oil-producing Arab states and their wealth-driven influence throughout the Muslim world and the West.³⁸

Effectively, SCF is an attempt to embrace modern interest-based commerce and finance, but to do so within a framework of *Shari'ah*-approved structures. For example, while almost all *Shari'ah* authorities forbid any transaction or investment which provides for interest income, SCF rules allow for interest in two ways. One way is to rule that a Muslim can invest in a permitted business that earns or pays interest but only if the amount is below a maximum level.³⁹ Any profit earned by the Muslim from that interest component, however, must be purified by contributing that portion to a *Shari'ah*-approved charity.⁴⁰ A second way to accommodate modern commercial transactions is to structure the forbidden transaction within *Shari'ah*-approved contract forms. These nominate contracts are based upon contract forms found in the classical rulings of the *Shari'ah* authorities prior to the advent of contemporary finance. Thus, a loan might be structured as a “cost-plus sale” where the lender buys the property and immediately sells it back to the borrower for a “profit”. This profit is the interest component in the typical loan transaction. The purchase price with the profit component included can be paid over time to resemble an amortized loan repayment schedule. Other forms are available to deal with interest and also with unduly speculative transactions, including sale-lease back contracts, and partnerships with variations and combinations. For the more complex transactions, these *Shari'ah* approved nominate contracts are often pieced together and used in combination to arrive at a *Shari'ah*-compliant modern commercial deal.⁴¹

³⁷ See Muslim-Investor.com, Resources -- Education/Curricula in Islamic Finance, Education and Banking, available at <http://muslim-investor.com/mi/education.phtml> (last visited Jan. 25, 2008) (listing university departments).

³⁸ See generally WARDE, *supra* note 9, who theorizes of a “First and Second Aggiornamento” to suggest a first movement driven by a centralization of power and influence flowing from Arab oil wealth and a second movement driven by decentralized social, political, and financial constituencies. For a media rendition of the oil wealth-driven industry, see Wayne Arnold, Islamic Banking Rises on Oil Wealth, Drawing Non-Muslims, INT’L HERALD TRIB., Nov. 22, 2007, available at <http://www.iht.com/articles/2007/11/22/business/islamic.php> (last visited Jan. 25, 2008).

³⁹ The first order of business for determining whether a business is *Shari'ah* compliant is to make certain that it is not involved in a “vice” industry such as interest-based financing, the pork industry, various forms of the entertainment industry, and gambling. The question for *Shari'ah* authorities is how much “involvement” in a prohibited business amounts to a violation of *Shari'ah* such that an investor must not invest in that company. The same question applies to a permitted business that might earn interest on deposits or accounts payable and pay interest on debt: How much interest is too much interest? For a discussion of the *Shari'ah* authority opinions on this matter by one of the leading *Shari'ah* authorities, see Nizam Yaquby, Participation and Trading In Equities of Companies Which Main Business Is Primarily Lawful but Fraught with Some Prohibited Transactions, Address at the Fourth Harvard Islamic Finance Forum, Harvard University (Sept. 30-Oct 1, 2000), available at <http://www.djindexes.com/mdsidx/downloads/yaquby.pdf> (last visited Jan. 25, 2008).

⁴⁰ See DeLorenzo, *supra* note 22.

⁴¹ See DeLorenzo & McMillen, *supra* note 34, at 143-150. Since the development of SCF, the debate among Islamic, economic, and *Shari'ah* scholars continues over the propriety of this new

B. Why is SCF important?

As a burgeoning industry, SCF is touted as one of the fastest growing sectors in the global financial markets.⁴² Total funds committed to SCF investments is estimated to be \$800 billion worldwide⁴³, with \$200 billion of assets under management in *Shari'ah*-compliant banks.⁴⁴ Annual growth in this sector is estimated at between 15-20%⁴⁵, based upon current trends fueled mainly by profits in the Muslim oil- and gas-producing countries and by a worldwide Muslim population reported to be the fastest growing among the world's major religions.⁴⁶

Within the SCF market, *Shari'ah*-compliant bonds, known in Arabic as *sukuk*⁴⁷, are the most explosive segment driven by huge petro-dollar profits creating enormous sovereign wealth and liquidity. As of the end of the second quarter 2007, outstanding *Shari'ah*-

field of *Shari'ah* scholarship. Some argue that the industry is nothing more than form over substance and an abuse of *Shari'ah*. Others contend that SCF is a convoluted way for *Shari'ah* to effect its purposes in modern Western financial institutions. For the former, the debate is over the perversion of *Shari'ah* and its pre-modern ethic and economic principles. This group of critics would prefer that *Shari'ah* be used to modify the existing political economies to move away from interest-based debt and highly speculative and leveraged derivative transactions. For the latter group of critics, SCF is more than just an attempt to mollify the *Shari'ah* authorities; it is a "Trojan Horse" to legitimize and to institutionalize *Shari'ah*, the purpose of which is the destruction of Western societies as such. For an example of the former group, see Haider Ala Hamoudi, *Muhammad's Social Justice or Muslim Cant?: Langdellianism and the Failures of Islamic Finance*, 40 CORNELL INT'L L.J. 89; El-Gamal, *supra* note 18. For the latter group, see KURAN, *supra* note 18; Alexiev, *supra* note 18.

⁴² Drake Bennett, *The Zero Percent Solution*, BOSTON GLOBE, Nov. 4, 2007, available at http://www.boston.com/news/education/higher/articles/2007/11/04/the_zero_percent_solution/ (last visited Jan. 25, 2008).

⁴³ Alexiev, *supra* note 18, at [page number here] & n.1.

⁴⁴ Islamic Banking---Status of Islamic Banking, Institute of Islamic Banking and Insurance, available at <http://www.islamic-banking.com/ibanking/statusib.php> (last visited Jan. 25, 2008).

⁴⁵ See Mohammed El Qorchi, *Islamic Finance Gears Up*, 42 Fin. & Dev., Dec. 2005, available at <http://www.imf.org/external/pubs/ft/fandd/2005/12/qorchi.htm> (last visited Jan. 25, 2008). Growth is reported to have reached 30% annually. See Karina Robinson, *Islamic Finance Is Seeing Spectacular Growth*, INT'L HERALD TRIB., Nov. 5, 2007, available at <http://www.ihf.com/articles/2007/11/05/business/bankcol06.php> (last visited Jan. 25, 2008).

⁴⁶ Gayle Young, *Fast Growing Islam Winning Converts in Western World*, CNN Interactive News, <http://www.cnn.com/WORLD/9704/14/egypt.islam/> (last visited Jan. 25, 2008). The Executive Vice President and General Counsel of the Federal Reserve Board of New York cited a White House report that Islam is the "fastest growing faith in the United States." Thomas C. Baxter, Jr., Executive Vice President & Gen. Counsel, Fed. Reserve Bank of N.Y. Welcome Speech to the Seminar on Legal Issues in the Islamic Financial Services Industry (March 1, 2005), available at <http://www.newyorkfed.org/newsevents/speeches/2005/bax050301.html> (last visited Jan. 25, 2008).

⁴⁷ *Sukuk* in Arabic is plural for bonds; *sak* is the singular form.

compliant bonds totaled \$80 billion, with another \$37.3 billion issued in the third quarter--double the amount issued during the same period the previous year.⁴⁸

All of this growth, underwritten mostly by the mobile, highly liquid capital flowing out of the GCC states⁴⁹, has generated an industry of financial institutions, law firms, accounting firms, financial advisors, and money managers establishing domestic and international links with the key investment figures in the GCC states in an effort to exploit the opportunity for substantial profits.⁵⁰ This enthusiasm has been translated to domestic U.S. financial industries in many ways.⁵¹ U.S. financial institutions seek to

⁴⁸ Mark Bendeich, *Islamic Finance: Safe Haven or Irrational Exuberance?* REUTERS, Dec. 10, 2007, <http://www.reuters.com/article/bankingfinancial-SP-A/idUSKLR27708220071210> (last visited Jan. 25, 2007). Growth in this industry is best illustrated graphically. For growth data on *Shari'ah* compliant bonds, see Appendix A. To put the *Shari'ah* compliant bond issuance in context, the total net issuances of all international bonds and notes for the third quarter of 2007 was \$396 billion, which represents a significant downturn in worldwide demand for such debt instruments. See BANK FOR INTERNATIONAL SETTLEMENTS, BIS QUARTERLY REVIEW 19-21, Dec. 2007, available at http://www.bis.org/publ/qtrpdf/r_qt0712.pdf (last visited Jan. 25, 2008). That *Shari'ah* compliant bonds were showing spectacular growth in the same quarter and representing approximately 10% of worldwide demand speaks volumes for the popularity and the liquidity of this particular market segment.

⁴⁹ The principal oil-producing Muslim states are located in and around the Persian Gulf: Bahrain, Kuwait, Qatar, Oman, Saudi Arabia, the United Arab Emirates, Iraq, and Iran. These countries, sans Iraq and Iran, formed the Gulf Cooperation Council in February 1981. See Council Charter of the Secretariat General of the Cooperation Council for the Arab States of the Gulf, available at <http://www.gcc-sg.org/eng/index.php?action=Sec-Show&ID=1> (last visited Jan. 25, 2007).

⁵⁰ For some of the promotional literature naming several of the "facilitators," see, e.g., John Butcher, *Shariah Funds Inc Introduces the First Islamic Hedge Fund Aided by Scholars*, HEDGE FUNDS REV., available at http://www.shariah-funds.com/news/images/Hedge_Funds-Rev.pdf. For specifically offices of such international law firms as Patton Boggs in Qatar, see the firm's Internet site, <http://www.pattonboggs.com/Locations/Office.aspx?office=4> (last visited Feb. 28, 2008). For Patton Boggs promotional material indicating the law firm is also a registered agent for lobbying on behalf of the Saudi Arabian government, see Patton Boggs LLP, Attorneys at Law, <http://www.pattonboggs.com/middleeast/> (last visited Feb. 28, 2008). The law firm of King and Spaulding also highlights its activities in the area on its Internet site. See King & Spaulding, http://www.kslaw.com/portal/server.pt?space=KSPublicRedirect&control=KSPublicRedirect&PracticeAreaId=141&us_more=0 (last visited [date]); see also Brian O'Connell, *Wealth Management: Gulf's Super Rich Return Home*, MEED, Dec. 21, 2007 (updated Jan. 9, 2008), available at http://www.meed.com/bankingandfinance/specialreport/2007/12/gulfs_superrich_return_home.html.

⁵¹ For GCC sovereign wealth funds purchasing U.S. assets, see David Enrich, *Oil-Rich Persian Gulf Countries Show Growing Financial Clout*, DOW JONES NEWSWIRE, Oct. 22, 2007, available at <http://www.zawya.com/story.cfm/sidDN20070920015851> (last visited Feb. 4, 2008). For the push to establish SCF in the U.S., see generally Wayne Arnold, *Adapting Finance to Islam*, N.Y. TIMES, Nov. 22, 2007, available at <http://www.nytimes.com/2007/11/22/business/worldbusiness/22islamic.html?ei=5087&em=&en=d6f0821c05a1d02f&ex=1195880400&pagewanted=all> (last visited Jan. 25, 2008).

underwrite *Shari'ah*-compliant bond issuances domestically and globally;⁵² Dow Jones and Company⁵³ and Standard & Poor's⁵⁴ have both established *Shari'ah*-compliant indexes that screen equities based upon software filters meant to eliminate *Shari'ah*-non-compliant businesses; *Shari'ah*-compliant U.S.-based managed equity funds⁵⁵ and off-shore hedge funds⁵⁶ managed or advised by entities related to U.S. financial institutions have been established and can now peg their performances against these indexes; and U.S. banks have begun to offer *Shari'ah*-compliant home loans and other credit facilities⁵⁷ with federal banking authorities opining about their legality and at least one state tax authority issuing a ruling on the tax implications of a *Shari'ah*-compliant transaction⁵⁸.

C. The Need for Heightened Scrutiny

When investing or entering into financial transactions, why should adherence to the normative principles of *Shari'ah* require any special or heightened scrutiny in relation to civil liability or criminal exposure? The most immediate answer is that, according to the proponents and practitioners of SCF, *Shari'ah* is not simply an approach to interest-free, ethical investing. Instead, SCF is invariably described by SCF proponents, practitioners,

⁵² Karen Lane, *Islamic-Bond Market Becomes Global By Attracting Non-Muslim Borrowers*, WALL ST. J., Nov. 16, 2006, available at <http://online.wsj.com/article/SB116361223362324035.html> (last visited Jan. 25, 2008); see also Press Release, Dow Jones, *Dow Jones Indexes and Citigroup To Launch First Islamic Bond Index* (Mar. 6, 2006), available at http://www.dj.com/Pressroom/PressReleases/Other/US/2006/0306_US_DowJonesIndexes_1095.htm (last visited Jan. 25, 2008).

⁵³ See Dow Jones Islamic Market Indexes, Dow Jones Indexes, available at <http://www.djindexes.com/mdsidx/?event=showIslamic> (last visited Jan. 25, 2008).

⁵⁴ See STANDARD & POOR'S, S & P SHARIAH INDICES, available at http://www2.standardandpoors.com/spf/pdf/index/SP_Shariah_Indices_Methodology_Web.pdf (last visited Jan. 25, 2008).

⁵⁵ See Index Comparisons, Dow Jones Islamic Fund, http://www.investaaa.com/cgi-bin/client_product.cgi?member=55&product_id=527 (last visited Jan. 25, 2008).

⁵⁶ See Joanna Slater, *Growing Interest: When Hedge Funds Meet Islamic Finance*, WALL ST. J., Aug. 9, 2007, available at http://online.wsj.com/article/SB118661926443492441.html?mod=todays_us_page_one (last visited Jan. 25, 2008).

⁵⁷ See, e.g., *Islamic Finance*, Devon Bank, <http://www.devonbank.com/Islamic/> (last visited Jan. 25, 2008) (Chicago-based Devon Bank internet site promoting its Islamic finance products).

⁵⁸ See, e.g., Shirley Chieu, *Islamic Finance in the United States: A Small But Growing Industry*, Chicago Fed Letter No. 214, May 2005, available at http://www.chicagofed.org/publications/fedletter/cflmay2005_214.pdf (last visited Jan. 25, 2008); Office of the Comptroller of the Currency, Interpretive Letter No. 806, Oct. 17, 1997, available at <http://www.occ.treas.gov/interp/dec97/int806.pdf>; Office of the Comptroller of the Currency, Interpretive Letter No.867, June 1, 1999, available at <http://www.occ.treas.gov/interp/nov99/int867.pdf>; see also State of New York Commissioner of Taxation and Finance Advisory Opinion Petition No. M010821A, Jul. 26, 2002, available at http://www.tax.state.ny.us/pdf/advisory_opinions/real_estate/a02_4r.pdf (last visited Jan. 25, 2008).

and scholars as the contemporary Islamic legal, normative, and communal response to the demands of modern finance and commerce.⁵⁹

As understood on its own terms or by the many constituencies who interpret it, *Shari'ah* is not predicated upon a personal or subjective understanding of what it means to be a Muslim. Neither is it simply an objective formal law or behavioral code regulating finance and commercial transactions. *Shari'ah* has been described as “holistic”⁶⁰, as “designating good order, much like *nomos*”⁶¹, and definitively by Joseph Schacht, the founding father of modern scholarship regarding Islamic jurisprudence, as “[t]he sacred law of Islam [which] is an all-embracing body of religious duties rather than a legal system proper; it comprises on an equal footing ordinances regarding cult and ritual, as well as political and (in the narrow sense) legal rules.”⁶²

In one of the first academic presentations of this new industry, Professors Frank Vogel and Samuel Hayes explain that *Shari'ah* is not a personalized, subjective, pietistic approach to Islam, but an institutionalized legal-political-normative doctrine and system.⁶³ This classical understanding of *Shari'ah* has been echoed by a leading professor of finance in Australia and a senior official in the Bahrain Ministry of Finance and National Economy.⁶⁴

Shari'ah is therefore not a religious legal code in which offending areas of law can be isolated and removed from a cauterized *corpus juris*. Instead, *Shari'ah* is understood by

⁵⁹ See generally VOGEL & HAYES, *supra* note 18. SCF is “legal” in the sense it includes aspects of binding law, especially in Muslim countries where *Shari'ah* is considered both constitutional and statutory, such as Saudi Arabia, Iran, and Sudan; “normative” in the sense that *Shari'ah* is considered an all-encompassing way of life; and “communal” in the sense that communities of Muslims have in fact embraced *Shari'ah* as authoritative at some level.

⁶⁰ Bassiouni & Badr, *supra* note 32, at 135.

⁶¹ WARDE, *supra* at note 9, at 33.

⁶² JOSEPH SCHACHT, AN INTRODUCTION TO ISLAMIC LAW I (1982).

⁶³ VOGEL & HAYES, *supra* note 18, at 23.

⁶⁴ MERVYN K. LEWIS & LATIFA M. ALGAOUD, ISLAMIC BANKING 24 (Edward Elgar ed., 2001). While the authors attempt to “tone down” this absolute statement of *Shari'ah* by suggesting that as a practical matter *Shari'ah* has in fact lived side-by-side with secular law and in some cases even incorporated it into *Shari'ah*, they honestly but almost unnoticeably add the following to their effort to soften *Shari'ah*: “The continuation of a custom of a particular place or community is allowable under Islamic law, and may in fact be assimilated into the law, as were many of the customs of the Arabs. **To be permissible a custom must not be contrary to revealed injunctions**, and this point remains highly controversial in some areas, for example the treatment of women.” *Id.* at 25. What the authors mean by “revealed injunctions” means any legal ruling of *Shari'ah* authorities where there is consensus among the authorities that the ruling is based on an explicit verse in the Qur'an or Sunna. See *infra* note 70 and accompanying text (discussing jurisprudential force of “consensus”). What is intriguing is that of all of the fixed unalterable laws of *Shari'ah*, the authors are concerned about the treatment of women. While many certainly argue that *Shari'ah* demeans and subordinates the Muslim woman, one might have thought that the fixed death penalty for an apostate – a Muslim who wishes to leave Islam – would have captured their concern sufficient for articulation. Apparently, it is not, in the authors' views, “highly controversial” among the *Shari'ah* faithful.

authorities and scholars as an indivisible “way of life”⁶⁵ which informs a *Shari’ah*-adherent Muslim’s entire being and identity as a Muslim⁶⁶, including his relationship to his family, the poor, the stranger, the visitor, national political life, the Muslim *Umma* (or nation), religious ritual, business and financial dealings, and the enemy.⁶⁷ While *Shari’ah* includes more than a millennium of legal decisions developed through Islamic jurisprudence and informal code-like compilations developed by the different “schools of jurisprudence”⁶⁸, *Shari’ah* proper is the overarching authoritative architecture for all Islamic jurisprudence and the specific legal decisions which make up the *corpus* of a juristic body of Islamic dictates and norms.

Understood in its proper context, anything deemed *Shari’ah*-compliant by Islamic legal authorities must first and foremost be within the gestalt of *Shari’ah*. It is not enough, according to *Shari’ah*, that a Muslim conducts his own affairs and business according to some narrow definition of “Islamic ethical business practices.” For a *Shari’ah*-adherent Muslim to conduct his business and financial affairs properly, he must not knowingly promote through his business dealings any forbidden action or violation of a fundamental precept of *Shari’ah* or the legal rulings promulgated thereunder. This is what the scholars mean when they describe *Shari’ah* as “holistic” or a fully integrated religious, moral, and legal code.⁶⁹

It has been the duty of the *Shari’ah* legal scholars over the ages to understand these precepts and to apply them to new and changing circumstances. The degree to which individual Muslims or the political powers ruling over them have adhered to *Shari’ah* as determined by the authoritative Islamic jurists has varied tremendously. It can be said with some historical confidence that *Shari’ah* has been honored more in the breach than in its observance.⁷⁰ But the breaches have not diminished the absolute authority of

⁶⁵ The literal meaning of *Shari’ah* is “the way” -- especially to the source of water (i.e., life).

⁶⁶ See, e.g., DeLorenzo & McMillen, *supra* note 34, at 136-137.

⁶⁷ Coughlin, *supra* note 24.

⁶⁸ See *supra* note 31. For a detailed discussion of the schools of jurisprudence, see *id.*

⁶⁹ See generally DeLorenzo, *supra* note 22.

⁷⁰ There is no shortage of academic literature on the political and religious turmoil that existed in the Muslim empires from soon after the death of Mohammed and the battles between the “traditionalists” who sought a *Shari’ah*-centered political world and those who opposed it for one reason or another. A good, deep history of Islam may be found in MARSHALL G. S. HODGSON, *THE VENTURE OF ISLAM: CONSCIENCE AND HISTORY IN A WORLD CIVILIZATION*, 3 vols. (1974). And, of course, the required reference to BERNARD LEWIS, *THE MIDDLE EAST: A BRIEF HISTORY OF THE LAST 2,000 YEARS* (1995). For the narrative of the failures in Islamic history for the political leaders to abide by *Shari’ah* from the “traditionalist” vantage, see SAYYID QUTB, *SOCIAL JUSTICE IN ISLAM* (2000). For the classic statement on this “theory” versus “practice” and the dominant role of *Shari’ah* authorities to determine the theory and even the practice when *Shari’ah* is put into practice, see Joseph Schacht, *supra* note 62. For the lament of a “moderate” *Shari’ah* academic scholar who would like to see *Shari’ah* and *usul al-fiqh* modernized so that it might be used to govern modern societies, he suggests that the failure of *Shari’ah* to keep pace with modernity was precisely because it often was not fully integrated into Islamic society but rather developed as a private affair among *Shari’ah* authorities. KAMALI, *supra* note 24, at 500-521.

Shari'ah and its jurisprudence, as articulated by Islamic legal scholars and the institutions they have established over the past 1200 years, to define the legal limits of permitted and proscribed behavior among the hundreds of millions of Muslims worldwide who consider *Shari'ah* a way of life, as much religion and moral guide as civil and criminal code.⁷¹

The implication of this fuller understanding of *Shari'ah* is that one cannot speak of *Shari'ah*-compliant finance, business, or economics in the U.S. without understanding *Shari'ah* as articulated by the *Shari'ah* authorities and its ramifications for the U.S. investor. This is especially true given the legal implications surrounding the duty to disclose for financial institutions contemplating an SCF transaction. Consider, for example, a mutual fund that promotes itself as *Shari'ah*-compliant. Having licensed the use of the Dow Jones Islamic Index (“DJII”), which utilizes a software filtering protocol determined to be *Shari'ah*-compliant by the *Shari'ah* advisory board retained by Dow Jones & Company, the mutual fund selects a subset of the indexed listed equities for its portfolio. A careful reading of the DJII’s marketing material, and of the registration statements filed by DJII-utilizing funds, indicates that disclosure issues abound.⁷²

Specifically, in the registration statement filed with the Securities and Exchange Commission for one of the first such funds, the Dow Jones Islamic Market Index Portfolio⁷³ (“Dow Jones Islamic Portfolio Fund”), other than a reference to certain “*Shari'ah* screens” or “filters” limiting the universe of acceptable investments, nothing is said of *Shari'ah*. For the investing public, all it learns about *Shari'ah* in the context of this *Shari'ah*-compliant mutual fund is that equities of companies involved in interest-driven profits, companies dealing with commodities such as alcohol or pork, or companies engaged in the “vice” industries such as entertainment and gambling, are prohibited. In addition, the standard disclosures include references to various financial ratios that work to eliminate companies that might generate too much interest income on its cash reserves or pay too much interest on its debt. In other words, the DJII and the mutual funds utilizing such an index appear in many ways like other “socially responsible investing” or customized “values-based” and “faith-based” indexes.

