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THE REGULATION OF SECURITIES AND ISLAMIC FINANCE IN DUBAI: IMPLICATIONS FOR MODELS OF SHARĪ‘AH COMPLIANCE

*Paul Lee**

ABSTRACT

The Dubai International Financial Centre (“DIFC”) has become an important component of an increasingly significant global market for Islamic finance. However, the state of academic discussion has not necessarily kept pace with its growing economic import. This paper improves the current state of literature by (1) examining the current regulatory infrastructure for securities and Islamic finance in the DIFC, (2) comparing its regulatory model with those of other important Islamic finance jurisdictions, and (3) exploring the implications of Dubai’s experience for the notions of legal transplants, convergence, and competition.

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I. INTRODUCTION

In recent years, Islamic finance has been playing an increasingly important role in the world economy. Islamic assets reached an estimated total of \$1.87 trillion USD globally at the end of 2013 after an average growth rate of 17% since 2009.¹ *Ṣukūk*, or Sharī'ah-compliant securities, accounted for about \$270 billion USD of this amount.² Currently, Malaysia could be considered the leading player in Islamic finance, with the United Arab Emirates ("UAE") ranking third by volume of *ṣukūk* issuances.³ Nevertheless, the UAE's Dubai International Finance Centre ("DIFC") has been growing in significance given its recent issuance trends and the international composition of its issuer-investor base.⁴

In contrast to its growing import in the region and in the world, however, the state of academic discussion on Dubai appears to have lagged behind. This paper improves the current state of literature by: (1) examining the regulation of securities and Islamic finance in Dubai; (2) assessing the relative costs and benefits of different models of Islamic finance regulation in different jurisdictions; and (3) drawing out the implications of Dubai's experience for the notions of legal transplantation, convergence and regulatory competition.

As may be evident, the focus of this paper will be on how Islamic finance is regulated, not what Islamic finance is. As such, this paper will not reproduce discussions of *ribā* or *gharar*, nor go into detail about the structure of various classical nominate contracts.⁵ Furthermore, the reader should note that this paper prefers the term "Sharī'ah compliance" over "Sharī'ah governance," as adopted by some of the literature.⁶ This is because the principal focus of this paper is the regulation

1. ISLAMIC FINANCIAL STABILITY BOARD, ISLAMIC FINANCIAL SERVICES INDUSTRY STABILITY REPORT 2015 7 (2015) (the Islamic Financial Stability Board does not define Islamic asset in its report, but the term presumably includes not just Islamic securities but Islamic insurance (*takāful*) and Islamic banking products).
2. RASAMEEL, 2013 ANNUAL GLOBAL SUKUK REPORT 11 (2014), available at rasameel.com/assets/attachments/RSFGlobalSukukMarketAnnual2013.pdf.
3. *Id.* at 2 (noting that Malaysia accounted for 69% of issuances); Khalid Howlader & Philipp L. Lotter, *Malaysia's Sukuk Market to Grow 10% over 2014 and 2015*, MOODY'S (Jun. 5, 2014) available at https://www.moodys.com/research/Moodys-Malysias-sukuk-market-to-grow-10-over-2014-and--PR_300889 (showing that Malaysia accounted for about two thirds of approximately \$290 billion USD in global *ṣukūk* outstanding at the time). RASAMEEL, *supra* note 2, at 3 (putting UAE's share of issuances at 6%, below the 12-13% of Saudi Arabia); see also IFSB, *supra* note 1, at 23.
4. The UAE saw a 16.8% increase in *ṣukūk* issuances in 2013, whereas Malaysia saw a decline of nearly 15.2%. RASAMEEL, *supra* note 2, at 2. Furthermore, the DIFC caters more to international issuers and investors, whereas Malaysia relies more to domestic issuers and investors. See *infra* note 166.
5. Very generally, *ribā* is akin to interest in conventional finance, and *gharar* refers to excessive uncertainty. The term "classical nominate contracts" refers to the many contemporary Islamic finance contracts that have been developed to overcome objections of *ribā* and *gharar*, and highlights the fact they are named after the classical Islamic law contracts from which they are derived. For a good discussion, see MAHMOUD A. EL-GAMAL, ISLAMIC FINANCE: LAW, ECONOMICS, AND PRACTICE 46-63 (2006).
6. See, e.g., Abdurrahman Raden Aji Haqqi, *Shariah Governance in Islamic Financial Institution: An Appraisal*, 11 US-CHINA L. REV. 112 (2013); Rihab Grassa, *Shariah Supervisory System in Islamic Financial Institutions: New Issues and Challenges: A Comparative Analysis Between Southeast Asia Models and GCC Models* (sic), 29 HUMANOMICS 333 (2013); Zulkifli Hasan, *Regulatory Framework*