But this is hardly the case. In a “secular” or even “ideologically” driven values-based index, a screen that filters out all tobacco and weapons businesses is just that. Even if the background social or political activism animating the screen is a “smoke-free

⁷¹ This is evident in SCF itself. The sole authorities for determining *Shari'ah* compliance or even what is “Islamic” regarding finance and commerce are the traditional *Shari'ah* scholars. Whatever criticism some critics might have of the “Islamist” bent of SCF, there is no serious challenge to the absolute authority of the traditionalists in this discipline. *See, e.g.,* VOGEL & HAYES, *supra* note 18, at 9-10, 23.

⁷² The fundamental standard regarding disclosure of risks and other pertinent information is whether the risks are material and whether any other information would be material to a reasonable investor. For a more thorough discussion of materiality and other disclosure issues, *see infra* Part IV.C.1.

⁷³ This fund was begun in 1999 and liquidated in 2002. For access to its SEC filings, *see* <http://www.sec.gov/cgi-bin/browse-edgar?action=getcompany&CIK=0001088654&owner=include&count=40> (last visited Feb. 4, 2008).

environment” and “pacifism,” the screen is marketed only as a screen that filters out tobacco and weapons industries. It does not purport to be based upon some universal theological-moral-legal system existing independently of the filters.⁷⁴

When the mutual fund, however, markets its product as “Islamic” or “*Shari’ah*-compliant”, it is making a claim that goes well beyond the disclosed screens or filters, even if all that is applied to make it “Islamic” or “*Shari’ah*-compliant” is the filters themselves. A cursory reading of the registration statement filed pursuant to the Investment Act of 1940⁷⁵ for the Dow Jones Islamic Portfolio Fund suggests that the lawyers tasked with writing the risk section of the document understood this reality, at least at some rudimentary level⁷⁶, and sought to eliminate the problem with one broad brushstroke:

The investment objective of the Dow Jones Islamic Market Index Portfolio (the "Portfolio") is to seek long-term capital gains by matching the performance of the Dow Jones Islamic Market Index^(SM) (the "Index") – a globally diversified compilation of equity securities **considered by Dow Jones' *Shari’ah* Supervisory Board to be in compliance with *Shari’ah* principles.** (Emphasis added.)⁷⁷

Notwithstanding representations throughout the registration statement that various practices of the fund will comply with “*Shari’ah* principles”, which are nowhere

⁷⁴ Thus, even if it promoted itself as ethical equity-based investing, if it was based upon *Shari’ah*, the disclosure issue would remain. Further, it is different than the so-called Catholic indexes. Even in the case of the “Catholic Values” funds, there is no representation that there is an underlying legal code requiring certain investment behavior by adherent Catholics. Instead, the funds follow “Catholic values” as they and their advisors determine them to be based upon the doctrine of the Catholic Church but they are just as clear that even if their “Catholic advisors” were to determine a company was not suited to these values, there is no requirement either by the rules of the fund or by the Catholic Church that such companies not be included in the fund. In other words, the Catholic funds are like other truly “values-based” funds where like-minded individuals agree on certain standards.

⁷⁵ Investment Company Act of 1940, Pub. L. No. 76-768, 54 Stat. 789.

⁷⁶ The lawyers’ imputed knowledge is “rudimentary” because very few of the lawyers acting as facilitators in the SCF industry fully understand or acknowledge what *Shari’ah* is beyond thinking of it as just another “value-based screen.”

⁷⁷ For the Dow Jones Islamic Market Index Portfolio’s Registration Statement filed pursuant to the Investment Company Act of 1940, Part B, Item 12, see Dow Jones Islamic Market Index Portfolio, Registration Statement (Form N-1A), available at <http://www.sec.gov/Archives/edgar/data/1088654/0000935489-99-000014.txt> (last visited Jan. 25, 2008). In addition, in Part A of the of the registration statement, there are warranty disclaimers relative to the DJII, the most important of which is:

Although Dow Jones uses reasonable efforts to comply with its guidelines regarding the selection of components in the Dow Jones Islamic Market Index, Dow Jones disclaims any warranty of compliance with Shariah law or other Islamic principles

While this might insulate Dow Jones from a claim of breach of warranty, it does not address the failure to disclose material risks relative to the very real problem of competing *Shari’ah* authorities.

articulated in a material way, the language in this section intends to sweep *Shari'ah* under the rug by reducing “*Shari'ah* principles” to whatever the Dow Jones *Shari'ah* Supervisory Board says they are. There are, however, a plethora of risk factors specifically associated with anything pegged to *Shari'ah* compliance that such a statement fails to capture. Fundamental disclosure issues for a reasonable investor would be: What is *Shari'ah*? Does applying *Shari'ah* “principles” pose any unique reputational or financial risks for the investment or might it actually pose a risk for the physical safety of the U.S. investor? In other words, if *Shari'ah* is hostile to Western political and financial institutions, would that be important for a U.S. investor to know prior to investing in a business which promotes *Shari'ah*-compliant investing?

The point of this example is not to analyze the liability exposure of the registration statement of the now defunct Dow Jones Islamic Portfolio Fund, but rather to illustrate how marketing an investment product as *Shari'ah*-compliant incorporates a set of factual predicates, many of which are material to the investment decision. According to the *Shari'ah* authorities themselves, *Shari'ah* -- of which SCF is only a small, integrated component -- is more than just a half-dozen filters operating in the background to eliminate interest, speculation, and vice. Rather, it is a motivating force and mark of Muslim identification for hundreds of millions of Muslims throughout the world, a *corpus juris* that incorporates a 1200-year old history of jurisprudence, of institutionalized legal schools with published legal decisions and other scholarly writings, together with more than a millennium of religious and political implications, all of which have generated a body of literature on the import of *Shari'ah* in the ancient and contemporary world.

These realities comprise a dangerous minefield for the naïve or willfully ignorant financial institution seeking to capitalize on the alluring new universe of investment vehicles marketed to *Shari'ah* adherents. This minefield includes questions these financial institutions and their professional facilitators have not even begun to ask, much less answer.⁷⁸ This Article begins the analysis and the necessary discussion of SCF's implications for the U.S. financial industry, the professionals advising their clients on SCF, and the policy-makers in and out of government. Policy-makers especially have an

⁷⁸ The following represent just a few of the queries one might expect to be addressed, all of which force the issue of what does the *Shari'ah* in *Shari'ah* compliant finance really mean: Is a company dedicated to atheism or polytheism *Shari'ah* compliant even if it passes the “objective” screens discussed in the text above? What about abortion clinics? Is a company that otherwise passes the publicly-disclosed filters remain *Shari'ah* compliant even if it is owned by or domiciled in the territory of the enemies of the Muslim nation (i.e., an Israeli-owned or domiciled company)? When the Dow Jones Islamic Index publicizes that weapons manufacturers are forbidden, does *Shari'ah* in fact forbid weapons manufacturing by Muslims for Muslim nations? Would it be material to a reasonable U.S. investor to know if the answers to any of these questions is “no”? What would happen if the U.S. went to war against a major *Shari'ah*-compliant Muslim nation and, as a result, the GCC states together with most of the authoritative *Shari'ah* scholars in the world declare the war an act of war against the entire Muslim nation? Will this declaration of war affect the Dow Jones' Islamic Index filters? Would any company owned by non-Muslim U.S. citizens be *Shari'ah*-compliant under those circumstances?

obligation to consider the ominous implications for U.S. national and financial security of a fully integrated *Shari'ah*-compliant financial industry.

III. Toward an Analytical Taxonomy

A. The Lawyer's Role in SCF

As indicated above, *Shari'ah*-compliant financing is nomenclature describing the contemporary Islamic legal, normative, and communal response to the demands of modern day finance and commerce.⁷⁹ *Shari'ah*-adherent Muslims desire to maintain their commitment to the normative demands of *Shari'ah*. At the same time, they wish to participate in the benefits and opportunities afforded by investment in international and Western financial structures that are neither *Shari'ah*-centric nor *Shari'ah*-compliant, at least according to the overwhelming majority of *Shari'ah* authorities.⁸⁰

Transactional lawyers are often required to opine on the transaction's compliance with existing law and the enforceability of the underlying agreements in a court of law or, in some cases, before an arbitrator.⁸¹ These legal opinions assure the parties that there are no hidden issues that might create obstacles to enforcement. In addition, lawyers are required by professional ethics to investigate compliance, disclosure, and due diligence issues in order to understand their clients' legal exposure when an innovative approach to existing financial or commercial transactions is contemplated.⁸² Lawyers and accountants themselves have direct exposure for documents submitted by a client to the Securities and Exchange Commission under several laws, including the Sarbanes-Oxley Act of 2002.

A fundamental predicate of a lawyer's opinion is the knowledge that the basic transactional building blocks of the deal are well-known, predictable, and do not pose any significant risk that a court will refuse to enforce them as intended by the parties. In simple terms, this means that the deal is structured in a way that has certainty, consistency, predictability, and transparency.⁸³

⁷⁹ See *supra* note 59 and accompanying text.

⁸⁰ See VOGEL & HAYES, *supra* note 18, at 24-28. Vogel and Hayes note especially the minority view that interest is not prohibited: "But such Muslims, though numerous, appear to be in the minority. A much larger number, **supported by a near-unanimity of traditional scholars**, seem certain that modern bank-interest falls within the revealed prohibitions and entails a major sin, tolerable only in the throes of necessity." *Id.* at 25 (emphasis added).

⁸¹ In some complicated cases, both judicial and arbitration venues are chosen depending upon the specific issue litigated or the type of enforcement sought. See, e.g., McMillen, *supra* note 9.

⁸² See generally David S. Ruder, *Lessons From Enron: Director and Lawyer Monitoring Responsibilities*, (Oct. 10, 2002) (paper presented to the 41st Annual Corporate Counsel Institute, Chicago, Illinois), available at http://www.law.northwestern.edu/professionaled/documents/Ruder_Lessons_Enron.pdf (last visited Jan. 28, 2008); see also MODEL RULES OF PROF'L CONDUCT R. 1.2(d) (2002); AM. BAR ASS'N, ANNOTATED MODEL RULES OF PROFESSIONAL CONDUCT 39-40 (5th ed. 2003).

⁸³ While the terms "certainty, consistency, predictability, and transparency" are oft-used in the law in this context, this memorandum borrows these precise terms and their meanings from one of SCF's biggest advocates and one of the most influential of the legal practitioners making a

The problems legal counsel face when attempting to analyze a specific SCF transaction and to opine on compliance and enforceability issues are often related to the *Shari'ah* “black box” phenomenon. Attorneys, accountants, and financial advisors who wish to structure a transaction to be *Shari'ah*-compliant do so by treating *Shari'ah* precisely as *Shari'ah* demands. For the *Shari'ah* faithful, *Shari'ah* is first and foremost the divine and perfect will of the ultimate lawgiver and there are strictures and obligations imposed on its adherents which are not subject to reasoned critique or discourse. As to the part of *Shari'ah* open to human analysis, it is reserved for *Shari'ah* authorities who cannot be challenged except by other equally authoritative *Shari'ah* authorities.⁸⁴ Further, because *Shari'ah* is understood as divine and the *Shari'ah* authorities are considered the trustees of its authority, integrity, and interpretation, the application of *Shari'ah*'s well-established and ancient doctrines to the modern practice of SCF necessarily lacks transparency.

Shari'ah's inability to provide transparency is systemic. Any legal or normative system that is not articulated and enforced within a political structure of codified laws, procedures, courts, binding legal opinions, and effective enforcement mechanisms will, by definition, lack transparency. *Shari'ah* is at its core a divinely ordained law which can never be subordinated to a secular political, legal, or regulatory system.⁸⁵ SCF is an attempt by the participants – financiers, businessmen, facilitators, and *Shari'ah* authorities – to fit the divine law within a modern secular political, legal, and financial system. But should a secular court or legislature attempt to codify *Shari'ah*'s precepts as they apply to SCF in an effort to establish transparency, it would fail its fundamental purpose because *Shari'ah* cannot be rendered subservient to secular law.⁸⁶

career of SCF in Michael J.T. McMillen, *Islamic Shari'ah-compliant Project Finance: Collateral Security and Financing Structure Case Studies*, 24 FORDHAM INT'L L.J. 1184 (2001).

⁸⁴ As discussed *supra* at notes 60-62 and accompanying text, there is no universal standard of authority or hierarchy for *Shari'ah* authorities. This fact alone and the development of authoritativeness is part of the black box of *Shari'ah*.

⁸⁵ See, e.g., McMillen, *supra* note 81, at 1196, n.14.

⁸⁶ According to *Shari'ah* doctrine rooted directly and firmly in the Qur'an, and agreed upon by all legal schools, no secular law can take precedence over Allah's divine law: “Whoever does not follow the revealed law and does not judge according to it is counted an unbeliever.” See, e.g., AL-AZAMI, *supra* note 29, at 12; see also Coughlin, *supra* note 24, at 90:

Known among Islamic jurists to take a more “liberal” view toward Islamic law, Mohammad Hashim Kamali, in his *Principles of Islamic Jurisprudence*, nonetheless comes down four-square on the notion of the absolute sovereignty of Allah that necessarily pre-empts all other forms of sovereignty – including the democratic concept of sovereignty of the people.

The blending of secular law and *Shari'ah* as it has unfolded in many Muslim countries would appear to be *ipso facto* evidence of the failure to tame *Shari'ah* since there are no Muslim dominated countries that one might call “mostly free” with real representative government except possibly Turkey and Indonesia. Most observers recognize Turkey's success has come at the expense of “religious freedom” since the Kemalists and their use of the army to suppress the public expression of Islam and *Shari'ah* is well documented. Indonesia is changing for the worse due in large part to the growing violence against non-Muslims which in turn is due in large part to

In contrast, domestic finance and commerce in the U.S., and indeed international financial transactions, are based upon Western legal structures that provide transparency. It is transparency which renders a complex transaction manageable and viable. When the parties to a transaction and the professionals facilitating it know that a given transaction format has been used before successfully, the risks of the deal are then limited to the specific business terms and market conditions rather than the formalities of the documents and their enforcement. In these transactions, the lawyer can opine with confidence because she knows the rules of the game and knows they are not subject to fiat or challenge.⁸⁷

This is not the case when a lawyer confronts a high-stakes, complex SCF transaction. In order to render a legal opinion that will satisfy the parties and necessary third parties such as a rating agency for a bond securitization, a number of issues arise that cannot be rationally addressed for at least two reasons: Certain transaction restrictions applicable to SCF are considered divine and unalterable; and those aspects of a transaction subject to human reason are not subject to *any* human reason, but to the reason of a *Shari'ah* authority. For example, interest income is understood by most *Shari'ah* authorities today to be forbidden. The result has been that SCF utilizes all sorts of *Shari'ah*-compliant transactional structures to convert the exact same income stream from interest to something else, such as lease payments. In legal parlance, this is the application of “form over substance”.⁸⁸

the increasing influence of *Shari'ah*. See, e.g., Freedom House, Country Reports, available at <http://www.freedomhouse.org/template.cfm?page=21&year=2007> (last visited Jan. 28, 2008) [hereinafter Freedom Survey 2007]. For a careful analysis of the extent to which *Shari'ah* is codified as the law of the land in Muslim countries, see TAD STAHNKE & ROBERT C. BLITT, U.S. COMM. ON INT'L RELIGIOUS FREEDOM, THE RELIGION-STATE RELATIONSHIP AND THE RIGHT TO FREEDOM OF RELIGION OR BELIEF: A COMPARATIVE TEXTUAL ANALYSIS OF THE CONSTITUTIONS OF PREDOMINANTLY MUSLIM COUNTRIES (Mar. 2005) [hereinafter STAHNKE & BLITT, RELIGIOUS FREEDOM SHARI'AH REPORT], available at http://www.uscirf.gov/countries/global/comparative_constitutions/03082005/Study0305.pdf (last visited Jan. 28, 2008). For an examination of “religious freedom” in such Muslim countries as Indonesia, Egypt, Iran, Saudi Arabia, see U.S. COMM. ON INT'L RELIGIOUS FREEDOM, ANNUAL REPORT (May 2005), available at <http://www.uscirf.gov/countries/publications/currentreport/2005annualRpt.pdf#page=71> (last visited Jan. 28, 2008). For the growing influence of *Shari'ah* in Indonesia, see Tom A. Peter, *At Massive Rally, Hizb Ut-Tahrir Calls For A Global Muslim State*, CHRISTIAN SCIENCE MONITOR, Aug. 14, 2007, available at <http://www.csmonitor.com/2007/0813/p99s01-duts.html> (last visited Jan. 28, 2008). For a good discussion of “modernist legislation” vis-à-vis *Shari'ah* in Muslim countries, albeit somewhat dated, see SCHACHT, *supra* note 62, at 100-111.

⁸⁷ Certainty, consistency, predictability, and transparency in transactional law are never perfect but operate within a range of comfort for investors. The market tends to step in and price deals inversely to their approximation of these goals. As transparency goes down, price goes up until the deal or product just is no longer in reach of the demand's willingness to pay.

⁸⁸ For a SCF-friendly practitioner's view of these problems, see McMillen, *supra* note 81.

The use of legal fictions to change the form or the consequence of a transaction without changing its substance is not new to secular law. Liability is often determined by the form rather than the substance of a transaction.⁸⁹ The idea is to use a legal fiction to convert a problematical “form” to an acceptable one. In the secular context, the problem itself and the mechanisms to overcome it can be understood, challenged openly, debated, and ultimately modified by lawyers, judges, and legislatures to fit changing circumstances.

The debate within *Shari’ah*, however, is effectively closed. Its principles remain divine and unalterable⁹⁰ and the application of these principles to changing circumstances are subject only to what the *Shari’ah* authorities acting independently of a secular legal and political system determine to be permitted and forbidden. Thus, *Shari’ah* informs the *Shari’ah*-adherent participants in a finance transaction that interest is divinely forbidden. The participants are also told it is forbidden because it is evil and causes the destruction of society.⁹¹ Somehow though, interest, wrapped up in a different form where all of the elements of interest exist but the name, exits the black box of *Shari’ah* as permissible and presumably good for society.⁹²

Thus a lawyer involved in a complex SCF transaction confronts challenges at many different levels. In this effort, the diligent lawyer would likely focus on four distinct phases of an SCF transaction: (1) determining if the generic investment or type of transaction is prohibited; (2) developing an alternative (i.e., *Shari’ah*-compliant) transactional structure necessary to achieve the financial or commercial goal of the “secular” or *Shari’ah* non-compliant investment or transaction; (3) drafting the necessary

⁸⁹ The existence of the “corporate veil” to protect the individual from liability is a good example of this “form” over “substance.” Even though an individual might “maintain the corporate formalities,” in substance he is acting as the sole entrepreneur but the law and the policy behind the law shield him from personal liability to promote the risk taking inherent in commercial endeavors. For a discussion of this “legal fiction,” see Sanford A. Schane, *The Corporation Is A Person: The Language Of A Legal Fiction*, 61 TUL. L. REV. 563 (1987).

⁹⁰ Even this is not exactly true. According to some scholars, interest was once not divinely prohibited *per se*. But the debate about the divinity of this prohibition as it exists today is not open to a societal or political discussion and conclusion. Rather, it is confined to the *Shari’ah* black box entrusted to the *Shari’ah* authorities. See generally KURAN, *supra* note 18; El-Gamal, *supra* note 18.

⁹¹ See, e.g., Text of the Historic Judgment on Interest Given by the Supreme Court of Pakistan, ALBALAGH, http://www.albalagh.net/Islamic_economics/riba_judgement.shtml (last visited Jan. 28, 2008).

⁹² Islamic scholars in academia have given this issue much attention. See, e.g., Mahmoud A. El-Gamal, *An Economic Explication of the Prohibitions of Riba in Classical Islamic Jurisprudence*, in THE PROCEEDINGS OF THE THIRD HARVARD UNIVERSITY FORUM ON ISLAMIC FINANCE: LOCAL CHALLENGES, GLOBAL OPPORTUNITIES 29-40 available at <http://www.ruf.rice.edu/~elgamal/files/riba.pdf> (last visited Jan. 28, 2008); see also KURAN, *supra* note 18; McMillen, *supra* note 87, at [page number] n.2; Timur Kuran, *The Genesis Of Islamic Economics; A Chapter In The Politics Of Muslim Identity*, Social Research (Summer 1997), available at http://findarticles.com/p/articles/mi_m2267/is_n2_v64/ai_19652892/pg_1 (last visited Feb. 1, 2008).

legal agreements and documents to implement the alternative transaction; and (4) preparing the filing of regulatory documents with government agencies.

At each stage, the lawyer is in effect wrapping the *Shari'ah* component of SCF in what appears to be a secular black box. By doing so, the lawyer exposes herself and her client to substantial civil and criminal liability. Part III.B below discusses various areas of legal risk, and Part III.C suggests an analytical taxonomy for evaluating these risks in the SCF context.

B. The legal landscape

1. Common law tort action for deceit or fraud

The regulation of disclosures by businesses, and by the financial industry in particular, has a long and storied history in U.S. jurisprudence. In most states, the common law incorporated the tort action of deceit, commonly referred to as fraud, to allow private rights of action for misrepresentation in the context of what is now referred to as commercial speech.⁹³ The essential elements of a common law fraud action are: (1) a false representation (2) of a material fact (3) which the defendant knew to be false and (4) with the intent to induce the plaintiff to rely upon it and (5) the plaintiff in fact justifiably relied upon the representation (6) thereby suffering damages as a result.⁹⁴

Most states have relaxed or altered many of the elements of common law fraud. For example, certain relationships under the common law might also give rise to a claim for constructive fraud, which allows recovery for an omission of material fact. The *scienter* elements have also been relaxed. Thus, the intent elements noted above in (3) and (4), have been “variously defined to mean everything from knowing falsity with an implication of *mens rea*, through various gradations of recklessness, down to such nonaction as is virtually equivalent to negligence or even liability without fault (and would be better treated as creating a distinct species of liability not based on intent).”⁹⁵

2. Federal securities laws

In addition to common law actions for fraud or misrepresentation, there are federal and state statutory regimes designed to govern disclosures in a myriad of business and financial contexts, including the sale of goods and the provision of loans; investments such as the formation of partnerships; and the sale of intangibles such as the offering of securities. In the world of SCF, the disclosure statutes most obviously implicated in civil and criminal liability issues are the federal and state securities laws.

⁹³ See *Nike, Inc. v. Kasky*, 539 U.S. 654 (2003) (per curiam) (Stevens, J., concurring) (discussing commercial versus non-commercial speech and suggesting that case was disposed of summarily on procedural grounds).

⁹⁴ LOSS & SELIGMAN, *supra* note 5, at 910.

⁹⁵ *Id.* at 911.

In the main, the securities laws relating to fraud and misrepresentation were modeled after common law fraud. But it is equally true that Congress intended the securities fraud statutes to have a broader reach than the common law. As a result, securities law sought to include within its enforcement orbit misrepresentations, omissions, schemes, and artifices that would not otherwise be captured by traditional common law fraud. In addition, many of the specific elements of common law fraud were relaxed or in some cases eliminated. While recent federal legislation aimed at curbing abusive class action litigation and subsequent Supreme Court caselaw suggest a trimming of the broad reach previously granted federal securities laws, this is counterbalanced by a concomitant movement at the state level to extend the reach of the state securities laws and to interpret them more liberally than the federal counterparts.⁹⁶

There are principally seven federal statutes that govern securities transactions: the Securities Act of 1933; the Securities Act of 1934; the Trust Indenture Act of 1939; the Investment Company Act of 1940; the Investment Advisors Act of 1940; the Securities Investor Protection Act of 1970; and the Sarbanes-Oxley Act of 2002.⁹⁷ Civil and criminal liability under the federal securities statutes for failure to disclose is regulated by the SEC and its principal weapons are the Securities Act of 1933 ("1933 Act") and the Securities Exchange Act of 1934 ("1934 Act").⁹⁸ The 1933 and 1934 Acts target different markets. The 1933 Act regulates initial offerings and the 1934 Act regulates all subsequent trading, but the overriding public policy is the same: "full disclosure of every essentially important element attending the issue of a new security" and a "demand that

⁹⁶ *Id.* at 1187-1192.

⁹⁷ Securities Act of 1933 (Truth in Securities Act), 15 U.S.C. §§ 77a to 77aa (2006) (focuses on initial distribution of securities); Securities Exchange Act of 1934, 15 U.S.C. §§ 78a to 78mm (focuses on ongoing post-distribution trading of trading); Trust Indenture Act of 1939, 15 U.S.C. §§ 77aaa to 77bbbbb (supplements the 1933 Act and focuses on distribution of debt securities); Investment Company Act of 1940, 15 U.S.C. §§ 80a-1 to 80a-64 (governs activity of publicly owned companies that invest in and trade securities); Investment Advisors Act of 1940, 15 U.S.C. §§ 80b-1 to 80b-21 (requires regulation and registration of those in business of advising others on securities investments); Securities Investor Protection Act of 1970, 15 U.S.C. §§ 78aaa to 78111 (creates nonprofit membership corporation designed to cover customer losses when broker-dealer firms cannot cover their customer accounts); Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified as amended in scattered sections of 11, 15, 18, 28, and 29 U.S.C.) (adds several additional layers of corporate reporting and ethics oversight). The Public Utility Holding Company Act of 1935, 15 U.S.C. §§ 79 to 79z-6, which governed public utilities, was repealed by the Energy Policy Act of 2005, Pub. L. No. 109-58, 119 Stat. 594.

⁹⁸ No analysis of the current SCF industry in the U.S. would be complete without an examination of the Investment Company Act of 1940 and the Investment Advisors Act of 1940. This is because much of the SCF investments are being propelled by mutual funds tracking the DJII and the S&P's version of the same thing. In addition, with the huge sovereign wealth in the GCC looking for sophisticated investment strategies, *Shari'ah* compliant hedge funds are right around the corner. The analysis which follows will examine these two acts to the extent they implicate these types of SCF investments and require a different analysis of the liability exposure for securities fraud.

persons, whether they be directors, experts, or underwriters, who sponsor the investment of other people's money should be held to the high standards of trusteeship."⁹⁹

Although both the 1933 and the 1934 Acts proscribe various types of conduct, including incomplete or inaccurate disclosure of material information, as an administrative matter the SEC dictates the specific kinds of minimal (and in some cases maximal) disclosure required by the specific provisions. Beyond the routine administrative functions granted the SEC, the main weapons against securities fraud are the civil and criminal remedies. Thus, the SEC has access to civil courts to seek injunctive relief, disgorgement, and even civil fines, in addition to ancillary equity-like relief. In addition, the Department of Justice, often as a result of an SEC administrative investigation and criminal referral, is authorized to file criminal charges for violations of the federal securities laws when it appears the offending party had the requisite intent.¹⁰⁰ Finally, private plaintiffs have express and implied rights of action under several provisions. The most used and abused of all such provisions is Rule 10b-5¹⁰¹, promulgated under the 1934 Act¹⁰², which provides for civil litigation¹⁰³ and criminal prosecutions.¹⁰⁴ Considering that the class action mechanism, although limited by recent legislation¹⁰⁵, is available to Rule 10b-5 claimants, the weapons available to prosecute claims for misstatements and omissions of material fact in SEC filings and elsewhere in the public domain are considerable.

3. State securities laws

State securities laws, usually referred to as blue sky laws, essentially track the development of securities disclosure law and securities fraud liability in federal securities law. As noted above, as a result of Congress' efforts to curb private securities fraud litigation and recent Supreme Court rulings regarding the new pleadings requirements, the state securities laws will take on ever greater importance in the securities plaintiff's arsenal of litigation weapons.¹⁰⁶

4. Federal and State consumer protection and anti-fraud laws

⁹⁹ H.R. REP. NO. 73-85, at 3 (1933); *see* 1934 Act, 15 U.S.C. § 78b (stating that one purpose of securities law is "to insure the maintenance of fair and honest markets").

¹⁰⁰ *See generally* LOSS & SELIGMAN, *supra* note 5, at Chapter 9-B-6.

¹⁰¹ 17 C.F.R. § 240.10b-5 (1997); *see Herman & Maclean v. Huddleston*, 459 U.S. 375, 380 (1983) ("The existence of this implied remedy is simply beyond peradventure.").

¹⁰² 15 U.S.C. § 78j.

¹⁰³ *See generally* LOSS & SELIGMAN, *supra* note 5, at 910, 1273-1301 (implied right of action under Rule 10(b)-5).

¹⁰⁴ 15 U.S.C. § 78ff(a) (criminal penalties); *see* LOSS & SELIGMAN, *supra* note 5, at 1418-1425. For a general survey of criminal liability under the securities acts, *see* Nic Heuer, Les Reese & Winston Sale, *Securities Fraud*, 44 AM. CRIM. L. REV. 956 (2007).

¹⁰⁵ *See* Jeffrey T. Cook, *Recrafting The Jurisdictional Framework For Private Rights Of Action Under The Federal Securities Laws*, 55 AM. U.L. REV. 621 (2006).

¹⁰⁶ *Supra* note 93.

Consumer protection statutes, which exist in most states, provide additional weapons to combat fraud. While the Federal Trade Commission Act (“FTC Act”)¹⁰⁷ does not apply to securities, it might be implicated where businesses market consumer products and represent that their businesses are run according to *Shari’ah*. Further, modeled in part after the FTC Act, the “little FTC Acts” enacted by most states are often more broadly interpreted than the FTC Act and many have an express or implied private right of action allowing the consumers themselves to battle fraud in the marketplace.¹⁰⁸

In California, for example, a private plaintiff sued Nike, Inc., an Oregon corporation, on behalf of all California residents under the California Unfair Competition Law¹⁰⁹ for fraud and failure to disclose. The suit was filed after Nike had made false and misleading public statements in the wake of media reports suggesting abuse at its foreign factories. Nike claimed its speech was protected under the First Amendment. The case went to the U.S. Supreme Court after Nike’s arguments to get the case dismissed on First Amendment grounds did not persuade the California Supreme Court. But the U.S. Supreme Court sent it back down to the California courts after it determined that certiorari had been improvidently granted.¹¹⁰ Nike settled the case.¹¹¹ The implications of this type of state action for the SCF industry will be addressed below. Also, at least three states allow their respective consumer protection statutes to be used for securities fraud, which would bring the entire SCF industry under consumer fraud scrutiny.¹¹²

Additional statutes implicated are the federal Lanham Act, which regulates *inter alia* fraud in the description of goods, services, or commercial activities,¹¹³ and laws governing consumer finance. Consumer finance in the U.S. falls within the ambit of the federal Truth-in-Lending Act (“TILA”)¹¹⁴ and the myriad of regulations promulgated thereunder referred to collectively as Regulation Z.¹¹⁵ Banks and other lenders

¹⁰⁷ 15 U.S.C. §§ 41-58.

¹⁰⁸ For a discussion of the broad sweep of state consumer fraud statutes, see Victor E. Schwartz & Cary Silverman, *Common-Sense Construction of Consumer Protection Acts*, 54 KAN. L. REV. 1 (2005).

¹⁰⁹ The law, known as the Unfair Competition Law (“UCL”), is codified at CAL. BUS. & PROF. CODE §§ 17200-17210 (Deering 2007).

¹¹⁰ *Supra* note 93. The UCL recently was amended by Proposition 64 to eliminate the right of private plaintiffs to sue as “private attorneys general” without a showing of injury. See Schwartz & Silverman, *supra* note 108, at 34-37.

¹¹¹ David Monsma & John Buckley, *Eighteenth Annual Corporate Law Symposium: Corporate Social Responsibility In The International Context: Is There An Emerging Fiduciary Duty To Consider Human Rights?*, 74 U. CIN. L. REV. 75 (2005).

¹¹² For Pennsylvania, see *Denison v. Kelly*, 759 F. Supp. 199, 202 (D. Pa. 1991) (referencing 73 PA. CONS. STAT. §§ 201-1-202-9.3 (2007)). For Illinois, see *Onesti v. Thomson McKinnon Secur., Inc.*, 619 F. Supp. 1262, 1267 (D. Ill. 1985) (referencing ILL. REV. STAT. ch. 121 1/2, § 262, et seq. (1985), now 815 ILL. COMP. STAT. 505/2 (2007)). For Arizona, see *State ex rel. Corbin v. Pickrell*, 136 Ariz. 589, 592 (Ariz. 1983) (referencing ARIZ. REV. STAT. ANN. §§ 44-1522 – 1531 (2007)).

¹¹³ 15 U.S.C. § 1125 (2006).

¹¹⁴ 15 U.S.C. §§ 1601-1693r.

¹¹⁵ 15 U.S.C. app. 12 CFR § 226.

advertising “zero interest loans” or “*riba* free loans” might in fact run afoul of the TILA disclosure requirements and the restrictions on deceptive advertising. The Home Ownership and Equity Protection Act (“HOEPA”)¹¹⁶, which is part of TILA, or the state versions of HOEPA might also apply to what amounts to predatory lending to *Shari’ah*-adherent Muslims to the extent that the fees and costs are almost always higher than conventional loans.

5. Due diligence and compliance statutes

The federal securities laws in several instances incorporate due diligence as defenses to the anti-fraud provisions and as such are an integral part of any legal analysis for civil or criminal exposure.¹¹⁷ In addition, due diligence is incorporated into several compliance regimes such as the Bank Secrecy Act¹¹⁸ and the anti-money laundering statutes¹¹⁹, many of which were modified by the Patriot Act. Insofar as SCF incorporates the *Shari’ah* obligation to tithe and also requires the “purification” of profits earned in violation of *Shari’ah*, the question for the legal practitioner is who decides what happens to the monies gifted to charities and which charities are selected. Given the historical connection between some of the largest and well-known Muslim charities and the funding of terrorist groups¹²⁰, these questions take on added focus in the context of material support of terrorism. Finally, the structure of the *Shari’ah* authority boards and their professional membership organizations raise antitrust issues.

C. A Suggested Analytical Taxonomy

The challenges described above for the SCF transactional lawyer and other professionals advising clients on the intricacies of legal compliance are not inconsequential. In agreements and in law, words are given context by the intent of the parties. The inherent problem of SCF is that the intent of the parties is to comply with *Shari’ah* but the intent of *Shari’ah* generally and in any particular transaction is typically lost on the secular SCF advisors.¹²¹ The latter, especially the lawyers, are very good at solving problems by restructuring a transaction through wordsmithing, thereby arriving at the same result in different form. But their approach is to deal only with the trees hindering the client’s path to the goal within the landscape of the transaction itself.

¹¹⁶ Pub. L. No. 103-325, 108 Stat. 2190 (codified as amended in scattered sections of 15 U.S.C.).

¹¹⁷ LOSS & SELIGMAN, *supra* note 5, at 1205 (defense of reasonable care under Section 12(a)(2) of the 1933 Act); *id.* at 1227-1239 (reasonable care and “expertizing” defenses under Section 11 of the 1933 Act).

¹¹⁸ 31 U.S.C. §§ 5311-5332 (2006).

¹¹⁹ *See infra* Part V.C.1.a.

¹²⁰ *See infra* Part V.C.1.b.

¹²¹ It is not enough to refute this proposition by stating that the intent of *Shari’ah* is known: the avoidance of interest, speculation, and vice. If the refutation were both true and meaningful, it would suggest that the speaker knows what *Shari’ah* means by interest, speculation, and vice. And, if that were true, the speaker could devise his own legal structures without reference to or assistance from *Shari’ah* scholars and authorities. But this is not the case.

For the typical secular financial transaction, this is sufficient because there is no dark forest in which to get lost. An obstacle in the path can be safely circumvented because the problem is transparent and thus its ramifications for disclosure and compliance are understood. When the trees, however, grow out of the forest known as *Shari'ah*, it is not at all clear to these professionals why they are where they are, what dangers might lurk there, and where the forest might lead. This is because *Shari'ah* is not accessible to the secular professionals. As a consequence, the forest is packaged as a black box and ignored. It is no surprise then that professional literature has paid little attention to the liability and criminal exposure issues unique to a financial or business transaction fitted to *Shari'ah*.¹²²

This Article seeks to facilitate academic and professional scrutiny of SCF by suggesting an analytical taxonomy separating SCF-related legal exposure in to two elements: that arising of out endogenous elements, and that arising out of exogenous elements.

1. Exposure arising out of endogenous elements

To understand the risks and exposure for a financial institution contemplating SCF, a lawyer must first understand what *Shari'ah* itself says it is – that is, what the *Shari'ah* authorities understand it to be, without reference to how SCF attempts to navigate the demands of modern finance. This inquiry can be termed an analysis of the endogenous elements or aspects of *Shari'ah*¹²³, and it will be relevant to many fundamental issues of SCF. Moreover, to the extent that *Shari'ah* compliance is determined by *Shari'ah* authorities, presumably there is something in the institution of *Shari'ah* itself that will inform a lawyer who qualifies for such a role and how. Finally, to the extent that *Shari'ah*

¹²² A good example is to look at the published works of the legal practitioners making a living providing expert legal services to the SCF industry. The articles by McMillen cited herein generally are examples but notably *see* McMillen, *supra* note 81, at [page number] n.18 and accompanying text where the author waxes on about the utilization of *Shari'ah* in Saudi Arabia and various other Muslim countries and does not raise even a word of caution regarding the abuses well documented under the *Shari'ah* legal system.

¹²³ Borrowed term from ENCYCLOPEDIA OF SOCIAL SCIENCE RESEARCH 308-309 (Michael Lewis-Beck, Alan Bryman & Tim Futing Liao eds., 2003), available at <http://www-personal.umd.umich.edu/~delittle/Encyclopedia%20entries/endogeneous%20variable.pdf> (last visited Jan. 28, 2008). The endogenous/exogenous taxonomy for analyzing disclosure has an ancient pedigree. In standard common law fraud, commentators such as Judge Story distinguished between the heightened duty to disclose for intrinsic elements of a deal versus the extrinsic:

Intrinsic circumstances are properly those which belong to the nature, character, condition, title, safety, use, or enjoyment, &c., of the subject-matter of the contract, such as natural or artificial defects in the subject-matter. Extrinsic circumstances are properly those which are accidentally connected with it, or rather bear upon it at the time of the contract, and may enhance or diminish its value or price, or operate as a motive to make or decline the contract; such as facts respecting the occurrence of peace or war, the rise or fall of markets, the character of the neighborhood, the increase or diminution of duties, or the like circumstances.

1 JOSEPH STORY, COMMENTARIES ON EQUITY JURISPRUDENCE 300, at 301-02 (W. H. Lyon, Jr. ed., Little, Brown & Co. 14th ed. 1918) (1834).

is in fact what its proponents say it is – a way of life combining authoritative Islamic legal, moral, theological, and normative social constructs – an attorney has a responsibility to ensure that her client has conducted the necessary due diligence to be certain that these structures do not violate U.S. law. Part IV below explores these endogenous elements in further detail.

2. Exposure arising out of exogenous elements

As discussed above, SCF is a term of art used to describe the contemporary Islamic response to the demands of modern finance and commerce. As such, the rules and norms of *Shari'ah* are being forced to attend to the demands of a Muslim demographic which desires to exploit the opportunities available in Western financial and legal structures yet at the same time to remain faithful to a system which rejects as unlawful and evil much of the Western financial premises about political economies and structures. To achieve this seemingly impossible goal, *Shari'ah* authorities have developed a range of transactional structures and legal-definitional parameters to guide them in their determination whether a given transaction or investment is permitted or prohibited.

In this part of the analysis, a lawyer should address the features of SCF that might raise liability exposure issues that are not inherent to *Shari'ah* principles but are adaptations of *Shari'ah* principles to fit Western financial structures and institutions. An example of a transactional structure to deal with this collision between a *Shari'ah* world and a Western one built on the time-value of money is the sale-lease back agreement.¹²⁴ While sale-lease back agreements are not unique to SCF and in fact are a popular vehicle in contemporary finance, in the two contexts they are not identical in structure and worlds apart in their purposes.¹²⁵ An example of the legal-definitional parameters set out by *Shari'ah* authorities to deal with the doctrinal conflicts between the two systems would be the ruling that, while interest income is absolutely forbidden in *Shari'ah*, it is not forbidden to invest in a company that earns less than X%¹²⁶ from interest income which is not a

¹²⁴ One such *Shari'ah*-based nominate lease contract is called *Ijara*. VOGEL & HAYES, *supra* note 18, at 143-145.

¹²⁵ Typically, a sale-lease back financing transaction is a way for a company to gain liquidity and to move a capital asset off the balance sheet to avoid the burdens to the company's debt ratios if standard capital asset financing is used. For a short discussion of the accounting aspects, see Richard J. Strotman, *Sale/leaseback: Financing Tool for the '90s*, CPA J. ONLINE (Apr. 1991), available at <http://www.nysccpa.org/cpajournal/old/10691657.htm> (last visited Jan. 28, 2008). The motivation for a *Shari'ah* sale-lease back, however, is to avoid interest and to accommodate *Shari'ah* fixed rules relative to the actual transfer of ownership of the property, who is responsible for repairs (lessor), who can cancel the contract under changed circumstances (lessee), and how the parties will treat future sale and option terms. In other words, the purposes of a secular sale-lease back are purely for accounting purposes or "form"; for the *Shari'ah* contract, however, the purpose is to effect the actual form required by *Shari'ah* as "substance".

¹²⁶ See Yaquby, *supra* note 38 (various *Shari'ah* authorities prohibit investment in companies that earn more than 5-15% of total earnings from interest income). The DJII achieves this prohibitory goal by screening out companies with a debt to market capitalization equal to or greater than 33%. For this and other ratios intended to screen for interest income, see M. H. Khatkhatay & Shariq Nisar, *Investment in Stocks: A Critical Review of Dow Jones Shari'ah Screening Norms*,

core business of the company (i.e., interest earned on liquid assets or accounts receivables). Further discussion of the exogenous elements of SCF is provided in Part V below.

IV. The Endogenous Elements: Disclosure of *Shari'ah* in SCF

A. The preliminary analysis

The first order of business for an attorney providing advice in the context of disclosure laws to a U.S. financial institution interested in SCF should be answering the following question: How intimate is the connection between SCF and *Shari'ah* itself? (In legal terms, how material is *Shari'ah* to SCF?) If *Shari'ah* is a material part of SCF, the attorney must confront the likelihood that it is a material fact of SCF in the context of disclosure laws. While the answer to the question might appear self evident – that is, *Shari'ah* has everything to do with SCF – extant literature by legal scholars and practitioners suggests that, even if *Shari'ah* is a material component of SCF, it is not material to any of the disclosure laws because *Shari'ah* is treated as a black box that merely turns out rules requiring specific kinds of contractual arrangements.

But secular lawyers' treatment of *Shari'ah* as a black box that does not concern them, except in the specific rulings relative to a given investment or transaction, is simply a willful avoidance of material facts. Those facts are the endogenous elements of *Shari'ah* that result in the “rules and principles” of SCF.¹²⁷ Indeed, according to the proponents and practitioners of SCF, *Shari'ah* is not just an approach to interest-free, ethical Islamic business practices or investing. Invariably, SCF is described by its proponents, practitioners, and scholars as the contemporary Islamic legal, normative, and communal response to the demands of modern day finance and commerce. What makes the response “Islamic” or one pursued almost exclusively by Muslims¹²⁸ is the fact that this legal, normative, and communal response to modern finance is framed and regulated by *Shari'ah* authorities ruling on what *Shari'ah* permits and prohibits. Thus, whether called *Shari'ah*-compliant finance, Islamic economics and finance, or even “ethical” investing, the one unifying characteristic of SCF is the appearance of authoritative Muslim *Shari'ah* scholars who, individually and collectively through various manifestations of

Paper Presented at the Int'l Conference on Islamic Capital Markets (Aug. 27-29, 2007), available at

<http://www.djindexes.com/mdsidx/downloads/Islamic/articles/DowJonesShariahScreeningNorms.pdf> (last visited Jan. 28, 2008).

¹²⁷ “*Shari'ah* rules and principles” is a term of art among *Shari'ah* authorities. Various standards publications are available to the public through the Islamic Financial Services Board (“IFSB”), one of the premier standards institutes of SCF. See IFSB Published Standards, Islamic Financial Services Board, <http://www.ifsb.org/index.php?ch=4&pg=140> (last visited Jan. 28, 2008) [hereinafter IFSB Standards].

¹²⁸ Excepting of course the non-Muslim facilitators and financial institutions who desire to exploit it for purely pecuniary gain.

consensus¹²⁹, define the “rules and principles” of SCF and set out how a *Shari’ah*-adherent Muslim may “lawfully” engage in commerce, investing, and finance.