of Islamic securities, where the emphasis lies on whether or not a given transaction is compliant with Shari'ah, and not the on-going governance of an Islamic firm or business.⁷ However, it describes requirements for Islamic financial institutions where relevant and much of the discussion could likely be extended to cover the related issue of Shari'ah governance.

Finally, the research methodology for this paper included qualitative interviews to address the lack of resources in this area. Over a period of two weeks in January of 2015, the author met with regulators and practitioners at leading international law firms in the DIFC in order to gain a better understanding of: (1) the regulatory approach, such as the thought process behind the promulgated rules and their origins; (2) how laws on the books were interpreted in practice, and (3) current developments and challenges facing the industry. Due to the interests involved in obtaining candid assessments and to facilitate information sharing, the identities of the participants are kept confidential. All errors contained in this paper are my own.

II. THE LEGAL AND REGULATORY FRAMEWORK IN DUBAI

Before the example of the Dubai International Financial Centre can be used to develop insights on various models of Islamic finance regulation and the notions of legal transplants, convergence, and competition, it is necessary to understand exactly how regulation in the DIFC works. This Section details (1) how the DIFC was established as a jurisdiction separate from the rest of the UAE with its own common law courts, (2) how the securities laws operate in the DIFC, (3) how Islamic finance is regulated in particular, and (4) the ways in which the financial supervisory authority of the DIFC is able to enforce against breaches of the rules.

A. *The Dubai International Financial Centre and the Adoption of Common Law*

The DIFC is a legal system parallel to the legal systems of the Emirate of Dubai and the UAE as provided for by a series of federal and local laws.⁸ The Constitution of the UAE generally confers exclusive authority to the federal government to regulate enumerated areas, including “civil and commercial transactions and company law,” while conferring residual authority to the individual emirates.⁹ Further, the UAE amended its Constitution in 2004 to allow for legislation governing the

of Shari'ah Governance System in Malaysia, GCC Countries and the U.K., 3 KYOTO BULL. ISLAMIC AREA STUD. 82 (2009). For a comprehensive definition of Shari'ah governance, see ISLAMIC FINANCIAL SERVICES BOARD, GUIDING PRINCIPLES ON SHARI'AH GOVERNANCE SYSTEMS FOR INSTITUTIONS OFFERING ISLAMIC FINANCIAL SERVICES 1-3 (2009), available at <http://www.ifsb.org/standard/IFSB-10%20Shariah%20Governance.pdf>.

7. Note that this paper makes no assessment as to whether particular types of transactions actually comply with Shari'ah—instead, it is concerned with the ways in which various jurisdictions have handled this issue.
8. See generally, Alejandro Carballo, *The Law of the Dubai International Financial Centre: Common Law Oasis or Mirage within the UAE?*, 21 ARAB L. Q. 91 (2007).
9. U.A.E. CONST., arts. 121 & 122 (amended 2009).

establishment of Financial Free Zones, which are “exempted from having to apply the rules and regulations of the Union.”¹⁰

The creation of the DIFC, under this constitutional grant, involved a series of federal and emirate-level laws. The UAE passed a federal law providing that Financial Free Zones may be established by federal decree, stipulating that the locations of these zones were to be fixed by a Cabinet resolution,¹¹ and that such zones would be exempt from federal civil and commercial laws.¹² That same year, the DIFC was established by federal decree.¹³ The emirate of Dubai then laid out its structure and functions,¹⁴ including the establishment of the Centre Authority,¹⁵ a separate court system,¹⁶ and the Dubai Financial Services Authority (“DFSA”).¹⁷

In that vein, one key feature of the DIFC is that unlike the rest of the UAE, which operates under civil law and in Arabic, the DIFC courts operate under common-law and in English.¹⁸ This common law system in the DIFC is buttressed mainly by the requirement that its judges must have been trained in common law. The DIFC Court Law provides that judges must have had “significant experience as a qualified lawyer or judge in the common law system.”¹⁹ Despite the fact that there is no explicit law providing for *stare decisis*, which is surprising, the appointment of common law-trained judges may be sufficient to ensure that precedential decisions are properly followed given that judges are the final arbiters of law as applied on a case-by-case basis.