Further, the *Shari’ah* authorities are clear: SCF is not a discreet or segregable component of *Shari’ah*. It is a fully integrated discipline within the *corpus juris* of *Shari’ah* which, in turn, is a holistic, all-encompassing way of life. *Shari’ah* is not divisible, moreover, in the sense that one might extract the SCF “commercial legal code” from *Shari’ah* and end up with a body of laws articulating a secular code of business conduct. This is demonstrated by the prohibitions against businesses that trade in pork products (seemingly a strictly dietary code issue) or the leasing of a building to a church (quite obviously a theological consideration informing a business law issue).¹³⁰ Even in the legal rulings relating to whether a Muslim bank or individual may receive interest from deposit accounts, the decision turns in large part on whether the deposits reside in a jurisdiction called the “abode of war”, where non-Muslims predominate, or the “abode of peace”, where Muslims predominate.¹³¹

The inclusiveness, universality, and indivisibility of *Shari’ah* are not just evidenced by the published work of *Shari’ah* authorities on the one hand and secular academic scholars on the other. Especially important for a lawyer attempting to determine what the “*Shari’ah*” of SCF is in the context of disclosure laws, and what if anything of this “*Shari’ah*” is material and subject to the duty to disclose, is what *Shari’ah* actually is in practice. An attorney in search of the actual presentation of *Shari’ah* as an extant and authoritative basis for law in modern times has the opportunity to examine several Muslim regimes which have implemented *Shari’ah* as the law of the land. The best examples of such implementation are Iran, Saudi Arabia, and Sudan.¹³² The Taliban of Afghanistan had also imposed a fully authoritative *Shari’ah* and many other Muslim regimes have utilized aspects of *Shari’ah* to complement a non-*Shari’ah* secular code. The more a country’s laws are based upon *Shari’ah*, the better the evidence of what *Shari’ah* is in actual practice devoid of all the academic theorizing and parsing.¹³³

¹²⁹ As the literature makes clear, consensus among *Shari’ah* authorities is an important part of the tradition and integrity of *Shari’ah*. In some Muslim countries, however, there is actual government oversight and regulation. See, e.g., THE POLITICS OF ISLAMIC FINANCE, *supra* note 10; see also Islamic Financial Services Board, *Guidance on Key Elements of the Supervisory Review Process of Institutions Offering Islamic Financial Services (Excluding Islamic Insurance (Takaful) Institutions and Islamic Mutual Funds)*, at ¶¶ 110-118 at 24-25 (Dec. 2007), available at

<http://www.ifsb.org/view.php?ch=4&pg=257&ac=36&fname=file&dbIndex=0&ex=1201533270&md=%C1h%D5%BB%AA%B9zc%C3%9E%7CV%29%0A%BA%3C> (last visited Jan. 28, 2008) [hereinafter IFSB Standard].

¹³⁰ *Supra* note 58 and accompanying text.

¹³¹ *Supra* note 59 and accompanying text.

¹³² See, e.g., STAHNKE & BLITT, RELIGIOUS FREEDOM SHARI’AH REPORT, *supra* note 86. Recently, northern Nigeria has been added to this list. See *Nigeria Turns From Harsher Side of Islamic Law*, N.Y. TIMES, Dec. 1, 2007, available at http://www.nytimes.com/2007/12/01/world/africa/01shariah.html?_r=1&oref=login (last visited Jan. 28, 2008).

¹³³ *Supra* note 129; see Freedom Survey 2007, *supra* note 86.

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It is beyond this Article's scope to determine what *Shari'ah* is in fact or what it means to the contemporary *Shari'ah* authorities sitting as the final arbiters of SCF. Examining the literature of *Shari'ah* over the course of its history, determining what *Shari'ah* is in Muslim countries that apply traditional *Shari'ah* rules and principles and, importantly, studying the published rulings by contemporary *Shari'ah* authorities on what *Shari'ah* is¹³⁴, what its purposes are, and what *Shari'ah* considers the appropriate means to achieve those ends, are, however, all part of any inquiry into the material endogenous elements of *Shari'ah* subject to disclosure.

B. The hypothetical: not so hypothetical

Notwithstanding a reluctance based on practical considerations to engage in a full analysis of the material endogenous elements of *Shari'ah*, in order to provide a factual predicate for the analysis of the disclosure (and other) laws that follow it will be helpful to assume a fact or two about *Shari'ah*. Therefore, by way of example and for purposes of the analysis, this Article assumes that, after a good faith investigation, a lawyer advising a financial institution desiring to enter the SCF industry will determine that there is a reasonable basis to conclude that a consensus exists among *Shari'ah* authorities on the fundamental purpose and methodologies of *Shari'ah*: submission. *Shari'ah* seeks to establish that Allah is the divine lawgiver and that no other law may properly exist but Allah's law. *Shari'ah* seeks to achieve this goal through persuasion and other non-violent means. But when necessary and under certain prescribed circumstances the use of force and even full-scale war to achieve the dominance of *Shari'ah* worldwide is not only permissible, but obligatory.

While this memorandum poses these conclusions as a hypothetical, they are hardly conjectural. In fact, they reflect the rulings of the classical *Shari'ah* authorities dating back almost a millennium and include the most contemporary of *Shari'ah* authorities issuing authoritative legal rulings today. This can be seen in an unpublished study of *Shari'ah* and its foundational role as controlling doctrine for *Shari'ah*-adherent terrorists in their holy war against the infidel.¹³⁵ This study, conducted by Major Stephen Collins Coughlin, examines *Shari'ah* as law as it is defined and interpreted by *Shari'ah* authorities themselves. Further, it surveys the binding rulings of *Shari'ah* authorities from the classical periods dating back to the early days after Mohammed's death, including also the so-called Golden Era of Islamic enlightenment, through the chaotic period around the fall of the Ottoman Empire, right through to the present. The contemporary survey also includes a best-selling 7th grade textbook used in Islamic day schools throughout the U.S. to validate the study's choice of authorities and to confirm that their legal rulings are used pedagogically as the foundation for understanding traditional, *Shari'ah*-centered Islam.¹³⁶ Further, Coughlin carefully authenticates the

¹³⁴ An integral part of this inquiry is a study of the extant rulings of the classical *Shari'ah* authorities considered to be authoritative by contemporary *Shari'ah* authorities.

¹³⁵ Coughlin, *supra* note 24.

¹³⁶ YAHYA EMERICK, WHAT ISLAM IS ALL ABOUT: A STUDENT TEXTBOOK (GRADES 7 TO 12) (5th

authorities so that one is not misled into accepting either a weak authority or an “extremist” view point. The work is the best of any such scholarship because it treats doctrinal *Shari’ah* as *Shari’ah* expects to be treated and as evidenced by the published rulings of the *Shari’ah* authorities: as a sectarian legal-political-military normative social construct sourced in divine and immutable law.

Coughlin’s study demonstrates that *Shari’ah* and the doctrines of war articulated as the Law of *Jihad* are as valid today as they were one thousand years ago. *Jihad* should be implemented as circumstances permit, and the contemporary authoritative *Shari’ah* scholars continue to teach, preach, and issue legal rulings to this effect. Coughlin’s investigation further explicates that, once the *Shari’ah* authorities reach a consensus on a legal ruling based on the *Qur’an* and *Hadith*, that ruling is considered immutable and irrevocable.¹³⁷ This adds yet further concretization to the rulings on *Jihad* because the purpose of Islam and the methodologies to achieve those ends per *Shari’ah* are universally accepted by the *Shari’ah* authorities with but relatively minor exceptions as to specifics.¹³⁸

Based upon a consensus of legal authorities, this study places the Law of *Jihad* in a milieu permeated by the consequences of the jurisprudential rule of consensus and establishes three fundamental points:

[1] The goal of *Jihad* to convert or conquer the entire world and the methodology to achieve this end by persuasion, by force and subjugation, or by murder is extant doctrine and valid law by virtue of a universal consensus among the authoritative *Shari’ah* scholars throughout Islamic history.

[2] The doctrine of *Jihad* is foundational because it is based upon explicit verses in the *Qur’an* and the most authentic of canonical *Sunna*, and it is considered a cornerstone of justice: until the infidels and polytheists are converted, subjugated, or murdered, their mischief and domination will continue to harm the Muslim nation. And,

[3] *Jihad* is conducted primarily through kinetic warfare but it includes other modalities such as propaganda and psychological warfare.

rev. ed. 2004).

¹³⁷ Coughlin, *supra* note 24, at 97-108, 134 et seq.

¹³⁸ One poignant example is Coughlin’s use of Averroes (aka Abu al-Walid Muhammad Ibn Muhammad Ibn Rusd), one of the leading *Shari’ah* authorities of the so-called Golden Era in Islamic history often touted as an age of Muslim enlightenment, pluralism, and peace. What Coughlin points out, based upon available English translations of Averroes’ major work on *Jihad*, is that even in their best light, *Shari’ah* authorities consistently maintain that infidels and polytheists “must be fought.” See, e.g., Coughlin, *supra* note 24, at 184. For the entire work on *Jihad* translated, see RUDOPH PETERS, *JIHAD IN CLASSICAL AND MODERN ISLAM 27-42* (2005).

Coughlin's thesis is supported by the rulings of at least one prominent contemporary *Shari'ah* authority. In a recent book, Mufti M. Taqi Usmani---a member of numerous *Shari'ah* advisory boards and one of the most respected *Shari'ah* authorities in the world---advocates violent and aggressive *Jihad* even against peaceful non-Muslims if they don't heed the call to Islam.¹³⁹ He bases his ruling explicitly on legal verses in the *Qur'an*, the actions of Mohammed and the successor Caliphates, and a consensus among *Shari'ah* authorities. If Coughlin is correct, then Usmani is but one example of a *Shari'ah* authority who both embraces the Law of *Jihad* as an extant doctrine for action by *Shari'ah*-adherent Muslims and bases his rulings on the classical *Shari'ah* authorities who fully embraced the consensus on the Law of *Jihad*.

C. Applying the endogenous elements of *Shari'ah* to the specific duty to disclose

As noted previously, the SCF industry in the U.S. includes a panoply of businesses regulated by the securities laws. Mutual funds tracking one of the Islamic indexes, publicly traded bond issuances and the trading of securitized bond issuances on a secondary market, and even U.S. public companies announcing their commitment to conducting their business according to the principles of *Shari'ah* are some of the more obvious examples. Do the facts of *Shari'ah* – representing the overriding purposes of *Shari'ah* and the methods authorized to achieve those purposes – require disclosure under the securities laws?

Failure to disclose a material fact (or the material misrepresentation of an asserted fact) is the basis for administrative, civil, and criminal actions under all of the securities laws requiring disclosure. The breach of this duty might arise in a registration, prospectus or other required filing with the SEC or “in connection with” a purchase or sale of securities. For example, the 1933 Act imposes a number of requirements upon issuers, underwriters, and dealers to make full and fair disclosures in securities offerings.¹⁴⁰ Section 11 of the 1933 Act (“Section 11”) provides that purchasers of securities may sue for material misrepresentations or omissions in registration statements as long as they did not know of the misrepresentation or omission at the time of purchase.¹⁴¹ The dragnet under Section 11 for potential defendants is fairly wide and includes: (1) any person who signed the registration statement; (2) any person who was a director or partner of the issuer at the time of the filing of the registration statement; (3) any person listed in the registration statement as a soon-to-be director or partner; (4) every accountant, engineer, appraiser, or other expert named in the statement after having consented, but only as to any liability arising from the portion of the statement attributed to the specific expert; or (5) any underwriter of the securities.¹⁴² In addition, Section 12 of the 1933 Act (“Section 12”) authorizes a purchaser of securities to sue the offeror or seller for any material

¹³⁹ MUFTI M. TAQI USMANI, *ISLAM AND MODERNISM* 123-39 (2006).

¹⁴⁰ *See, e.g.*, 15 U.S.C. 77g (2006) (disclosures required in registration statements); § 77j (disclosures required in prospectuses); § 77aa (schedules of information required in registration statements).

¹⁴¹ *Id.* § 77k.

¹⁴² Respectively (1) § 77f; (2) § 77k(a)(2); (3) § 77k(a)(3); (4) § 77k(a)(4); and (5) § 77k(a)(5).

misrepresentation or omission in a prospectus and adds “oral communications” to the landscape.¹⁴³ The depth of the exposure from both of these provisions is the fact that a private plaintiff need not allege or show actual reliance on the misrepresentation or show that the absence of the material omission was in fact a contributing element.¹⁴⁴

The preeminent statutory authority regarding disclosure in securities transactions is Section 10(b) of the 1934 Act and its regulatory offspring Rule 10b-5. It has been the source for much litigation due to its breadth and the fact that it includes an implied private right of action, thereby adding private plaintiff and class action claims to the enforcement suits by the SEC and DOJ criminal prosecutions.¹⁴⁵ The essential elements of a Rule 10b-5 action are:

(1) a misstatement or omission; (2) of material fact; (3) with *scienter*; (4) in connection with the purchase or the sale of a security; (5) upon which the plaintiff reasonably relied; and (6) that the plaintiff’s reliance was the proximate cause of his or her injury.¹⁴⁶

Once these elements of the Rule 10b-5 cause of action are established, a criminal penalty can be imposed under section 32(a) if the government satisfactorily proves a willful violation of the 1934 Act.¹⁴⁷

This Article examines two unique elements to most fraud claims based upon allegations that the defendant omitted material information about *Shari’ah* in public filings and representations: materiality and *scienter*. Because the discussion regarding materiality in a federal securities fraud action also applies to fraud claims under the common law, state blue sky laws, or other anti-fraud federal and state statutes, the discussion of materiality will not treat the latter separately. These two elements of the fraud action are carved out for special attention because a failure to consider them properly will contribute to the conclusion that the *Shari’ah* black box poses no great risk to U.S. companies involved in SCF. This conclusion, if reached without due consideration of the matters raised herein, would be faulty and very costly.

1. Materiality

a. The Supreme Court’s standards

Materiality is a fundamental element for an action alleging a failure to disclose under the securities laws. The essential elements of such a claim might be, in addition to those set forth above in the hypothetical, as follows:

¹⁴³ *Id.* § 771.

¹⁴⁴ See generally LOSS & SELIGMAN, *supra* note 5, at 1217-1239.

¹⁴⁵ *Supra* notes 101-104 and accompanying text.

¹⁴⁶ LOSS & SELIGMAN, *supra* note 5, at 1273-1301; see also Heuer, Reese & Sale, *supra* note 104.

¹⁴⁷ 15 U.S.C. § 78ff(a); see also Heuer, Reese & Sale, *supra* note 104, at [page number] & nn.53-54.

(1) Plaintiff bought shares in a closed-end mutual fund which represented itself to be *Shari'ah*-compliant.

(2) An important part of these representations was the high-repute of the *Shari'ah* advisory board members who were to watch over the fund's *Shari'ah* compliance.

(3) Various representations by the defendant financial institution and its agents and representatives spoke of the ethical and socially responsible nature of *Shari'ah*.

(4) It was subsequently discovered and made public that the *Shari'ah* advisory board members all treated the rulings and pronouncements of Ibn Taymiyyah, a fourteenth-century Hanbali *Shari'ah* authority and scholar “with strikingly modern-sounding views” on commerce and finance¹⁴⁸, as authoritative. It was also discovered and made public that Ibn Taymiyyah was a key *Shari'ah* authority for most of the terrorists associated with al Qaeda. Ibn Taymiyyah, it turns out, was a leading advocate of a *Shari'ah* centered political organization for Muslims which would declare holy war against infidels and Muslims who rejected *Shari'ah*. In fact, all sorts of “Islamists” who have declared war on the U.S. and seek the establishment of a worldwide Caliphate are students and followers of the *Shari'ah* “rules and principles” espoused by Ibn Taymiyyah insofar as he advocates Muslims to war against infidels.¹⁴⁹

(5) There is a consensus among *Shari'ah* authorities from all schools of *Shari'ah* jurisprudence that forced subjugation or *Jihad* against non-Muslims is obligatory when efforts to peacefully convert the non-Muslims fail and war is a viable option.

In addition to these allegations, which would support an SEC enforcement action or a private right of action for rescission, a plaintiff might opt to pursue damages. In such a case, one might anticipate the following: When the information alleged above became public knowledge, the fund suffered irreparable reputational damage and many of the U.S. investors sold their shares in the mutual fund, causing the value of the traded shares to plummet. The complaint would also allege that the plaintiff purchased shares in the mutual fund without knowing anything about *Shari'ah* other than what the defendants represented to the public. Since the defendants promoted their *Shari'ah* authority board members as highly respected scholars and authorities in their field, and since these authorities ruled that *Shari'ah* forbade interest and excessive speculation in investments, and also prohibited investing in various “vice” industries, the plaintiff reasonably relied on these representations in the belief that *Shari'ah* was a “socially responsible” business practice and worth utilizing as an investment “screen”. Had the plaintiff known the facts about *Shari'ah* as they have now come to light, plaintiff would never have invested in a

¹⁴⁸ VOGEL & HAYES, *supra* note 18, at 38.

¹⁴⁹ See Coughlin, *supra* note 24, at 147-150.

Shari'ah-compliant mutual fund. In addition to damages, the plaintiff would apply to certify a class of similarly situated investors.

The first issue confronting the plaintiffs under Rule 10b-5 would be whether the omissions of fact relating to *Shari'ah* doctrine relative to the treatment of apostates (both non-Muslims and Muslims) were material. The leading decision in this area is *TSC Industries, Inc. v. Northway, Inc.*,¹⁵⁰ where the Supreme Court addressed whether a failure to disclose in the context of a proxy solicitation was material.

The Court began by rejecting what it considered to be too low a threshold for materiality as adopted by the lower court. The Court considered a standard of “all facts which a reasonable shareholder *might* consider reasonable”¹⁵¹ “too suggestive of mere possibility, however unlikely.”¹⁵² The Court went on to explain in detail the objective standard it chose for materiality:

An omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote. . . . Put another way, there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the "total mix" of information made available.¹⁵³

Arguably, the question whether the *Shari'ah* in SCF is a material fact that ought to be disclosed will rest on one of two analytical approaches, or possibly both. The first approach seeks to determine the materiality of *Shari'ah* in principle. It asks: Would a reasonable post-9/11 investor consider the connection between *Shari'ah* and SCF important to his or her decision to invest? In other words, would a reasonable investor looking to invest in something promoted as “*Shari'ah*-compliant” want to know what *Shari'ah* and its “rules and principles” say about constitutional government, treatment of infidels, the Law of *Jihad*, and the use of suicide-homicide bombers, and other acts of terrorism? Would the reasonable investor want to know about the published statements by international terrorist leaders citing *Shari'ah* authorities as justification for their holy war against the U.S. and other Western nations? These and similarly phrased questions all attempt to get at the associational link between *Shari'ah* in principle as an authoritative set of rules and principles advocating violence and SCF. If in fact such an association exists, would it be material information to a reasonable investor?¹⁵⁴

¹⁵⁰ 426 U.S. 438 (1976).

¹⁵¹ 485 U.S. 224, 445 (1988) (emphasis in the original).

¹⁵² *Id.* at 449 (quoting from 478 F. 2d at 1302).

¹⁵³ *Id.* at 445-449 (footnotes and citations omitted).

¹⁵⁴ A related question would be who decides and how does one decide what *Shari'ah* is? This is not specific to the query of materiality. As noted supra, if a financial institution relies upon specific *Shari'ah* authorities, the question might be as simple as determining what these specific *Shari'ah* authorities consider to be authentic and authoritative *Shari'ah* rulings on *Jihad*, terrorism, and violence against non-Muslims and non-*Shari'ah*-compliant Muslims. Aside from a careful examination of the rulings on these subjects issued by the relevant *Shari'ah* authorities, a

The second analysis relevant to materiality goes beyond the association in principle of SCF with *Shari'ah* and its call to violence and asks whether there is enough evidence of association in fact. This analysis asks: Is the nexus between *Shari'ah* and violence so contingent or speculative that it would render any theoretical association between *Shari'ah* and violence immaterial? This is another way of analyzing the argument often made against any association between *Shari'ah* or Islam and violence. In the context of *Shari'ah*, the argument is made that *Shari'ah* can be interpreted in peaceful ways or in violent ways, and that those *Shari'ah* authorities who interpret *Shari'ah* violently and in ways that would shock the conscience of a reasonable U.S. investor are the extremists and represent such a small percentage of the recognized *Shari'ah* authorities that it would render any theoretical link between *Shari'ah* and violence against non-Muslims and non-*Shari'ah*-compliant Muslims so tenuous as to be immaterial to a reasonable investor. In short, this is an argument that accepts that violence is associated in principle with *Shari'ah*,¹⁵⁵ but argues that the association is less than material because it is not representative of *Shari'ah* as espoused by the vast majority of contemporary *Shari'ah* authorities.

While Coughlin's investigation and documentation would demonstrate this argument to be lacking evidentiary credibility, the analysis in a courtroom would turn on an examination of the facts and the law. As the Court opined in *TSC Industries*, "[t]he issue of materiality may be characterized as a mixed question of law and fact, involving as it does the application of a legal standard to a particular set of facts."¹⁵⁶ In addition to a simple factual showing that Islamic terrorists base their *raison d'être* for violence on the dictates of *Shari'ah* as expressed by the classical *Shari'ah* authorities and some contemporary ones, the fact question as presented might also be addressed by introducing evidence establishing what the contemporary *Shari'ah* authorities consider to be the purposes and authorized methods of *Shari'ah*. This question might be presented to a jury by introducing evidence (i) of the rulings of the contemporary *Shari'ah* authorities, (ii) of the rulings of classical *Shari'ah* authorities upon which the contemporary authorities have relied, and (iii) of *Shari'ah in actu*, which would include a brief on Muslim-dominated regimes generally recognized as following *Shari'ah*, including their *Shari'ah*-

problem in any event if they have not published rulings in these areas, one would be well-advised to look to the classical *Shari'ah* authorities upon which these contemporary *Shari'ah* authorities rely as authoritative in their SCF rulings. While such a reliance might not be dispositive (i.e., a *Shari'ah* authority might rely on Ibn Taymiyyah for purposes of determining what kind of nominate contract *Shari'ah* allows for any given transaction, but in fact reject Ibn Taymiyyah's rulings on *Jihad* and war against the infidels). But at the very least, it raises an important fact question for the reasonable investor that might very well rise to the level of materiality: Do the *Shari'ah* authorities of the particular financial institution consider Ibn Taymiyyah's *Shari'ah*-based rulings on war against non-Muslims and non-*Shari'ah* compliant Muslims authoritative? If not Ibn Taymiyyah's, whose?

¹⁵⁵ This is procedurally akin to a defendant's position on a motion to dismiss or for summary judgment. Assuming all the allegations are true, as a matter of law, there is no actual evidence that *Shari'ah* is the cause of violence rather than its excuse.

¹⁵⁶ 426 U.S. 438, 450 (1976).

based criminal codes and punishments and their track record for violations of the basic norms of the Law of Nations and human decency.¹⁵⁷

The legal question presented by this second analysis will not be different in kind from the first analytical approach, which examines the association in principle between *Shari'ah*, its call to violence, and SCF. In both, one must determine if the law requires disclosure of qualitatively material facts as opposed to quantitatively material facts. Quantitative materiality requires companies only to disclose hard, empirical facts such as financial data and any criminal convictions of management personnel. Qualitative materiality requires a fuller disclosure of behavior that might be considered unethical or even illegal but which has not yet resulted in an actual conviction.¹⁵⁸

While qualitative materiality is frowned upon by the courts and commentators because it renders the duty to disclose open to wholesale uncertainty about what must be disclosed in the first instance, the problem of disclosure for the *Shari'ah*-compliant financial institution is not circumscribed by this concern. Disclosure remains a significant legal issue for the company looking to promote its SCF business (or simply to disclose publicly the involvement in SCF) because of the difference between whether a duty to disclose exists in the first instance and what must be disclosed to make a partial disclosure not misleading to the reasonable investor.¹⁵⁹ Thus, to the extent an SCF business actively promotes its SCF business or includes SCF within the risk factors in its SEC filings, this disclosure opens the door to a full and accurate disclosure of all facts which a reasonable investor would find material. It hardly seems in doubt that a post-9/11 investor, when contemplating an investment in something represented as *Shari'ah*-compliant, would consider material any factual link between *Shari'ah* and the call for violence against non-Muslims and non-*Shari'ah*-compliant Muslims, or more specifically against the U.S. or U.S. interests abroad. Indeed, it would be improbable that a post-9/11 investor would not want to know what *Shari'ah* says about the Law of *Jihad* and the use of *Shari'ah* by Islamic terrorists even if the reporting company made no disclosure or representation about being *Shari'ah*-compliant. The fact of *Shari'ah* compliance would likely be sufficiently material for the duty of disclosure to exist independently of any partial representation.¹⁶⁰

¹⁵⁷ See *supra* note 86; *supra* notes 249-250 and accompanying text.

¹⁵⁸ See generally LOSS & SELIGMAN, *supra* note 5, at 171-174. For a thorough discussion of the quantitative-qualitative distinction in disclosure, see John M. Fedders, *Qualitative Materiality: The Birth, Struggles, And Demise Of An Unworkable Standard*, 48 CATH. U.L. REV. 41 (1998).

¹⁵⁹ Common law fraud did not originally impose a duty to disclose; rather, once a statement represented something as fact, it had to be truthful. Materiality gets at “truthfulness” in that “half-truths” can be as misleading as false statements. The development of the law on the disclosure of omitted facts has always lagged behind the duty to disclose the whole of a truth partially told. For a discussion in this development relative to securities fraud cases, see LOSS & SELIGMAN, *supra* note 5, at 910-918.

¹⁶⁰ This would be the case whether a company made no disclosure at all or represented itself as focused on “socially responsible” or “ethical” investing without any mention of *Shari'ah*. If the business model was in fact based upon *Shari'ah*, this would remain a material fact.

The confusion at a procedural level for the legal advisor attempting to weigh the materiality issue within the overall analysis of liability exposure might be the existence of counterfactual claims suggesting that *Shari'ah* has a peaceful face in addition to its connection to Islamic terror. But these “counter-facts” would simply create a fact question. This suggests that a well-pled complaint alleging a sufficient nexus between SCF, *Shari'ah*, terror, and violence would survive a motion for summary judgment. This seems especially true given the effectiveness of *Shari'ah*-inspired terrorists to convert calls for violence based upon *Shari'ah* into actual violence.

b. Global Security Risk: a material fact?

The close nexus in the hypothetical factual predicate for this discussion between *Shari'ah* and global terrorism is, as explained above, more than just theoretical. Efforts by corporate legal counsel to dismiss these concerns will invariably run up against the wall of common understanding linking in material ways the violent and oppressive world of *Shari'ah* one hears about in the public media¹⁶¹, terrorism committed in the name of *Shari'ah*¹⁶², *Shari'ah* itself¹⁶³, and something calling itself SCF. This common understanding has already begun to articulate itself in the debate over materiality in the context of what is a material or relevant disclosure with respect to shareholder proxy statements.

In at least two instances, the New York City Comptroller, as the custodian and trustee of several major New York City employee pension funds which had acquired substantial stock in Halliburton Company and General Electric, demanded that these two U.S. multinational corporations doing business in Iran approve a shareholder proposal at their respective annual meetings to examine the “potential financial and reputational risks” associated with doing business in terror-sponsoring countries.¹⁶⁴ The first effort was directed against Halliburton and began in late 2002, culminating in a final negative

¹⁶¹ Recent media stories about the *Shari'ah* criminal law include only recently a Muslim convert to Christianity sentenced to death, a rape victim sentenced to lashes, and thieves having their hands amputated. See, e.g., Josh Gersten, *Widespread Outrage At Afghan Facing Death For Abandoning Islam*, N.Y. SUN, Mar. 21, 2006. For a scholarly look at the *Shari'ah* criminal law from the time of the Ottoman Empire until today, see RUDOLPH PETERS, *CRIME AND PUNISHMENT IN ISLAMIC LAW: THEORY AND PRACTICE FROM THE SIXTEENTH TO THE TWENTY-FIRST CENTURY* (2005).

¹⁶² See MARY HABECK, *KNOWING THE ENEMY: JIHADIST IDEOLOGY AND THE WAR ON TERROR* (2006).

¹⁶³ For *Shari'ah* as expressed by *Shari'ah* authorities over the past millennium, see DAVID COOK, *UNDERSTANDING JIHAD*; PETERS, *supra* note 138; Coughlin, *supra* note 24, at 83-223. See generally, THE LEGACY OF JIHAD 141-367 (2005).

¹⁶⁴ The SEC documents from which this narration is drawn can be found through a Lexis search: for the Halliburton “No Action Letter” file, see 2003 SEC No-Act. LEXIS 433 [hereinafter Halliburton No-Action File]. For General Electric, see 2005 SEC No-Act. LEXIS 137 [hereinafter GE No-Action File]. For a broader article discussing these cases in some detail in the context of compliance by foreign subsidiaries of U.S. corporations, see Terence J. Lau, *Triggering Parent Company Liability Under United States Sanctions Regimes: The Troubling Implications Of Prohibiting Approval And Facilitation*, 41 AM. BUS. L.J. 413 (2004).

response to Halliburton's request for an SEC no-action letter in March 2003. The denial of a no-action letter was perhaps influenced by the Comptroller's statement that "[t]he link between Iran and Halliburton is of special interest to the public, including institutional, professional and non-professional investors, who are paying a great deal more attention to the relationship between their investments and terrorism."¹⁶⁵

Almost two years later, the SEC took the same hands-off policy when GE came knocking at the door also seeking a no-action letter to support its contention that it need not include a proxy proposal by the Comptroller at its annual shareholders' meeting.¹⁶⁶ In its correspondence in opposition to GE's request, the Comptroller quoted at length from the Congressional Conference Report on the 2004 Budget, which requested that the SEC establish an Office of Global Security Risk to evaluate the risks caused by the conduct of business operations in terrorist states.¹⁶⁷ The SEC denied GE's no-action letter and ultimately established an Office of Global Security Risk, the purpose of which is to "monitor whether the documents public companies file with the SEC include disclosure of material information regarding global security risk-related issues."¹⁶⁸

¹⁶⁵ Letter from Janice Silberstein, Assoc. Gen. Counsel, City of N.Y., Office of the Comptroller, to Sec. and Exch. Comm'n, Div. of Corporate Fin., Office of the Chief Counsel (Feb. 7, 2003), in Halliburton No-Action File, *supra* note 164.

¹⁶⁶ See GE No-Action File, *supra* note 164.

¹⁶⁷ Letter from Richard S. Simon, Deputy Gen. Counsel, The City of N.Y., Office of the Comptroller, to Sec. and Exch. Comm'n, Div. of Corporate Fin., Office of the Chief Counsel (Dec. 10, 2004), in GE No-Action File, *supra* note 164.

¹⁶⁸ U.S. Securities and Exchange Commission, Office of Global Security Risk, <http://www.sec.gov/divisions/corpfin/globalsecrisk.htm> (last visited Jan. 30, 2008). In this context, the SEC proposed the following:

II. Disclosure of Business Activities in or With Countries Designated as State Sponsors of Terrorism

The federal securities laws do not impose a specific disclosure requirement that addresses business activities in or with a country based upon its designation as a State Sponsor of Terrorism. However, the federal securities laws do require disclosure of business activities in or with a State Sponsor of Terrorism if this constitutes material information that is necessary to make a company's statements, in the light of the circumstances under which they are made, not misleading. [Note 6 citation appears here in the text. See below.] The term "material" is not defined in the federal securities laws. Rather, the Supreme Court has determined information to be material if there is a substantial likelihood that a reasonable investor would consider the information important in making an investment decision or if the information would significantly alter the total mix of available information. [Note 7 citation appears here in the text. See below.]

The materiality standard applicable to a company's activities in or with State Sponsors of Terrorism is the same materiality standard applicable to all other corporate activities. Any such material information not covered by a specific rule or regulation must be disclosed if necessary to make the required statements, in the light of the circumstances under which they are made, not misleading. The materiality standard's extensive regulatory and judicial history helps companies and their counsel to interpret and apply it consistently, and we remain committed to employing this standard to company disclosure regarding business activities in or with State Sponsors of Terrorism.

It is clear that U.S. companies can no longer consider their associations with countries or entities tainted by terror a private, non-material, or irrelevant matter. While the courts have not yet entered the fray, the executive and legislative branches have laid down some markers. This suggests that the closer a company gets to a “state sponsor of terror”, the more it has to disclose. Prudent counsel suggests that the closer a company gets to *any* association with terror, the more it has to disclose. The obvious question raised by the two proxy examples above would be: If a shareholder submits a proxy proposal to a publicly reporting financial institution involved in SCF requiring a full study of the risks associated with *Shari’ah*, will the company have legitimate grounds to argue that the risks of *Shari’ah* and its connection to terror are not relevant? Outside of the proxy arena, if a company engages in SCF and represents to the public that *Shari’ah* is a standard set by *Shari’ah* authorities relied upon by the company, has the company disclosed enough about *Shari’ah* to tell the whole story? Given the hypothetical this analysis has been working with, the answer appears to be “no”.

2. *Scienter*

Unlike materiality, which is an element in any type of fraud action, *scienter*, or intent, is a critical element of the common law and of most statutory provisions imposing liability on a wrongdoer.¹⁶⁹ As understood by the common law, a plaintiff’s claim for deceit could only survive a motion to dismiss if the pleadings alleged that the defendant knew the falsity of the representation and that the false representation was made in an effort to induce reliance by the plaintiff. Over time, this standard has been relaxed to include not merely false representations but also half-truths. This means that having opened the door to a representation, the putative defendant must be certain to have told the whole truth, or at least the whole material truth.¹⁷⁰

Although the Commission is well positioned to review disclosure relating to business activities regardless of the country in which they are conducted, we do not have the expertise or information necessary to identify the particular countries whose governments have funded, sponsored, provided a safe haven for, or otherwise supported terrorism. Nor is it the Commission’s role to determine the degree to which a public company’s business activities may support terrorism or may be inconsistent with U.S. foreign policy or U.S. national interests.

Note 6: Rule 408 of Regulation C, [17 CFR 230.408] and Rule 12b-20 under the Securities Exchange Act of 1934 [17 CFR 240.12b-20].

Note 7: *TSC Industries v. Northway, Inc.*, 426 U.S. 438 (1976). It has also held that materiality of contingent or speculative events or information depends on balancing the probability that the event will occur and the expected magnitude of the event. *Basic v. Levinson*, 485 U.S. 224, 238 (1988).

Concept Release on Mechanisms to Access Disclosures Relating to Business Activities in or With Countries Designated as State Sponsors of Terrorism, 72 Fed. Reg. 65862, 65863 (proposed Nov. 23, 2007) (to be codified at 17 C.F.R. pts. 228, 229, 230, 239, 240 & 249) (footnotes omitted).

¹⁶⁹ See generally LOSS & SELIGMAN, *supra* note 5, at 910-11, 1018-31.

¹⁷⁰ *Supra* note 159.

But the question remains: Having omitted some important part of the story, and assuming that the omitted part was material, did the defendant withhold the omitted part (a) knowingly and (b) with intent to deceive? Successful civil and criminal fraud litigation is as much about properly alleging *scienter* as it is proving it.¹⁷¹ Judges will decide the former; jurors are most likely to decide the latter¹⁷².

Today, fraud claims alleging a failure to disclose might be based upon violations of federal securities laws, state blue sky laws, state consumer protection laws, or other federal and state anti-fraud statutes. While the common law has generally moved away from requiring a specific intent to defraud and toward a standard of recklessness -- and in those jurisdictions which have adopted Section 552 of the *Restatement (Second) Of Torts*¹⁷³ the move has included even negligent misrepresentation -- specific claims under federal or state anti-fraud statutes will vary depending upon the statute, the specific jurisdiction, and whether the action is administrative, civil, or criminal.

For example, under federal securities laws, there are statutes and rules permitting SEC administrative and civil enforcement actions and private causes of action that do not impose a requirement to plead or prove *scienter*. Thus, under the 1933 Act, which has arguably become far more important for those seeking to pursue class action claims¹⁷⁴, Sections 17(a)(2) and (a)(3) are free of any *scienter* requirement for SEC civil actions and, to the extent that a private right of action exists, the no-*scienter* rule is likely to extend to private plaintiffs.¹⁷⁵ Also, Section 11, which relates to misrepresentations in a registration statement, imposes absolute liability on the issuer without any reference to *scienter*, but does provide for reasonable care defenses as a kind of substitute for *scienter* for other defendants.¹⁷⁶ Section 12(2) imposes liability without reference to *scienter* in

¹⁷¹ This is especially true after the passage of the Private Securities Litigation Reform Act of 1995 (PSLRA), which ratcheted up the *scienter* pleadings requirements and froze discovery during a defendant's motion to dismiss to eliminate frivolous suits and to eliminate the "leverage" plaintiffs use by propounding reams of discovery requests early on to tie-up company management and extort a settlement. For a good discussion of the pleadings requirements post-PSLRA, see Ray J. Grzebielski & Brian O. O'Mara, *Whether Alleging "Motive and Opportunity" Can Satisfy the Heightened Pleading Standards of the Private Securities Litigation Reform Act of 1995: Much Ado About Nothing*, 1 DEPAUL BUS. & COM. L.J. 313 (2003).

¹⁷² Certainly this is true in the Second Circuit Court of Appeals, given the ruling in *Press v. Chemical Investment Services Corp.*, 166 F.3d 529, 538 (2d Cir. 1999) ("Whether or not a given intent existed is, of course, a question of fact." (quoting *SEC v. First Jersey Sec., Inc.*, 101 F.3d 1450, 1467 (2d Cir. 1996))); see also *id.* ("Whether a given intent existed is generally a question of fact." (quoting *In re Time Warner*, 9 F.3d 259, 270-71 (2d Cir. 1993))). For an argument in favor of the Second Circuit's approach to *scienter*, see Daniela Nanau, *Analyzing Post-Market Boom Jurisprudence in the Second and Ninth Circuits: Has the Pendulum Really Swung Too Far in Favor of Plaintiffs?*, 3 CARDOZO PUB. L. POL'Y & ETHICS J. 943 (2006).

¹⁷³ RESTATEMENT (SECOND) OF TORTS §552(1) (1977).

¹⁷⁴ See *supra* notes 171-172; see also Cook, *supra* note 105 (providing an overall examination of the jurisdictional issues raised by the recent federal legislation affecting class actions alleging securities fraud).

¹⁷⁵ See generally LOSS & SELIGMAN, *supra* note 5, at 1019 & n.345.

¹⁷⁶ See generally *id.* at 1227-39 (except the discussion on "expertizing" at 1232-33).

public offerings¹⁷⁷ but provides an out for a defendant who can “sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission.”¹⁷⁸

Another serious avenue for enforcement that avoids the *scienter* issue arises under the Investment Advisors Act of 1940 (“Investment Advisors Act”). Fund managers who embrace SCF while ignoring *Shari’ah* as a material part of the disclosure will likely face serious scrutiny as the SEC and large institutional investors come to understand the intimacy between the terms “*Shari’ah*-compliant”, “Islamic finance”, and even “socially responsible Islamic investing” and the *Shari’ah* witnessed in Iran, Saudi Arabia, and Sudan. Indeed, an SCF investment or business which attempts to disguise the “*Shari’ah*” and utilize a less emotionally charged term has added to its exposure, since that would be circumstantial evidence that the putative defendants knew of the dangers of *Shari’ah* and sought to minimize them by using a more acceptable public relations-sensitive nomenclature.

Specifically, investment advisors, including those who might otherwise fall within a registration exemption, come within the Act’s anti-fraud provisions. Thus, under Rule 206(4)-1:

a. It shall constitute a fraudulent, deceptive, or manipulative act, practice, or course of business within the meaning of section 206(4) of the Act for any investment adviser registered or required to be registered under section 203 of the Act, directly or indirectly, to publish, circulate, or distribute any advertisement:

...

5. Which contains any untrue statement of a material fact, or which is otherwise false or misleading.¹⁷⁹

Rule 206(4)-8, captures the pooled investment fund advisors:

a. *Prohibition.* It shall constitute a fraudulent, deceptive, or manipulative act, practice, or course of business within the meaning of section 206(4) of the Act for any investment adviser to a pooled investment vehicle to:

1. Make any untrue statement of a material fact or to omit to state a material fact necessary to make the statements made, in the light of the circumstances under which they were made, not misleading, to

¹⁷⁷ Per its terms, Section 12(2) creates civil liability for misrepresentations when someone “offers or sells a security” and does so “by means of a prospectus or oral communication.” 15 U.S.C.S. § 771(a)(2); see also *Gustafson v. Alloyd Co.*, 513 U.S. 561, 569 (1995) (stating that a “prospectus” is a specific kind of document under the 1933 act and misrepresentations of the written kind must be in the prospectus to be the basis for an action under Section 12(2)).

¹⁷⁸ 15 U.S.C. § 771(a)(2) (2006).

¹⁷⁹ 17 C.F.R. § 275.206(4)-1 (2008).

any investor or prospective investor in the pooled investment vehicle; or

2. Otherwise engage in any act, practice, or course of business that is fraudulent, deceptive, or manipulative with respect to any investor or prospective investor in the pooled investment vehicle.¹⁸⁰

As the Supreme Court made clear in *SEC v. Capital Gains Research Bureau*,¹⁸¹ the Investment Advisors Act was meant to safeguard the fiduciary relationship between the advisor and the investor. The nature of the SEC proceeding, the heightened duty of such fiduciaries, and the purposes of the act eliminate the need to show intent to injure as in common law fraud.¹⁸² The exposure of investment advisors to the claim that they have a duty to disclose all of the material facts about *Shari'ah* prior to any investment in an SCF fund, securitization, or company seems quite substantial, which is further highlighted by the complete lack of attention given the duty and its breach by the SCF industry.

While *scienter's* common law and statutory roles appear greatly diminished in the contexts discussed above, that is not the case for implied rights of action under Rule 10b-5. Congress and the Supreme Court have gone a long way to gut both the 1934 Act and the blue sky laws of their private class action fear factor -- in part by requiring strict pleading of all necessary elements, including *scienter*.¹⁸³ The attorney representing the financial institution must keep in mind, however, that the SEC and institutional plaintiffs with significant investments at stake will continue to employ Rule 10b-5 and state securities anti-fraud provisions. Institutional investors with large investment portfolios are less inclined to turn to class actions when they can bring far more manageable private civil claims that carry enough investment clout to make a difference to the defendant.

Moreover, even after the Supreme Court's decision in the oft-cited *Ernst & Ernst v. Hochfelder* case¹⁸⁴, while a Rule 10b-5 allegation requires more than negligence, a reckless disregard for the truth likely suffices. This is as much about artful pleading as it is about nailing down the legal standard, especially after a financial institution opens the

¹⁸⁰ For the SEC Final Rule, see 72 Fed. Reg. 44,756, 44,761 (Sep. 10, 2007) (codified at 17 C.F.R. pt. 275).

¹⁸¹ 375 U.S. 180, 195 (1963).

¹⁸² *Id.* For a discussion of whether there is a private right of action to void contracts under Section 215 of the Investment Advisors Act, see *Transamerica Mortg. Advisors (tama) v. Lewis*, 444 U.S. 11, 18-19 (1979); see also LOSS & SELIGMAN, *supra* note 5, at 1241-47.

¹⁸³ See *supra* note 171; see also Jeffrey W. Stempel, *Class Actions and Limited Vision: Opportunities for Improvement Through a More Functional Approach to Class Treatment of Disputes*, 83 WASH. U. L. REV. 1127 (2005) (discussing the Class Action Fairness Act of 2005 (CAFA)).

¹⁸⁴ 425 U.S. 185 (1976); see also *Sundstrand Corp. v. Sun Chemical Corp.*, 553 F.2d 1033 (7th Cir. 1977) (stating the classic "recklessness" standard as follows: "[H]ighly unreasonable [conduct], involving not merely simple, or even inexcusable negligence, but an extreme departure from the standards of ordinary care, and which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it").

door to a partial but misleading truth.¹⁸⁵ Thus, a financial institution that recognizes the threshold duty to disclose something about *Shari'ah* and the *Shari'ah* authorities who set the standards for the particular SCF investment or business must be extremely careful to capture all of the material facts about *Shari'ah*, its purposes, and its methods. Failure to recognize an extant connection between *Shari'ah* and violence after representing *Shari'ah* as divine Islamic law based on the *Qur'an*, the *Sunna*, and legal rulings of the competent *Shari'ah* authorities will suffice to satisfy the *scienter* requirement---at least at the pleadings stage.

Recklessness, especially in a case where a representation was made but without all the requisite material facts, is a notoriously fact-based standard that allows a showing of proof through circumstantial evidence.¹⁸⁶ The caselaw suggests a “totality of the circumstances” test where a variety of factors come into play to establish recklessness.¹⁸⁷ The specific factors typically cited include how material the omission was; how available the omitted facts were to the defendant; whether there was an extant standard of care in the industry giving rise to a duty to disclose the omitted facts; how egregious the breach was; and what the the likely consequences were of not disclosing the material facts.

Rule 10b-5 is important because it operates as a “catch-all” anti-fraud statute with an implied private right of action. But beyond Rule 10b-5, there are many state securities laws which require no *scienter* and are broader in their reach than Rule 10b-5. Arizona’s blue sky anti-fraud provisions have been given an expansive reach to get at all kinds of securities fraud without the burden of *scienter*.¹⁸⁸ Arizona blue sky laws also permit punitive damages.¹⁸⁹ In addition, at least three states provide for a securities fraud claim

¹⁸⁵ See *supra* note 159; see also *City of Monroe Employees Ret. Sys. v. Bridgestone*, 399 F.3d 651, 687 (6th Cir. 2005). In the *Bridgestone* case, the court quoted *Rubin v. Schottenstein*, 143 F.3d 263, 267 (6th Cir. 1998) (en banc), as follows:

The question thus is not whether a [defendant’s] silence can give rise to liability, but whether liability may flow from his decision to speak . . . concerning material details . . . , without revealing certain additional known facts necessary to make his statements not misleading. This question is answered by the text of [SEC] Rule 10b-5(b) itself: it is unlawful for any person to “omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading”

Bridgestone, 399 F.3d at 687.