Additionally, the DIFC provides for the laws of England and Wales as a residual source of law, formally incorporating general common law principles that may escape statute or regulation.²⁰ This may be important to capture various equitable defenses and remedies that are not generally codified, but are instead found in case law. Finally, the DIFC Courts’ Code of Conduct provides that “[p]ractitioners shall fearlessly advance, defend and protect the interests of their client,” incorporating the norm of adversarial proceedings normally associated with common law.²¹ Consequently, with the possible exception of trial by jury, it would appear that all the major

10. U.A.E. CONST., art. 121; CONST. AMEND. NO. 1 OF 2004, translation available at https://www.difc.ae/files/5714/5449/7479/Constitutional_Amendment_No_1_of_2004_English.pdf.

11. FED. L. NO. 8 OF 2004, art. 2 (as modified by CABINET RESOL. NO. 28 OF 2007) (U.A.E.).

12. *Id.* art. 3 (this exemption from civil and commercial laws does not extend to criminal and anti-money laundering laws).

13. FED. DECREE NO. 9 OF 2004 (U.A.E.).

14. DUBAI L. NO. 9 OF 2004 (amended 2011) (U.A.E.).

15. *Id.* art. 6.

16. *Id.* art. 8.

17. *Id.* art. 7.

18. *See, e.g., Welcome to the DIFC Courts*, <http://difccourts.ae> (last visited Feb. 12, 2015); Carballo *supra* note 8. Note that the DIFC Court of Appeal has final authority on cases in the DIFC. DIFC LAW NO. 12 OF 2004, art. 5(B)(2) (amended 2011).

19. DIFC LAW NO. 10 OF 2004, art. 9(3)(b).

20. DIFC LAW NO. 3 OF 2004, art. 8(2)(e).

21. DIFC COURTS, THE MANDATORY CODE OF CONDUCT FOR LEGAL PRACTITIONERS IN THE DIFC COURTS (2014) available at <http://difccourts.ae/code-of-conduct>.

characteristics one might expect of a common law system have support within the legal and regulatory framework of the DIFC.

In this manner, the DIFC has set itself apart from the rest of the UAE by establishing a common law system within its boundaries. Further taking advantage of its legal independence, the DIFC has also enacted a set of commercial laws that are generally more sophisticated than the laws of the UAE, including securities laws and laws addressing Islamic finance as detailed below.²²

B. *The Regulation of Securities and Investor Protection*

With respect to securities laws, this paper explores three notable components: (1) the rules governing an offer of securities or funds, (2) continuous disclosure requirements, (3) anti-fraud and insider trading provisions. While relevant to securities regulation and investor protection more generally, this paper will not address corporate governance rules or fiduciary duties for corporate directors and fund managers in order to maintain an appropriately limited scope of inquiry.

As a general matter, any offer of securities in or from the DIFC, as well as the listing of new securities on an exchange in the DIFC, must take place after a prospectus has been filed with the Dubai Financial Services Authority and the DFSA has issued a notice approving the prospectus—as provided for in the DIFC Markets Law and DFSA Markets Rules.²³ These prospectus requirements are important for investor protection not only because the disclosure of information they provide, but also because offers of securities and fund units are prohibited where the respective prospectus contains misleading statements or omissions.²⁴

As a technical matter, sales of shares in funds, such as mutual funds, index funds, private equity funds, hedge funds, funds of funds, and of course Islamic funds investing in Shari‘ah compliant assets, are governed separately by the Collective Investment Law.²⁵ The one exception is for funds listing on an exchange (“**Listed Funds**”), which are covered by the Markets Law.²⁶ The offer of a fund in or from

22. See, e.g., *Doing Business in the Dubai International Financial Centre*, PRICEWATERHOUSECOOPER (Nov. 2008), https://www.pwc.com/en_M1/m1/publications/doing-business-in-the-difc-2009.pdf (listing a summary of laws promulgated in the DIFC); Legal Database, DUBAI INTERNATIONAL FINANCIAL CENTRE, <http://www.difc-ae.com/legal-database.html>.