¹⁸⁶ See *Bridgestone*, 399 F.3d at 669 (quoting *Helwig v. Vencor, Inc.*, 251 F.3d 540, 555 (6th Cir. 2001)), wherein the court explained that “[a]s for materiality, whether or not a statement is material turns on ‘a fact-intensive test.’” The court also stated that “[m]ateriality depends on the significance the reasonable investor would place on the withheld or misrepresented information.” *Id.* (quoting *Basic Inc. v. Levinson*, 485 U.S. 224, 240 (1988)). That is, would the information, had it been presented accurately, have “‘significantly altered the ‘total mix’ of information made available?’” 251 F.3d at 563 (quoting *Basic*, 485 U.S. at 231-32).

¹⁸⁷ See *Bridgestone*, 399 F.3d at 669 (citing *PR Diamonds, Inc. v. Chandler*, 364 F.3d 671, 680 (6th Cir. 2004)).

¹⁸⁸ Ariz ARIZ. REV. STAT. ANN. § 44-1991 (1999); see also Richard G. Himelrick, *Arizona Securities Fraud Liability: Charting a Non-Federal Path*, 32 ARIZ. ST. L.J. 203 (2000).

¹⁸⁹ See *id.* at 230 & n. 186.

under their respective consumer anti-fraud statutes¹⁹⁰, of which two have a private right of action allowing for punitive damages.¹⁹¹ Even a state like California, which does not recognize securities fraud as a cause of action under its consumer fraud statute, will allow a consumer fraud claim relating to a “holder” of securities where the allegation is of fraud, but not in connection with the “sale” or “purchase” of a security.¹⁹² These state consumer fraud actions are effective weapons in the hands of a sophisticated plaintiffs’ bar against financial institutions treading down the seemingly golden path of SCF.

D. Sedition: *Shari’ah* as the advocacy of the violent overthrow of the U.S. government

The Smith Act of 1940 makes it criminal to “knowingly or willfully advocate[], abet[], advise[], or teach[] the duty, necessity, desirability, or propriety of overthrowing or destroying the government of the United States”.¹⁹³ The Supreme Court has taken four occasions to review cases prosecuted under the Smith Act. In the first case, *Dennis v. United States*,¹⁹⁴ the Court heard appeals from Communist Party leaders who had been convicted of violating the Smith Act and whose conviction had been affirmed by the lower court. The Court examined the First Amendment and other constitutional challenges, upheld the statute as constitutional, and affirmed the convictions.

The second time the Court took a look at the Smith Act was six years later in the case of *Yates v. United States*.¹⁹⁵ By this time, however, the Court was now under the spell of Chief Justice Earl Warren and the other liberal Justices of the time. They had already tested their mettle in *Brown v. Board of Education*¹⁹⁶ some three years earlier, and one could reasonably have wondered whether the Court would sustain a First Amendment challenge and effectively overrule *Dennis*.

The Court did not even address the First Amendment issue. What the Court did was to limit the Smith Act to cases where the advocacy for the overthrow of the government was more than merely theoretical and to require a nexus between the advocacy and some action that was being urged to achieve the treasonous goal.

¹⁹⁰ See *supra* note 112.

¹⁹¹ For case law regarding Illinois’ private right of action, see *In re CLDC Management Corp.*, 18 B.R. 797, 799-800 (Bankr. D. Ill. 1982) (implied private right of action allowed); *Martin v. Heinold Commodities*, 163 Ill. 2d 33, 67 (1994) (punitive damages allowed). For case law regarding Arizona’s private right of action, see *Holeman v. Neils*, 803 F. Supp. 237 (D. Ariz. 1992) (implied private right of action allowed); *Dunlap v. Jimmy GMC of Tucson, Inc.*, 666 P.2d 83 (Ariz. Ct. App. 1983) (punitive damages allowed).

¹⁹² *Strigliabotti v. Franklin Res., Inc.*, No. C 04-00883 SI, 2005 U.S. Dist. LEXIS 9625 (N.D. Cal. March 7, 2005).

¹⁹³ 18 U.S.C. § 2385 (2006).

¹⁹⁴ 341 U.S. 494 (1951).

¹⁹⁵ 354 U.S. 298 (1957)

¹⁹⁶ *Brown v. Bd. of Educ.*, 345 U.S. 972 (1953).

In *Scales v. United States*,¹⁹⁷ the Court reexamined the Smith Act. In this case, the defendant sought to have his conviction for being a member of the Communist Party set aside on statutory, constitutional, and procedural grounds. While the procedural aspects are not relevant to this discussion, the statutory and constitutional parts of the case are. The first argument raised by the defendant-petitioner was based on the claim that another federal statute had been enacted providing that mere membership in the Communist Party would not constitute a *per se* violation of any federal statute.¹⁹⁸ From this, the petitioner concocted the argument that the Smith Act's membership clause had been repealed *pro tanto*. The Court rejected this argument on several grounds, but most importantly because the Court found that the petitioner's Smith Act conviction was for being a member of an organization which called for the violent overthrow of the U.S. There was nothing unique about the Communist Party except its doctrine for violent overthrow; the Smith Act applied to any organization, not just to the Communist Party.

The petitioner also challenged his Smith Act conviction on *per se* constitutional grounds.¹⁹⁹ The petitioner argued that the membership clause of the Smith Act violated his Fifth and First Amendment rights. The Fifth Amendment claim essentially boiled down to this: Although the trial court instructed the jury that the defendant had to be an "active member" of the criminal group, in accord with the earlier decision in *Yates* which required a nexus between advocacy and action, the trial court did not require that the defendant actually participate in the criminal activity. It was enough that the defendant knew of the criminal designs of the group at large and that the defendant was an active member, even if such activity was wholly legal. As such, the petitioner argued that this violated his Fifth Amendment rights to due process because it convicts a person for mere association and not overt criminal activity. The First Amendment claim was similarly an argument that his right to freedom of association was unconstitutionally infringed by virtue of the threat of criminal prosecution for mere non-criminal membership.

The Court rejected the argument, asserting that:

Any thought that due process puts beyond the reach of the criminal law all individual associational relationships, unless accompanied by the commission of specific acts of criminality, is dispelled by familiar concepts of the law of conspiracy and complicity. . . . In this instance it is an organization which engages in criminal activity, and we can perceive no reason why one who actively and knowingly works in the ranks of that organization, intending to contribute to the success of those specifically illegal activities, should be any more immune from prosecution than he to whom the organization has assigned the task of carrying out the substantive criminal act.²⁰⁰

¹⁹⁷ 367 U.S. 203 (1961).

¹⁹⁸ 367 U.S. at 207-210. The intervening statute purportedly overruling the Smith Act membership clause, the Internal Security Act of 1950, 64 Stat. 987 (codified at 50 U.S.C. § 781), was repealed by Act of Dec. 17, 1993, Pub. L. No. 103-199, Title VIII, § 803(1), 107 Stat. 2329.

¹⁹⁹ The petitioner also raised "as applied" claims but these boiled down to an evidentiary analysis.

²⁰⁰ 367 U.S. at 225.

Thus, the Court concluded that a Smith Act membership conviction will stand when (a) the defendant knows (b) that the group to which the membership attaches intends criminal purposes and (c) that the defendant's membership evidences a specific intent to promote the criminal goals of the organization (d) even if the defendant's membership and involvement is not itself criminal activity.

In *Noto v. United States*,²⁰¹ the fourth of the Smith Act cases to come before the Court and a companion case to *Scales*, the Court overturned the conviction because it found the nexus between the theory of violence and the actual call to violence too remote. Quoting from its opinion in *Scales*, the Court explained that the advocacy must be:

“not of . . . mere abstract doctrine of forcible overthrow, but of action to that end, by the use of language reasonably and ordinarily calculated to incite persons to . . . action” immediately or in the future.²⁰²

Given this judicial treatment of the Smith Act, a lawyer representing a U.S. company which retains *Shari'ah* authorities must be critically aware of several threatening circumstances. One, if the *Shari'ah* authorities advocate the Law of *Jihad* against the U.S., this advocacy probably falls within the Smith Act as refined by the Supreme Court. The argument here rests on two prongs. First, the *Shari'ah* authorities are not mere advocates of theory or theology but authorized religious leaders who have been retained by the company precisely because their legal rulings and pronouncements are authoritative. Moreover, the call to violence at some point in the future when *Shari'ah*-adherent Muslims have the logistical opportunity to conduct *Jihad* is captured by the Smith Act, as the Court explained when it stated that advocacy is an actual call to violence whether it advocates violence “immediately or in the future”.²⁰³

Second, the *Shari'ah* authorities are not speaking as advocates to an empty auditorium, but as jurists who issue normative and instructional commands to the members of their group – i.e., *Shari'ah*-adherent Muslims. Further, these *Shari'ah* authorities are chosen because the *Shari'ah* faithful listen and act upon their legal rulings. Thus, the call to violence is likely to result in violence. Evidence of this direct nexus can be observed in numerous terrorist and violent events that occur immediately after *Shari'ah* authorities issue legal rulings calling for violence. One relatively recent event was the violence over the publication of cartoons in a Danish paper which satirized Mohammed. The cartoons had been public for several months and it was not until certain leading *Shari'ah*

²⁰¹ 367 U.S. 290 (1961).

²⁰² 367 U.S. at 297.

²⁰³ *Id.* In *Brandenburg v. Ohio*, 395 U.S. 444 (1969), in a per curiam decision, the Court held in striking down a state law criminalizing speech advocating violence that such speech is constitutionally protected unless it is intended and likely to cause imminent illegal conduct. The *Brandenburg* Court understood its decision as concordant with the Smith Act cases cited. The question of “imminence” will no doubt plague future cases and remain a fact-based inquiry. Imminence will likely involve not simply the timing of the threat of violence, but also its seriousness and its likelihood.

authorities called for a “day of outrage” and “worldwide protest” that protests, violence, and murder erupted *en masse*.²⁰⁴

Additionally, to the extent that *Shari’ah* authorities are employed by a U.S. corporation to issue legal rulings on *Shari’ah* and, while serving in that capacity, issue rulings which include a call to *Jihad* against the United States, the corporations should not ignore the threat of criminal exposure. The important case on this point is the Supreme Court’s decision in *New York Central v. United States*.²⁰⁵ Federal prosecutors indicted a railroad company based on the conduct of an assistant traffic manager, who paid illegal rebates.²⁰⁶ While corporations could be liable for breach of civil law duties, prior caselaw had established there was no criminal liability for corporations because, as artifices of the law, they could not have the requisite *mens rea*. The Court, however, took this opportunity to transport the concept of *respondeat superior* from tort law and import it into the criminal law:

Applying the principle governing civil liability, we go only a step farther in holding that the act of the agent, while exercising the authority delegated to him to make rates for transportation, may be controlled, in the interest of public policy, by imputing his act to his employer and imposing penalties upon the corporation for which he is acting in the premises.

...

... [W]e see no good reason why corporations may not be held responsible for and charged with the knowledge and purposes of their agents, acting within the authority conferred upon them. If it were not so, many offenses might go unpunished and acts be committed in violation of law where, as in the present case, the statute requires all persons, corporate or private, to refrain from certain practices, forbidden in the interest of public policy.²⁰⁷

In the matter under discussion, legal counsel will be somewhat misguided to argue in defense of their corporate clients that the *Shari’ah* authorities were employed strictly to issue legal rulings on financial matters and all other rulings fall outside the scope of their employment. Typically, criminal *respondeat superior* applies where the agent (i)

²⁰⁴ Olivier Guitta, *The Cartoon Jihad: The Muslim Brotherhood's project for dominating the West*, WEEKLY STANDARD 22, Feb. 20, 2006, available at <http://www.weeklystandard.com/Content/Public/Articles/000/000/006/704xewyj.asp> (last visited Jan. 31, 2008).

²⁰⁵ 212 U.S. 481 (1909).

²⁰⁶ 212 U.S. at 498. The Elkins Act made it an offense to “give or receive a rebate whereby goods are transported in interstate commerce at less than the published rate.” Preet Bharara, *Corporations Cry Uncle and Their Employees Cry Foul: Rethinking Prosecutorial Pressure on Corporate Defendants*, 44 AM. CRIM. L. REV. 53, 61 n.42 (2007) (quoting *New York Central*, 212 U.S. at 498).

²⁰⁷ 212 U.S. at 494.

committed a crime; (ii) within the scope of employment; and (iii) with intent to benefit the company.²⁰⁸ Arguably, a crime was committed by advocating violent *Jihad* against the U.S. The problem with legal counsel's defense on the "scope of employment" element is the fact that *Shari'ah* authorities have stated time and again that there is no separation between a ruling on commercial matters and one on *Jihad*. As illustrated by the very software "filters" employed in SCF, the legal rulings on prohibited vice industries are part and parcel of the undivided whole of *Shari'ah*. This explains the SCF legal ruling by many *Shari'ah* authorities that Muslims, including U.S. Muslims, should not invest in U.S. defense industries, yet these same *Shari'ah* authorities praise and obligate Muslim investment in weapons for Muslim nations. In other words, the ruling on weapons in the context of SCF is part and parcel of the Law of *Jihad*.²⁰⁹ Finally, by definition, every legal ruling by a *Shari'ah* authority is for the achievement of Allah's divine law and for the attainment of truth and therefore of benefit to all Muslims, including the companies in which they invest.

While it is not necessarily the case that an aberrant ruling by an "extremist" *Shari'ah* authority will always be imputed to his employer, it is not a stretch to conclude that a company employs a *Shari'ah* authority precisely because his legal rulings are authoritative and because *Shari'ah* is a holistic and integrated legal and normative unit.²¹⁰ Thus, a ruling on *Jihad* by a *Shari'ah* authority is no less a part of his role as an internationally renowned *Shari'ah* authority and his employment as such than his other rulings on SCF.

V. The Exogenous Elements of SCF: Disclosure, Due Diligence, and Other Compliance Issues

Beyond the duty of disclosure of endogenous elements of *Shari'ah* -- facts which would be material to a reasonable investor who has been told of an investment or business transaction represented to be *Shari'ah*-compliant -- several other legal issues arise in the context of how SCF is actually structured. Thus, beyond the question of what must be disclosed about *Shari'ah* itself, the "rules and principles" of *Shari'ah* have been fitted to modern finance and business to achieve a product that is represented as *Shari'ah*-compliant. These contemporary structures are exogenous to *Shari'ah* but very much a part of how *Shari'ah* has been manipulated to accommodate modern finance and commerce. These exogenous elements reflect on how *Shari'ah* has been transformed, modeled, and presented in various SCF contexts.

It is important to keep in mind a fundamental principle of SCF and a corollary of that principle. The principle is that *Shari'ah* compliance must be judged by one or more

²⁰⁸ W. PAGE KEETON, PROSSER AND KEETON ON TORTS 499-508 (5th ed. 1984). For a general discussion on corporate liability, see Note, *Corporate Crime: Regulating Corporate Behavior through Criminal Sanctions*, 92 HARV. L. REV. 1227, 1247-51 (1979).

²⁰⁹ In his essay on the proper role of a *Shari'ah* authority for a mutual fund, DeLorenzo argues that beyond the "quantitative" rules, there are "socially responsible" screens that must be applied over the purely objective ones. DeLorenzo, *supra* note 22, at 6.

²¹⁰ See *infra* notes 245-250 and accompanying text.

Shari'ah authorities. It is clear from the literature that a non-Muslim cannot determine what is *Shari'ah*-compliant and further that a Muslim who is not recognized by his peers as a *Shari'ah* authority cannot assume the role of one. The corollary of this principle is that the *Shari'ah* authorities are themselves bound by the community of *Shari'ah* authorities within which they operate. The exact nature of this community or “consensus”, both in terms of its theoretical elasticity and its geographic boundaries, is only vaguely articulated in the SCF literature, but the implications of its contours both when adhered to and when breached are significant.

A. Disclosure

Our analysis begins with an examination of several questions about what it means to represent to the public that a financial institution or business has embraced SCF. Is there a duty to represent to the public what a *Shari'ah* authority is and how any given authority has obtained that status? Is it material to the investment? Is the failure to articulate the risks associated with conflicting SCF rulings from a more authoritative *Shari'ah* authority a disregard of minimal standards of disclosure?²¹¹

Moreover, is there a duty to disclose to the public whether the *Shari'ah* authorities chosen by a U.S. financial institution have issued authoritative rulings on matters that would implicate discrimination or violence against non-Muslims and non-*Shari'ah*-compliant Muslims? Is it important that a financial institution's *Shari'ah* authority relies on the *Shari'ah* rulings of authorities who have called for a worldwide Islamic Caliphate ruled by *Shari'ah*? Further, when the *Shari'ah* authorities rule that investment in a military or weapons industry are forbidden by *Shari'ah*, is it important for the U.S. financial institution to disclose to the reasonable post-9/11 investor whether there is such a *Shari'ah* ban on investments by Muslims in Muslim military industries for weapons to be sold to Muslim regimes?

In this context, the *Nike* case discussed above takes on a new dimension. Recall that Nike, an Oregon corporation, was sued in California under its Unfair Competition Law on the grounds that Nike's public statements in defense of its labor practices abroad were actionable.²¹² The California Supreme Court was not inclined to restrict the statute's reach and rejected Nike's argument that its free speech rights were violated. Nike had argued that the extension of such business fraud statutes to generic discussions by companies that have more to do with social commentary on issues of public importance than promoting the sale of specific goods and services is to effectively deny First Amendment protections to U.S. businesses. In effect, after being attacked in the media and having chosen to speak in its own defense, Nike had invited the lawsuit under California's Draconian consumer fraud statute. The company could have continued to

²¹¹ It seems *Shari'ah* authorities themselves understand the reputational and even financial risks of not imposing some broad standards for entry into the elite group of *Shari'ah* authorities and for not standardizing what is *Shari'ah*-compliant and what is not. See, e.g., IFSB Standards, *supra* note 127.

²¹² *Nike, Inc. v. Kasky*, 539 U.S. 654 (2003); see also *supra* notes 140-142 and accompanying text.

litigate the case for years, attempting to prove that it had spoken truthfully about its offshore labor practices, but it understood that every new twist and turn in the litigation would amount to millions of dollars in bad publicity for a company that spent millions trying to build and maintain its brand.

Nike's experience raises the following question for proponents of SCF: When U.S. companies tout SCF as "ethical" and "socially responsible investing" or as simply innocuous "interest-free" and "vice-free" investing, does this amount to consumer fraud? In California at least, the groundwork for an affirmative finding has been prepared.

Another exogenous factor has been addressed by the academic and professional SCF literature. A significant focus of SCF publications is the dearth of competent *Shari'ah* authorities worldwide. This is due to the fact that, while *Shari'ah* authorities are available in sufficient numbers to answer the needs of the *Shari'ah*-adherent communities worldwide²¹³, there is a severe shortage of these authorities who are sufficiently versed in English and modern finance to handle the international documentation invariably drafted with an eye towards institutions working out of London or New York. Because there are only approximately 20-25 sufficiently trained *Shari'ah* authorities, each of these exclusive club members sits on dozens of the *Shari'ah* supervisory boards around the world. The result is a small clique that advises the lion's share of competing financial institutions on how to develop new SCF products and transaction structures.²¹⁴

The legal advisor must evaluate the disclosure issues given the fact that a *Shari'ah* authority's rulings and artful craftsmanship in finding new transactional structures to avoid *Shari'ah* prohibitions might very well differ from one institutional client to another given the relative financial remuneration. Furthermore, are there issues that ought to be disclosed to a reasonable investor relating to confidentiality and the systems put in place to protect confidentiality? What duty of care do the *Shari'ah* authorities owe the financial institutions? Are they considered experts for purposes of the 1933 Act? Do they participate in writing the portions of the registration statement or prospectus that deal with *Shari'ah*?

In all of these areas, the materiality and *scienter* issues discussed above will play into the calculus for the legal advisor as the examination of these and other exogenous elements unfold. An additional facet of the disclosure complex, especially as it relates to the *scienter* standard of recklessness, is the implication for the financial institutions and their

²¹³ This is assisted by the burgeoning use of Internet sites which provide legal rulings (*fatawa*) to the *Shari'ah* faithful anywhere in the world. See, e.g., IslamOnLine.net, <http://www.islamonline.net/english/index.shtml> (last visited Jan. 31, 2008).

²¹⁴ Alexiev, *supra* note 18, at n.43. The number 20-25 was derived by developing a list of names of *Shari'ah* authorities which appear in SEC filings and the major SCF Internet sites. If one includes *Shari'ah* authorities who deal almost exclusively in Pakistan, Malaysia, or the GCC states, the number is probably closer to 60. See generally Islamic Banking and Finance Issue #3 Summary, <http://islamicbankingandfinance.com/summary3.html> (last visited Jan. 31, 2008) (summarizing an issue of the London-based journal *Islamic Banking and Finance*, which discusses this "bottleneck").

professional advisors of a duty to conduct due diligence to make certain that what they have said about SCF is the whole of the material truth.

B. Due diligence

The articulation of a breach of duty to disclose is closely related to the duty to exercise reasonable due diligence as either an element of *scienter* or a defense where *scienter* is not at issue. For example, under the 1933 Act, Sections 11 and 12(a)(2) provide for a due diligence defense for certain defendants who have failed to disclose all relevant material facts.²¹⁵ The caselaw and literature on these defenses is extensive, and legal counsel for any financial institution will have to seriously consider the implications of ignoring the exogenous structures set up for a *Shari'ah*-compliant investment or business. At the very least, each of the exogenous disclosure issues should be the subject of a carefully prepared legal opinion. Failure to rely on an expert legal opinion will likely expose the financial institution and its management to greater liability insofar as failure to do so rises to the level of reckless breach of the duty of care. The duty to rely on a formal legal opinion intimates the lawyer's exposure to liability for failure to conduct a reasonably competent investigation.

C. Other compliance issues

1. Global security risks revisited

The due diligence requirements implied in the *scienter* element of many fraud actions and provided expressly as defenses under securities laws are only one component of the due diligence analysis pertinent to SCF. In the main, the effort to combat the global security risks associated with Islamic terror networks and the regimes which support those networks has incorporated many strategies, only some of which are appropriately suited to the task at hand. One approach is through trade sanctions and embargoes. These foreign policy initiatives are authorized by such laws as the Trading with the Enemy Act ("TWEA")²¹⁶ and the International Emergency Economic Powers Act ("IEEPA"),²¹⁷ which authorize the Office of Foreign Assets Control ("OFAC") of the Treasury Department to establish sanction regimes on states identified by the President as falling within the jurisdictional reach of either of the two laws.²¹⁸

The Halliburton affair described above, which began as a seemingly innocuous inquiry by the New York City Comptroller on behalf of some shareholders into disclosure requirements of an annual proxy statement, soon spiraled out of control. After Halliburton was forced to report to its shareholders on the financial and reputational risks of doing business in a terror-sponsoring state, the Comptroller was still unsatisfied and considered the company's disclosures inadequate. Soon thereafter, OFAC got involved

²¹⁵ See *supra* notes 176-178 and accompanying text.

²¹⁶ 50 U.S.C. app. § 1 (2007).

²¹⁷ 50 U.S.C.S. §§ 1701-1706 (2007).

²¹⁸ See, e.g., Notice of March 8, 2007--Continuation of the National Emergency With Respect to Iran, 72 Fed. Reg. 47 (March 12, 2007).

and referred the matter to the DOJ, which initiated a grand jury investigation.²¹⁹ Other companies doing business in terror-sponsoring states have also run into trouble.²²⁰ While the implications for financial institutions relying on *Shari'ah* authorities associated with or sympathetic to terrorists do not touch upon TWEA or IEEPA compliance per se, the duty of disclosure of material facts under the compliance regimes remains.

a. Reverse money laundering revisited

Another approach to the global security risk of Islamic terrorism has been through the strengthening of anti-money laundering laws and regulations. The “heavy lifting” of this effort of late has been accomplished by the Patriot Act and its amendments to the Bank Secrecy Act (“BSA”)²²¹ and the anti-money laundering statutes.²²² But with all of the fanfare and political disputation surrounding this legislation by civil libertarians, civil rights activists, and various Muslim organizations,²²³ the latter of which have argued that

²¹⁹ See HALLIBURTON COMPANY, FORM 10K FOR THE FISCAL YEAR ENDED DEC. 31, 2006, at 58, available [at http://www.sec.gov/Archives/edgar/data/45012/000004501207000072/ed10k2006_final.htm](http://www.sec.gov/Archives/edgar/data/45012/000004501207000072/ed10k2006_final.htm) (last visited Jan. 31, 2008):

Operations in Iran

We received and responded to an inquiry in mid-2001 from the Office of Foreign Assets Control (OFAC) of the United States Treasury Department with respect to operations in Iran by a Halliburton subsidiary incorporated in the Cayman Islands. The OFAC inquiry requested information with respect to compliance with the Iranian Transaction Regulations. These regulations prohibit United States citizens, including United States corporations and other United States business organizations, from engaging in commercial, financial, or trade transactions with Iran, unless authorized by OFAC or exempted by statute. Our 2001 written response to OFAC stated that we believed that we were in compliance with applicable sanction regulations. In the first quarter of 2004, we responded to a follow-up letter from OFAC requesting additional information. We understand this matter has now been referred by OFAC to the DOJ. In July 2004, we received a grand jury subpoena from an Assistant United States District Attorney requesting the production of documents. We are cooperating with the government’s investigation and responded to the subpoena by producing documents in September 2004.

Separate from the OFAC inquiry, we completed a study in 2003 of our activities in Iran during 2002 and 2003 and concluded that these activities were in compliance with applicable sanction regulations. These sanction regulations require isolation of entities that conduct activities in Iran from contact with United States citizens or managers of United States companies. Notwithstanding our conclusions that our activities in Iran were not in violation of United States laws and regulations, we announced that, after fulfilling our current contractual obligations within Iran, we intend to cease operations within that country and withdraw from further activities there.

²²⁰ See Lau, *supra* note 164, at 418-19.

²²¹ 31 U.S.C. §§ 5318 et seq. (2006).

²²² See generally Eric J. Gouvin, *Bringing Out the Big Guns: The USA Patriot Act, Money Laundering, and the War on Terrorism*, 55 BAYLOR L. REV. 955 (2003).

²²³ See, e.g., CairChicago.org, Action Alert (Dec. 1, 2005), available at http://www.cairchicago.org/actionalerts.php?file=aa_blog12012005 (last visited Jan. 31, 2008)

the government's effort is unduly focused on *Islamic* terrorism, the legislation still fails to grapple effectively with the problem of money laundering in support of terrorism. Almost all of the BSA and the regulations promulgated thereunder and the anti-money laundering statutes approach the problem of terrorist financing in the traditional way, notwithstanding a dangerous new *modus operandi*. The BSA and anti-money laundering statutes are intensely focused on spotting and reporting suspicious money transfers, especially cash transfers, which have criminal sources.²²⁴

This approach to battling the funding of terrorism fits the traditional approach to anti-money laundering efforts, which looks for money from illegal activities such as drugs and gambling, typically in the form of cash, and its laundering into clean money invested in legitimate businesses. As long as the effort is "following the money" in the form of cash from its entry in the regulated and reporting financial system (what the experts call "placement")²²⁵ as it winds its way to its ultimate destination, the system works at least moderately well, although most experts will admit that it both misses large sums and suffers from over-reporting of perfectly legitimate cash transactions.²²⁶ Much of contemporary terror financing, however, is conducted through what has been termed "reverse money laundering".

Reverse money laundering stands the classic model on its head---perfectly legitimate funds are wired or transferred to U.S. domestic charities and organizations and then to overseas charities and organizations, or sometimes just directly overseas. These transactions are difficult to spot unless government regulators already have the specific charities and organizations in question under surveillance.²²⁷ Such proactive or prophylactic surveillance runs into privacy and constitutional thickets. Assuming the federal government does not have sufficient evidence for a probable cause or FISA warrant²²⁸, targeting Muslim charities would be roundly protested as racial profiling irrespective of the actual legal or constitutional infirmities of the practice.²²⁹ As a result,

(announcing a special Internet web log site opposing the Patriot Act on "civil rights" grounds, published by the Council on American-Islamic Relations (CAIR)).

²²⁴ See Gouvin, *supra* note 222, at 976-77.

²²⁵ FEDERAL FINANCIAL INSTITUTIONS EXAMINATION COUNSEL, BANK SECRECY ACT/ ANTI-MONEY LAUNDERING EXAMINATION MANUAL 8 (2006), available at http://www.ffiec.gov/pdf/bsa_aml_examination_manual2006.pdf (last visited Jan. 31, 2008).

²²⁶ See Gouvin, *supra* note 222, at 967-69.

²²⁷ *Id.* at 976-77.

²²⁸ "FISA" is the Foreign Intelligence Surveillance Act of 1978, Pub. L. No. 95- 511, 92 Stat. 1783 (codified as amended at 50 U.S.C. §§ 1801-1862), which was amended materially by the Patriot Act. See USA Patriot Act, § 218, 115 Stat. 291 (amending 50 U.S.C. §§ 1804(a)(7)(B) & 1823(a)(7)(B)). A Fifth Amendment "criminal" warrant typically requires a showing of probable cause before a judge. The FISA requirements for a warrant, which are directed at foreign threats, even if on domestic soil, has relaxed standards. For a thorough explanation of these standards, see Richard Henry Seamon & William Dylan Gardner, *The Patriot Act and the Wall Between Foreign Intelligence and Law Enforcement*, 28 HARV. J.L. & PUB. POL'Y 319 (2005).

²²⁹ See David Hardin, *The Fuss Over Two Small Words: The Unconstitutionality of the USA PATRIOT Act Amendments to FISA Under the Fourth Amendment*, 71 GEO. WASH. L. REV. 291, 291 & n.395 (2003).

while administrative “blocking orders” promulgated under the authority of the IEEPA have been an effective tool in disrupting and shutting down some of the largest and most dangerous Muslim charities funding terrorism,²³⁰ prosecutions of terror-financing through charities have had mixed results.²³¹

This problem raises its ugly head with SCF in two ways. One way, although it does not yet appear to be the norm in the U.S., is through a charitable contribution made at source by an SCF financial institution or business. This would occur because faithful Muslims must gift a certain percentage of their income to charity. It appears that in the Middle East and Malaysia, SCF companies, banks, and investment funds might actually calculate the amount the individual Muslim investors owe from profits and distribute those funds automatically to Islamic *Shari’ah*-approved charities, and only then would the net, after-

²³⁰ See generally Montgomery E. Engel, *Donating “Blood Money”: Fundraising For International Terrorism By United States Charities and the Government’s Efforts to Constrict the Flow*, 12 CARDOZO J. INT’L & COMP. L. 251 (2004). Specifically, Engel writes that:

The authority of the President to issue both Executive Orders 12,947 and 13,224 originates in the International Emergency Economic Powers Act (“IEEPA”). Upon declaration of a national emergency in response to an “unusual and extraordinary threat,” IEEPA grants the President broad authority to govern the disposition and block the assets of “any person, or with respect to any property, subject to the jurisdiction of the United States.” The Supreme Court has upheld IEEPA’s broad grant of authority to the President in its form as amended in 1977. The Court refused to limit the President’s authority to continued blocking or freezing but ensured that it extended to the permanent disposition of assets suggested by IEEPA’s congressional grant of the power to “transfer,” “compel,” and even “nullify” assets. Underlying this deferential grant, the Court recognized a legitimate and discretionary exercise of the President’s power to govern foreign policy by using frozen assets as a “bargaining chip” in dealing with a hostile country.

Id. at 258-59 (footnotes omitted). The role of Muslim charities in financing terror has been discussed in Congressional testimony as well. See *Role of Charities and NGOs in the Financing of Terrorist Activities: Hearing Before the Subcomm. on International Trade and Finance of the S. Comm. on Banking, Housing, and Urban Affairs*, 107th Cong. (2002) (statement of Matthew Levitt, Senior Fellow, Washington Institute for Near East Policy), available at http://banking.senate.gov/02_08hr/080102/levitt.htm (last visited Feb. 1, 2008). Military strategists have also looked at this modality for furthering the terrorist war aims. See Major Wesley J. L. Anderson, *Disrupting Threat Finances: Utilization of Financial Information to Disrupt Terrorist Organizations in the Twenty-First Century* (November 4, 2007) (unpublished thesis, School of Advanced Military Studies, U.S. Army Command and General Staff College), available at <http://stinet.dtic.mil/cgi-bin/GetTRDoc?AD=A470454&Location=U2&doc=GetTRDoc.pdf> (last visited Feb. 1, 2008).

²³¹ Prosecutions for the “material support of terrorism” are notoriously difficult cases to try before a jury because they often require reams of financial data evidence, circumstantial evidence of associational links, and the defense often raised by defendants that they had no specific knowledge that the money they contributed was going to support illegal activities. A recent case with these dynamics, the largest federal terror-financing case to date, ended in mistrial on the bulk of the charges. See the court filings (organized and with commentary) in the criminal prosecution *U.S. v. Holy Land Foundation for Relief and Development*, Criminal Action No. 3:04-CR-240-G, 2007 U.S. Dist. LEXIS 50239 (N.D. Tex. July 11, 2007), available at <http://www.nefafoundation.org/hlfdocs.html> (last visited Jan. 31, 2008).

Shari'ah-charitable-tax profits be distributed to the individual investor. In the U.S., although many of the reporting companies and mutual funds involved in SCF are unclear about this service, most appear to allow the individual investor to calculate and make her own charitable contribution.²³²

Several questions arise for those SCF businesses and investments which net the returns to the investor after this charitable payment: Which charities are *Shari'ah*-compliant? Who makes this determination? Do the businesses or financial institutions direct these contributions, or are these decisions made by the *Shari'ah* authorities? Is there any vetting of the recipients of these charities to determine what they do with these funds? Why is this process not transparent?

A second form of this problem arises when some of the gross income of a business is from *Shari'ah*-prohibited sources. This typically occurs in two ways. The first is via the exceptional event when a *Shari'ah* "filter" misses a tainted source of income altogether. This might happen when a *Shari'ah*-compliant company in a *Shari'ah*-compliant mutual fund acquires a forbidden company, the main business of which is in a forbidden industry such as finance or hog farming. Assuming the acquired company's forbidden assets are not *de minimis*, the acquisition renders the parent company in the mutual fund's portfolio *Shari'ah*-prohibited and the equity position in that company must be sold. The proceeds of that sale will include a certain amount of profits attributed to the forbidden assets. That amount must be calculated and "purified".²³³

The second occasion for purification is more typical. For example, a mutual fund is permitted to invest routinely in companies which earn up to a fixed percentage of their income from interest. Notwithstanding this leniency, any profits to the mutual fund attributed from this forbidden income must be "purified" at some point.²³⁴

Because the calculation of this purification can be complex, most *Shari'ah* authorities either insist or prefer that the purification take place by the SCF institution so the *Shari'ah* authorities will have the opportunity to assess the amount needed to be purified and supervise the logistics.²³⁵

²³² One of the leading *Shari'ah* authorities recommends that *Shari'ah*-compliant mutual funds calculate the *Shari'ah*-based religious tax called *zakat* for the investors and withhold it at source as a value added. See generally *supra* note 22 and accompanying text. The assumption for this memorandum has been that if a reporting mutual fund does not disclose that it has the authority to gift *zakat* contributions on behalf of the individual investors, then the mutual fund has left that for the individual investors.

²³³ *Id.*; see also Yaquby, *supra* note 39; ISLAMIC FINANCIAL SERVICES BOARD, EXPOSURE DRAFT: GUIDING PRINCIPLES ON GOVERNANCE FOR ISLAMIC COLLECTIVE INVESTMENT SCHEMES 14-17 (Dec. 2007), available at <http://www.ifsb.org/view.php?ch=4&pg=140&ac=31&fname=file&dbIndex=0&ex=1201805784&md=%EB%FA%AF%F7%DD%E3%80%1F%9C%ED%9F%07%EE%E7%23> (last visited Jan. 31, 2008).

²³⁴ See *supra* note 230.

²³⁵ *Id.*

As in the charitable contribution discussion, the purification process typically is not fully disclosed in public filings of U.S. SCF financial institutions. The questions raised above about disclosure for the general charitable tax apply here *mutatis mutandis*. But since most *Shari'ah* authorities have ruled that it is more appropriate to have the purification process carried out by the SCF company rather than by the individual investor, one might reasonably assume that this is the general rule.²³⁶

In both instances, the legal advisor to the SCF financial institution or business must be careful about how these charitable contributions are made and who the beneficiaries of these funds are. Given the history of Islamic charities funneling contributions to terrorist organizations directly and indirectly through other charitable organizations in a laundering process, the anti-money laundering laws must be analyzed carefully by the attorney to be certain that the financial institution is not facilitating a criminal violation and that there is strict compliance with all reporting requirements.

The principal anti-money laundering statutes are Title 18, Sections 1956 and 1957. As indicated above, the focus of these statutes is on criminalizing the movement of funds from unlawful activity. As such, they have a limited application to the issue of charitable contributions directed by *Shari'ah* authorities related to a given SCF financial institution. The legal advisor, however, must take the following into consideration in proffering his advice. Section 1956(a)(2) criminalizes the following:

(2) Whoever transports, transmits, or transfers, or attempts to transport, transmit, or transfer a monetary instrument or funds from a place in the United States to or through a place outside the United States or to a place in the United States from or through a place outside the United States—

(A) with the intent to promote the carrying on of specified unlawful activity; . . .²³⁷

Two issues stand out. One, a purely domestic transfer of legal funds with the requisite criminal intent is not a per se violation. Arguably, if a domestic transfer took place but with the understanding that the funds would find their way overseas as part of the criminal intent, such a transfer would be prohibited. Thus, a U.S. financial institution might run afoul of this provision when it “purifies” its forbidden assets by transferring

²³⁶ While it does not appear that the DJII calculates the “purification” requirement for its index of funds with a concomitant reduction in the stated values and returns for its universe of stocks, one index actually promotes this feature:

Incorporates Dividend Purification: In addition, the application of a dividend adjustment factor in the creation of the MSCI Islamic Index Series results in more relevant benchmarks, as they reflect the total return to an Islamic portfolio net of dividend purification.

MSCI Global Islamic Indices, <http://www.ms cibarra.com/products/indices/islamic/> (last visited Jan. 31, 2008).

²³⁷ 18 U.S.C. §1956(a)(2)(A) (2006).

funds to a terrorist-supporting charity overseas or possibly even to a domestic charity as a conduit to problematic overseas groups.

The second issue is intent. The statute requires that the defendant have the intent to move the funds to promote one of the illegal activities enumerated. Terrorism is one of those criminal activities set out in Section 1956(c)(7). A lawyer representing a financial institution contemplating “purification” must consider the possibility that the charitable gift might be going to a charity with intimate connections to terrorists.²³⁸ In this context, prudent legal counsel must determine who directs the funds to the charitable contribution, whether the charities or universe of acceptable charities are chosen by the *Shari’ah* authorities, and whether this decision is binding on the financial institution. The issue here is obvious. If the financial institution places this decision-making authority into the hands of the *Shari’ah* authorities it has retained, it is possible that any criminal “intent” or “purposes” connecting the *Shari’ah* authorities to these charities will be attributed to the financial institution. The criminal culpability in this case is similar to that described above in the discussion of the Smith Act.

While many financial institutions involved in SCF attempt to distance themselves from the *Shari’ah* authorities, a lawyer analyzing these issues must determine who made the decision about which charities would be considered *Shari’ah*-complaint and thus recipients for the “purification” of funds. Moreover, if it turns out that these charities have ties to terrorists or are implicated in the material support of terrorism, the lawyer must determine whether this fact was known to any agent of the company.²³⁹

Obviously, the criminal exposure arising from the “purification” process might lead responsible legal counsel to ask the following questions about any list of potential charities: Are these well-known non-Muslim charities? If they are Muslim charities, have they been vetted and by whom? The three largest Muslim charities in the U.S. have all been implicated in financing terror and subject to administrative blocking orders wherein their assets were frozen and they were effectively shut down.²⁴⁰

²³⁸ As one commentator began an analysis into the problem of Muslim charities being used to funnel funds to Islamic terrorists:

On December 4, 2001, nearly three months after the terrorist attacks of September 11th and barely three days after a pair of terrorist suicide bombings killed 25 and injured 200 in Israel, President Bush declared the Holy Land Foundation for Relief and Development (“HLF”) of Richardson, Texas, a terrorist organization, its assets frozen, and announced that its offices had been raided by the FBI. Purportedly the largest Muslim charity in the United States, HLF had been under investigation by the FBI for its alleged financing of the Islamic Resistance movement, or Hamas, for nine years. Ten days later, the Bush Administration acted again, freezing the assets and raiding the offices of two more Muslim charities, the Benevolence International Foundation (“BIF”) and the Global Relief Foundation (“GRF”), both located in the Chicago, Illinois area.

Engel, *supra* note 230, at 251 (footnotes omitted).

²³⁹ Or, as set out *supra* note 184 and accompanying text, was this fact willfully or recklessly avoided?

²⁴⁰ See *supra* note 238.

The practice of Muslim charities funneling money to terrorists is so widespread and the problem so insidious that the federal government keeps an updated list on the dozens of such organizations worldwide.²⁴¹ But it will not suffice for the legal advisor to simply determine that the charities are “well-known” Muslim charities and not currently listed as designated supporters of terrorism. At a minimum, the following queries would need to be undertaken: Who are the ultimate beneficiaries of the contributions? (In other words, who or what is the ultimate recipient of the charities’ “good deeds”?) Do these charities have overseas branches? Is the financial institution wiring the funds domestically or internationally? Who or what organization founded the organizations and who controls them today?

Once these questions are answered, the legal advisor will need to be careful that, whatever policies are put in place to avoid criminal exposure under Sections 1956 and 1957, the client continues to monitor these “charitable contributions” carefully.²⁴²

b. Material support of terrorism and related civil exposure

Material support of terrorism is a federal crime under 18 U.S.C. §§2339 (A) and (B). The Intelligence Reform and Terrorism Prevention Act of 2004²⁴³ amended the definition of “material support” to read as follows:

(1) the term “material support or resources” means any property, tangible or intangible, or service, including currency or monetary instruments or financial securities, financial services, lodging, training, expert advice or assistance, safehouses, false documentation or identification, communications equipment, facilities, weapons, lethal substances, explosives, personnel (one or more individuals who may be or include oneself), and transportation, except medicine or religious materials.²⁴⁴

A *Shari’ah* authority issuing, promoting, or advocating a legal ruling for *Jihad* to anyone for the purpose of conducting terrorism would clearly fall within the definition of “expert advice” “derived from . . . specialized knowledge”. In addition, a New York federal district court found that an attorney who passed along a legal ruling calling for *Jihad* had provided “material support” in the form of “personnel” as part of a terror-laden conspiracy. In *U.S. v. Satter*²⁴⁵, the court upheld attorney Lynne Stewart’s conviction for violating Section 2339(A) by merely passing along a *fatwa* or legal ruling regarding *Jihad* issued by her client, Sheikh Omar Abdel Rahman, to terrorists in Egypt who

²⁴¹ See U.S. Department of the Treasury, Key Issues: Protecting Charitable Organizations, http://www.ustreas.gov/offices/enforcement/key-issues/protecting/charities_execorder_13224-a.shtml#a (last visited Jan. 31, 2008).

²⁴² Typically, good legal counsel, when developing a due diligence plan, will construct it such that it accounts for the threshold *prima facie* requirements of an indictment or other criminal charging process rather than an acquittal at trial.

²⁴³ 108 Pub. L. No. 458, 118 Stat. 3638 (2004).

²⁴⁴ 18 U.S.C. § 2339(A)(b) (2006).

²⁴⁵ 395 F. Supp. 2d 79 (S.D.N.Y. 2005).

respected his authority in matters of *Shari'ah*. The court concluded that passing along a legal ruling was like providing “personnel” to the co-conspirators and amounted to material support.²⁴⁶

A U.S. company that promotes the legal rulings of a *Shari'ah* authority who is known for issuing such rulings on the Law of *Jihad* could risk extraordinary criminal exposure. While it is not likely that the company would promote the actual rulings relative to *Jihad* or do so with the intent to cause violence, this will not be the standard. The question will be what role does the *Shari'ah* authority occupy within the company or what relationship does he have to the company if he is an “outside advisor”. To the extent that criminal *respondeat superior* implicates the corporate entity in the *Shari'ah* authority’s *scienter*, a defense built upon lack of knowledge by the board of directors will not be effective. And the fact that such legal rulings are published in broad daylight and available from English open sources will render the corporation’s plea of lack of intent all the more unavailing to the extent it rises to the level of “willful blindness” or “recklessness”.

Additional areas of criminal and civil liability exposure relate to the anti-money laundering statutes. To the extent that any “purification” funds move from the financial institution to a charity and these funds are found to support the terrorist activities, there is additional criminal exposure under Sections 2339(A) and (B). Both of these statutes forbid the provision of material support for terrorism. The distinction between the two statutes is important. Section 2339(A) requires a showing that the defendant provided support knowing its intended purposes. Under Section 2339(B), the defendant need only know of the status of the target organization as a terrorist organization and need not know or intend that the material support is going to support terrorism.²⁴⁷ The discussion above regarding corporate criminal exposure for the intent of the company’s agents applies here as well and must be considered by legal counsel.

In addition to criminal exposure, to the extent that a U.S. financial institution can be criminally linked to terrorist organizations as a result of the “purification” funds or via other “material support” relationships between the *Shari'ah* authorities and the terrorists, additional statutes provide civil exposure to victims of such violence, even if the violence occurs outside the jurisdiction of the U.S. The most important of these statutes is Title 18, Section 2333, which provides for civil remedies and treble damages for any U.S. national injured by terrorists. Several federal circuits have allowed private rights of action under this statute against defendants who have “aided and abetted” the offending terrorists by violating Sections 2339(A) and (B).²⁴⁸

Beyond the civil exposure in Section 2333, the Alien Tort Statute (“ATS”)²⁴⁹ probably exposes companies linked criminally to terrorism to enormous civil liability. It is bad enough to be sued by U.S. nationals for damages caused by terrorism, but the potential

²⁴⁶ *Id.* at 99.