23. DIFC LAW No. 1 OF 2012, art. 11(1), 14(1, 2) (U.A.E.) (amended 2014). DFSA MARKETS RULES, art. 2.6.2 (amended 2014). There are three types of exemptions available from the requirement for an approved prospectus: (1) exempt offerors listed by the DFSA, generally governments and international government organizations, DIFC LAW No. 1 OF 2012, art. 13, DFSA MARKETS RULES A.5.1.1; and (2) exempt offers and (3) exempt securities, covering various issuances such as those in connection with a merger or takeover, certain distributions to shareholders, certain exchanges of shares, certain issuances of listed shares, issuances to directors/employees, de minimis issuances involving less than \$100,000, private offering to less than 50 persons, and issuances where those acquiring securities are likely to be sophisticated, such as certain institutional clients, buyers paying more than \$100,000, or where securities are denominated in amounts of at least \$100,000. DIFC LAW No. 1 OF 2012, art. 14(3); DFSA MARKETS RULES art. 2.3 & 2.4.

24. DIFC LAW No. 1 OF 2012, art. 20; DIFC LAW No. 2 OF 2010, art. 56.

25. DIFC LAW No. 1 OF 2012, art. 10(1).

26. *Id.* at art. 10(2).

the DIFC, regardless of the particulars of the fund, must be accompanied by a prospectus.²⁷ However, only funds domiciled in the DIFC being marketed to the general public (“**Domestic Public Funds**”) must file such a prospectus with the DFSA (there is no pre-approval requirement for the prospectus unless the fund is a Listed Fund, but the Domestic Public Fund must itself be registered).²⁸

If an offer of securities or funds, defined broadly,²⁹ takes place with a misleading prospectus, the issuer, other offerors, the fund manager, the directors of the issuer, the directors of the offerors and the directors of the fund may become civilly liable for any loss caused.³⁰ Although certain affirmative defenses are permitted,³¹ these appear to be reasonably limited in scope.³²