²⁴⁷ For the discussion of this point in an earlier appeal arising out of the same trial, see *U.S. v. Sattar*, 314 F. Supp. 2d 279, 301-02 (S.D.N.Y. 2004).

²⁴⁸ See, e.g., *Boim v. Quranic Literacy Inst.*, 291 F.3d 1000 (7th Cir. 2002).

²⁴⁹ 28 U.S.C. § 1350 (2006).

for mass litigation by foreigners for such damages is much worse. Once the criminal connection is made through the anti-money laundering or the material support of terrorism statutes, the plaintiffs' bar will then allege that terrorism is a violation of some norm of the law of nations that is "specific, universal, and obligatory" and that there is a proximate cause between the "material support of terrorism" alleged and the injuries suffered.²⁵⁰

2. Antitrust

Another area of civil liability exposure related to the exogenous structure imposed by the need for *Shari'ah* authority boards arises under antitrust law. As noted above, at present approximately two dozen *Shari'ah* authorities monopolize the positions available on the *Shari'ah* authority boards of the major *Shari'ah*-compliant financial institutions worldwide. There has been a concerted effort among these *Shari'ah* authorities to impose universal standards to prevent materially divergent opinions. This effort has been spearheaded by the Accounting and Auditing Organization for Islamic Financial Institutions ("AAOIFI") and the Islamic Financial Services Board ("IFSB"), the former of which seeks to establish accounting standards for the various transactional structures and the latter to set the standards by which *Shari'ah* authorities self-regulate and interact with the financial institutions that employ them.²⁵¹

According to the IFSB and the independent writings of many *Shari'ah* authorities, there are designs to establish industry-wide minimal credentials a newcomer would be required to obtain to enter this apparently lucrative consulting business.²⁵² The initial antitrust issue raised by such efforts is the problem of "group boycotts" or the implications of "self-regulation" for a small, discreet, and insular group of authorities who have almost total market share deciding how one gains entry into the market.²⁵³ Applying the standard

²⁵⁰ The ATS is a jurisdictional statute. *See Sosa v. Alvarez-Machain*, 542 U.S. 692 (2004). It gives an alien plaintiff access to federal courts if there is an allegation that the alien suffered some harm that is in "violation of the law of nations or a treaty of the United States." *Id.* In the Court's opinion, it held that the norm of law violated must be "specific, universal, and obligatory." *Id.* at 732. The U.S. laws against terrorism and the "material support of terrorism" are in accord with the Law of Nations and at the very least are "specific, universal, and obligatory." *See, e.g., Filartiga v. Pena-Irala*, 630 F.2d 876, 885 (2d Cir. 1980) (stating that torture is a violation of the Law of Nations); *see also* Torture Victim Protection Act of 1991, § 2(b), Pub. L. No. 102-256, 106 Stat 73 (codified at 28 U.S.C. § 1350).

²⁵¹ *See supra* note 15 and accompanying text; *see also* Islamic Financial Services Board, <http://www.ifsb.org/index.php> (last visited Jan. 31, 2008); Accounting and Auditing Organization for Islamic Financial Institutions, <http://www.aaofii.com/index.shtml> (last visited Jan. 31, 2008).

²⁵² IFSB Standards, *supra* note 127 (footnotes omitted).

²⁵³ *See generally Northwest Wholesale Stationers, Inc. v. Pacific Stationery & Printing Co.*, 472 U.S. 284 (1985); *see also* Robert Pitofsky, Chairman, Fed. Trade Comm'n, Self Regulation and Antitrust (Feb. 18, 1998), *available at* <http://www.ftc.gov/speeches/pitofsky/self4.shtm> (last visited Jan. 31, 2008); Debra A. Valentine, Gen. Counsel, Fed. Trade Comm'n, Industry Self-Regulation and Antitrust Enforcement: An Evolving Relationship (May 24, 1998), *available at* <http://www.ftc.gov/speeches/other/dvisraelspeech.shtm> (last visited Jan. 31, 2008).

“rule of reason”, courts will look to the motivations and anti-competitive effects of such “industry standards.”²⁵⁴

This is especially problematic in SCF because, should a non-recognized *Shari’ah* authority attempt to market his services to the financial institutions seeking *Shari’ah* guidance, a ruling by the existing *Shari’ah* authorities that the newcomer has not satisfied their credentialing requirements would render the market closed to that newcomer. This is because financial institutions who market SCF products to the *Shari’ah*-adherent consumer are extraordinarily sensitive to the problem that public disputes among the *Shari’ah* authorities over what is permitted or prohibited could devastate both the demand for SCF products generally and render any given SCF product suspect.²⁵⁵

The problem of “self-regulation” would become an issue for the financial institutions if they play a material part in this effort to control entry into the market by newcomers in a *de jure* or *de facto* collusion with the dominant group.²⁵⁶ Another problem is “rules collusion”²⁵⁷. Here, the effort by the financial institutions and their agents, the *Shari’ah* authorities, to agree upon what transaction structures and investments should be considered “*Shari’ah*-compliant” will limit the development of new competitive products by market players. This, in turn, will make it more difficult for the consumer to distinguish between SCF products and raise the cost of searching for newer, innovative SCF products -- thereby shaping and softening competition among cartel members in order to increase the profits of the parties to the agreement.²⁵⁸ The fact that such a financial market is predicated upon a consensus of the market’s private rules advisors suggests that SCF within the financial industry presents substantial exposure to antitrust liability.

²⁵⁴ *Id.*

²⁵⁵ See generally McMillen, *supra* note 9, at 458-67 (attempting to cure the lack of transparency, certainty, consistency, and predictability of SCF by arguing for the IFSB to propose Model Acts like the Model Acts propounded by the National Conference of Commissioners on Uniform State Laws).

²⁵⁶ See *Am. Soc’y of Mech. Eng’rs v. Hydrolevel Corp.*, 456 U.S. 556 (1982). In fact, the SCF financial institutions participate at various levels in setting the standards for the industry. See, e.g., AAOIFI Members, <http://www.aaofii.com/members.html> (last visited Jan. 31, 2008). The private banks do not appear to play as significant a role in setting standards for the IFSB. See, e.g., IFSB Members, <http://www.ifsfb.org/index.php?ch=3&pg=7&ac=10> (last visited Jan. 31, 2008).

²⁵⁷ For an interesting discussion of “rules collusion” as “Type III,” see Robert H. Lande & Howard P. Marvel, *The Three Types of Collusion: Fixing Prices, Rivals, And Rules*, 2000 WIS. L. REV. 941, 949-84 (2000).

²⁵⁸ *Id.* The anti-competitive effects of the rule-making monopoly currently enjoyed by the *Shari’ah* authorities go in some measure to the endogenous aspects of what *Shari’ah* itself says about who is qualified to be part of the *Ulema* or scholarly elite with any real authority. Historically and institutionally, because the *Shari’ah* authorities have used “consensus” and the limitation of new interpretations via the doctrine of the “closing of the gate of *itjima*” as a self-regulator, they have been extraordinarily successful in keeping the group over time true to the early doctrines developed after the formal schools had articulated them. See, e.g., Coughlin, *supra* note 24, *passim*.

3. Racketeering

As described above, the leading two dozen *Shari'ah* authorities effectively establish all of its rules and regulations. If, in fact, these men have as their ultimate and collective goal the implementation of a *Shari'ah*-based Caliphate in the U.S. and their methodologies include the Law of *Jihad*---meaning violence when necessary or possible and otherwise fraud and misrepresentations about the true purpose of *Shari'ah*---the prima facie case for a lawsuit under the Racketeer-Influenced and Corrupt Organizations Act (“RICO”) is almost unavoidable. This is especially true now that the Patriot Act has added the federal terror-related crimes to the RICO predicate offenses and beefed up the predicate offenses relating to money laundering.²⁵⁹ A cursory examination of the elements of a viable RICO prosecution reveals the enormous exposure.

RICO is violated when a defendant, or in this case a cadre of defendants acting as *Shari'ah* authorities, engage in a “pattern of racketeering activity” and by having:

- (1) **Invested income** from a pattern of racketeering activity in an “enterprise”;
- (2) **Acquired or maintained an interest in an “enterprise”** through a pattern of racketeering activity;
- (3) **Conducted or participated in the affairs of an “enterprise”** through a pattern of racketeering activity; or
- (4) **Conspired to do any of the above.**²⁶⁰

The “pattern of racketeering activity” simply means two or more of the predicate offenses within a ten-year period.²⁶¹ Predicate offenses include mail and wire fraud, material support of terrorism, and money laundering.²⁶² The “enterprise”, which is an entity, person, or group of entities or persons associated in some *de jure* way (e.g., partnership) or as a *de facto* association, exists separately from the defendants.²⁶³ In this scheme, the enterprise is the financial institution involved in SCF. As discussed above, to the extent that a U.S. financial institution has criminal culpability for the predicate offenses²⁶⁴, that particular institution would join the list of defendants and operate as part of the enterprise. The evidence of the RICO crime then would include the fraud and ulterior motives of the *Shari'ah* authorities and how they have manipulated the enterprise to

²⁵⁹ CHARLES DOYLE, CRS REPORT FOR CONGRESS, CRIMINAL MONEY LAUNDERING LEGISLATION IN THE 109TH CONGRESS (2006), available at <http://www.house.gov/gallejly/issues/crime/crimedocs/RS22400.pdf> (last visited Feb. 2, 2008).

²⁶⁰ 18 U.S.C. § 1962(a)-(d) (2006); see also NIELS B. SCHAUMANN, GILBERT LAW SUMMARIES: SECURITIES REGULATION 394 (6th ed. 2002).

²⁶¹ § 1961(5); see also *H.J. Inc. v. Nw. Bell Tel. Co.*, 492 U.S. 229 (1989) (stating that must show the predicate acts are related to one another and that they amount to, or constitute a threat of, continuing racketeering activity).

²⁶² See, e.g., § 1961(1)B & G; see also *supra* note 259.

²⁶³ § 1961(4).

²⁶⁴ See *Schofield v. First Commodity Corp.*, 793 F.2d 28 (1st Cir. 1986) (discussing criminal *respondeat superior* under RICO).

achieve their criminal ends. If such an indictment were handed down, it could lead to a pretrial asset freeze²⁶⁵ and a post-conviction forfeiture of the criminal enterprise's assets.²⁶⁶

4. Banks and consumer loans

Regulated commercial banks and private lenders have recognized the SCF market and have made significant inroads establishing this new industry. At least one U.S. commercial bank has attempted to design a *Shari'ah*-compliant depository account.²⁶⁷ The unique feature of this kind of account is that it must be "at risk" as an equity investment and not viewed as a guaranteed deposit with interest income. A U.K. bank has developed a regulatory work-around²⁶⁸, but U.S. regulators have not yet permitted such accounts, although one community bank in Illinois advertises a *Shari'ah*-compliant "profit-sharing deposit account" which purportedly does not earn interest but rather a share of the bank's profits. This bank apparently received an exemption from a *Shari'ah* authority because the bank guarantees the principal of the deposit, as required by U.S. banking laws, and such "no risk" guarantees are typically considered forbidden under *Shari'ah*.²⁶⁹

Another impediment for commercial banks entering this market appears to have been overcome. In a typical SCF home mortgage transaction, the lender purchases the property and either resells it immediately to the borrower at a stepped-up price to be paid out over time (i.e., a cost-plus sale) or leases it back to the borrower through a sale-lease back arrangement. The problem for commercial banks in these transactions is that U.S. law does not allow banks to own real estate except in limited circumstances, such as the bank's own offices or property acquired through foreclosures on bad loans.²⁷⁰ Two banks have received approval from the Office of the Comptroller of Currency ("OCC") for such SCF transactions.²⁷¹ The rationale for the approvals was a substance-over-form analysis. Since these mortgage products were in fact disguised loans with interest and the real estate was only owned for a limited purpose, the Comptroller did not see these *Shari'ah*-compliant mortgages as a violation of the prohibition against owning real estate. The

²⁶⁵ § 1963(d); *see also* § 1956(b)(3)-(4).

²⁶⁶ § 1963(a)-(c).

²⁶⁷ *See* William L. Rutledge, Executive Vice President, [institution], Regulation and Supervision of Islamic Banking in the United States, Address Before the 2005 Arab Bankers Ass'n of N. Am. Conference on Islamic Fin.: Players, Products & Innovations in New York City (Apr. 19, 2005), available at <http://www.nubank.com/islamic/regulation.pdf> (last visited Jan. 28, 2008).

²⁶⁸ *Id.*; *see also* Callum McCarthy, Chairman, FSA Muslim Council of Britain Islamic Fin. and Trade Conference, Regulation and Islamic Finance (June 13, 2006), available at http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2006/0613_cm.shtml (last visited Jan. 31, 2008).

²⁶⁹ *See* Rutledge, *supra* note 267.

²⁷⁰ 12 U.S.C. § 29 (2006). For a senior officer at the Federal Reserve Bank of New York remarking favorably on Islamic banking in the United States, *see* Michael Silva, *Islamic Banking Remarks*, 12 AM. LAW & BUS. REV. 201, 201 & n.4 (2006).

²⁷¹ *See supra* note 58.

OCC also granted one of the banks approval to use the cost-plus sale transaction structure to accommodate construction loans and other consumer loans.²⁷²

While the Comptroller was focused on the real estate-banking regulations, one area that the attorney for any lender must pay special care to address is compliance with all of the various consumer anti-fraud statutes. The statutes implicated in traditional bank lending are found in TILA, the Lanham Act, and many of the anti-fraud statutes referenced above.

Commercial banks and other lenders must comply with TILA²⁷³ and its complex Regulation Z.²⁷⁴ TILA prohibits specific types of misrepresentations or misleading omissions in advertising.²⁷⁵ It requires lenders to make standardized disclosures whenever other price terms are advertised. For example, any advertisement that states an interest rate must state the annual percentage rate (“APR”).²⁷⁶ An oral response to consumer inquires about closed-end loans, however, may only state the APR.²⁷⁷ Advertisements quoting a down payment by percentage or amount, the amount of any monthly loan payment or finance charge, the number of payments, or the period of repayment must also state the APR, the terms of repayment, and the amount or percentage of any down payment.²⁷⁸

The problem lenders have is that they are marketing the SCF products as interest-free and therefore *Shari’ah*-compliant.²⁷⁹ In fact, and as scrutinized by the OCC and likely by the

²⁷² *Id.*

²⁷³ *Supra* note 114.

²⁷⁴ *Supra* note 115.

²⁷⁵ For a thorough discussion of the strengths and weaknesses of TILA in regulating misleading advertising, see Patricia A. McCoy, *The Middle-Class Crunch: Rethinking Disclosure in a World of Risk-Based Pricing*, 44 HARV. J. ON LEGIS. 123 (2007).

²⁷⁶ 15 U.S.C. § 1664(c) (2006), 12 C.F.R. § 226.24(b) (2005).

²⁷⁷ 15 U.S.C. § 1665(a).

²⁷⁸ *Id.* § 1664(d); Supp. I to Part 226 – Official Staff Interpretations, 12 C.F.R. pt. 226 (construing § 226.24(c)), available at <http://ecfr.gpoaccess.gov/cgi/t/text/text-idx?c=ecfr&sid=52c796f4a8897e30772fa9be6632dfd5&rgn=div9&view=text&node=12:3.0.1.1.7.5.8.6.27&idno=12>.

²⁷⁹ See, e.g., University Bank, Opening Doors to Islamic Financing, <http://www.university-bank.com/IslamicBanking/homefinance.html> (last visited Feb. 1, 2008) (declaring Islamic Financial Corporation’s loans “free of interest”). While deep in University Bank’s “Frequently Asked Questions,” <http://www.university-bank.com/IslamicBanking/faq.html> (last visited Feb. 1, 2008), the bank attempts to explain that “[a]n accountant may argue that rent in the latter two and profit in the former is interest, but in none of these cases is it *riba*. Some accountants argue that anything that may be perceived as generating a benefit from the passage of time has interest in it. The *Sharia’*a scholars have not defined *riba* in this way, rather *riba* necessarily relates to loans of money or exchanges of money like commodities when they are used as money.”

Interestingly, in contrast to what one might expect of, an argument aimed at the IRS or OCC - - which would downplay the “form” and argue that the “substance” of the transaction is a loan -- University Bank represents to its customers that its *Shari’ah*-compliant transactions are in fact substantively not loans and that their form is their substance. For example, again buried in its Frequently Asked Questions:

IRS and state tax authorities²⁸⁰, these various interest-free transactions are merely disguised loans. The banks are treating these products and representing them to the government authorities as conventional loans with interest income while marketing them to the public as interest-free *Shari'ah*-compliant non-loan transactions.²⁸¹

Full disclosure requires these banks to indicate that the loans are not interest-free and to fully disclose in all of their advertising the true APR. This would require an explanation that, while a loan might be considered “riba-free” for *Shari'ah* purposes, it is considered a standard loan with interest for all secular legal purposes. Unfortunately, even this might not be true. For example, it is unclear how a bankruptcy court would treat the transaction. Much would depend on whether the debtor or the lender was in bankruptcy. How the lender’s attorney navigates these issues in print advertisements and on the Internet will likely come to a regulator’s or court’s attention.²⁸²

An additional concern for *Shari'ah*-compliant consumer loans is that they are typically more costly than conventional loans. This is true because of the machinations inherent in the transactional documents and because much of the documentation must be duplicated – one set to track *Shari'ah* compliance and one set to track government regulations. In addition, *Shari'ah* supervision adds a cost in most cases as do some extra taxes attributed to the transfer of title as required by *Shari'ah*.²⁸³ Because these consumer loans are

Query: Isn’t the Islamic system of purchasing houses the same thing, the same mechanics, as the traditional mortgage system only with different labeling?

SHAPETM: This too is inaccurate. The process of qualifying a consumer and disclosing costs and risks to a consumer is the same as the mortgage system. This process is regulated by federal and state statutes in the United States. Hence, the paperwork is the same or very similar prior to and after making the acquisition, but not the acquisition itself.

The acquisition mechanics are fundamentally different without creating all of the same rights and obligations as in a traditional mortgage. **Hence, it is not a question of labeling, but of actual structure.**

Id. (emphasis added).

²⁸⁰ See *supra* note 58.

²⁸¹ See *supra* note 279.

²⁸² Bankruptcy and loan defaults open up an entire Pandora’s box of issues that this memorandum will not and cannot address. Legal commentators have discussed this in passing; however, only in the most cursory of terms. See, e.g., McMillen, *supra* note 9.

²⁸³ See, e.g., Devon Bank, Frequently Asked Questions, <http://www.devonbank.com/Islamic/faq.html> (last visited Feb. 1, 2008):

Why are your costs higher than conventional loans?

To be Shariah-compliant, our costs must be related to our actual expenses. Our products have a higher documentation fee due to the extra work in product design and assembling documents for a closing—it is not an automated process as it is for a conventional loan. Our profit rate is otherwise the same as an equivalent traditional mortgage. There are a few transaction costs that are higher because of the dictates of the specific deal structure needed to satisfy the requirements of an Islamic financing transaction, such as two deeds

marketed to a specific minority community with a unique cultural affinity to *Shari'ah*, and because the added costs of these loans have no economic value per se, it is possible that the marketing of these products will fall within the scope of the anti-predatory loan laws, such as the Home Ownership and Equity Protection Act ("HOEPA")²⁸⁴ or the state versions of HOEPA, which are typically more aggressive and have lower thresholds for offending predatory high-cost loans.²⁸⁵

VI. Conclusion

Shari'ah-compliant finance exposes financial institutions and other businesses to a host of disclosure, due diligence, and compliance issues, all of which elevate the civil liability and criminal exposure such companies otherwise factor into their business risk profiles.²⁸⁶ Preliminary legal analysis indicates that little of this increased civil and criminal exposure has been recognized, analyzed, or guarded against in any meaningful way.²⁸⁷ Rather than confronting issues material to a typical post-9/11 investor, lawyers and accountants have placed SCF in a secular black box, immune from the exacting scrutiny required of professional advisors in the modern U.S. legal regime. But failure of companies to diligently investigate their investments, and failure to disclose the risks caused by these investments, may ultimately result in massive liability to those who remain willfully ignorant of the realities of the SCF industry.

In pursuing SCF, U.S. businesses face civil liability in the realms of tort law, securities law, and antitrust. Furthermore, these businesses face criminal exposure in securities, antitrust, anti-sedition, racketeering, and money-laundering statutes. The failure by

to record instead of one. Otherwise, all our costs are the same as a traditional mortgage.

We do not charge a premium for religious accommodation.

²⁸⁴ Pub. L. No. 103-325, 108 Stat. 2190 (1994) (codified as amended in scattered sections of TILA, 15 U.S.C. §§ 1601-1667).

²⁸⁵ See generally C. Lincoln Combs, *Banking Law and Regulation: Predatory Lending in Arizona*, 38 ARIZ. ST. L.J. 617 (2006).

²⁸⁶ While it has not been the purpose of this memorandum to detail the legal risks for the professional facilitators, there is substantial legal exposure for the legal, accounting, and financial professionals who provide the knowledge and expertise to develop the financial and legal instrumentalities of SCF. While "scheme liability" under a Rule 10b-5 private right of action has been put to rest by *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 2008 U.S. LEXIS 1091 (U.S. 2008), to the extent that the lawyers get involved in drafting the "representations", liability will still apply. See LOSS & SELIGMAN, *supra* note 5, at 1329-1332 (discussing "primary liability" for lawyers under Rule 10b-5); *id.* at 1465-1469 (discussing the "duty to report evidence of a material violation" under Part 205 to Title 17 of the Code of Federal Regulations promulgated by the SEC pursuant to Section 307 of the Sarbanes-Oxley Act of 2002).

²⁸⁷ This conclusion has been reached by a thorough review of the published proprietary and non-proprietary information disseminated by many of the financial institutions and the professional facilitators (i.e., the law firms, accounting firms, and financial advisors who promote SCF as a business model and marketing niche) and of the published academic and trade journals which have treated SCF in some detail over the past decade. Some of this material will be referenced throughout this memorandum as its relevance to disclosure, due diligence, compliance, industry standards, and best practices are examined.

corporate management and their legal advisors to confront these issues in serious fashion is not surprising given the wholesale failure of the participants and facilitators in this industry to undertake a serious analysis of the risks. The extant academic and professional literature reads more like promotional material and not serious legal analysis conducted by men and women trained to protect clients from their own blind enthusiasm. The legal industry has gone down this road too many times in the past. This time, the risk is not simply financial; it is existential. Lawyers, academics, and regulators alike must acknowledge the potentially dire consequences of *Shari'ah*-compliant financing and take steps to address its legal and ethical issues.