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27. DIFC LAW No. 2 OF 2010, art. 50 (amended 2014). The exact prospectus requirements differ somewhat across three types of funds: (1) funds domiciled in the DIFC (“**Domestic Funds**”); (2) funds not domiciled in the DIFC, but managed by a firm authorized in the DIFC (“**Domestic External Funds**”); and (3) funds neither domiciled in the DIFC nor managed by a DIFC-authorized firm (“**Foreign Funds**”). DIFC LAW No. 2 OF 2010, art. 13-14; DFSA COLLECTIVE INVESTMENT RULES, pt. 14-15 (amended 2014). Prospectus requirements for Domestic Funds, including Domestic External Funds, again vary based on their investor base: (1) the fund will have more than 100 investors, retail clients, or was not privately placed (“**Public Fund**”); (2) the fund will have less than 100 investors, no retail clients, an initial investment threshold of at least \$50,000, and was privately placed (“**Exempt Fund**”); (3) the fund will have less than 100 investors, no retail clients, an initial investment threshold of at least \$500,000, and was privately placed (“**Qualified Investor Fund**”). DIFC LAW No. 2 OF 2010, art. 16; DFSA COLLECTIVE INVESTMENT RULES, pt. 14. Finally, there are slight variations for certain Domestic Funds—feeder funds, property funds, private equity funds, and hedge funds. DFSA COLLECTIVE INVESTMENT RULES, art. 14.4.
28. DIFC LAW No. 2 OF 2010, arts. 28, 51(1)(b); DFSA COLLECTIVE INVESTMENT RULES, arts. 10.2, 14.2.2(1)(b).
29. The prohibitions on misleading statements and omissions apply to (1) Prospectus Offers and (2) an Offer of Units of a fund. Prospectus Offers include an Offer of Securities to the Public and having securities admitted to trading on an exchange (including Listed Funds), DIFC LAW No. 1 OF 2012, art. 14(4), where an Offer of Securities to the Public means any communication presenting information on the terms of the offer and the securities offered so as to enable an investor to decide to buy or subscribe to the securities (excluding communication relating to securities that are already listed, or in the ordinary course of business). DIFC LAW No. 1 OF 2012, art. 12, DFSA MARKETS RULES, art. 2.2.1. An Offer of Units applies to any offer or invitation of an offer that would create a contract for the issue or sale of fund units, with an exception if (1) the offer is limited only to the person to whom it is made and not in the form of an advertisement or other promotion/marketing; (2) the transaction is an unsolicited brokerage transaction, made pursuant to a discretionary portfolio management agreement, or is a redemption of a fund unit; or (3) the offer is directed solely at a market counterparty. DIFC LAW No. 2 OF 2010, art. 19(2)-(3), DFSA COLLECTIVE INVESTMENT RULES, arts. 4.1.2, 4.1.3 & 4.1.4.
30. DIFC LAW No. 1 OF 2012, art. 24, DIFC LAW No. 2 OF 2010, art. 58. DFSA MARKETS RULES, art. 2.10.1, DFSA COLLECTIVE INVESTMENT RULES, art. 14.6.1. These rules also impose liability on anyone who is stated in the prospectus as accepting responsibility for the prospectus or any portion thereof (with respect to such portion), as well as anyone who has authorized its contents. Note that there is a limited exception for directors of issuers/offerors where the securities in question are debentures. *Id.*
31. Generally, a person is not liable if they reasonably believed after making all reasonable inquiries that the prospectus was not misleading. DIFC LAW No. 1 OF 2012, art. 21, DIFC LAW No. 2 OF 2010, art. 57. DFSA MARKETS RULES, art. 2.11.1, DFSA COLLECTIVE INVESTMENT RULES, art. 14.6.3. There is also a defense if the buyer of the securities of fund units knew that the statement in question was misleading or knew of the omission. *Id.*
32. For instance, the U.S. securities laws have similar due diligence defenses. *See* 15 U.S.C. § 77k(b).

In addition to disclosure requirements at the time of issuance via the prospectus, continuous disclosure requirements are necessary to prevent market manipulation or fraud with respect to securities that will continue to be traded, especially where unsophisticated investors may be involved. In the DIFC, such continuous disclosure requirements attach to issuers who have made a public offer of securities or have listed on an exchange, including managers of Listed Funds (“**Reporting Entities**”),³³ as well as to the manager of any fund domiciled in the DIFC, or a fund not domiciled in the DIFC where the manager is a DIFC-authorized firm (“**Fund Managers**”). Reporting Entities and Fund Managers must disclose audited annual reports and, in many cases, unaudited half-year reports.³⁴ Reporting Entities must also make timely disclosures of inside information,³⁵ defined as information of a precise nature related to the Reporting Entity that is not generally available and that would have a significant effect on the price of the security or related securities.³⁶

Unlike the prospectus rules, there is no specific provision for civil liability with respect to these continuous disclosures. However, rules on the disclosure of inside information contain prohibitions against false or misleading statements as well as material omissions,³⁷ and there is a general rule of civil liability where a person intentionally, recklessly, or negligently contravenes a rule.³⁸ Furthermore, general anti-fraud provisions that serve as an additional bulwark for investor protection cover all disclosures.

These include prohibitions against: (1) disseminating information that is known or can reasonably be expected to be known to lead to misleading impressions,³⁹ (2) inducing someone to deal in an investment⁴⁰ by making a statement known to be false or with recklessness as to whether it is misleading, by concealing material facts, or by recording information known to be materially misleading;⁴¹ and (4) perpetrating fraud on any person.⁴² There are also various prohibitions against conduct that might be characterized as market abuse.⁴³ Finally, these provisions are comple-

33. DIFC LAW NO. 1 OF 2012, art. 38.

34. DFSA MARKETS RULES, pt. 5.1, 5.2. & 6.9. DFSA COLLECTIVE INVESTMENT RULES, pt. 9.4. *See also* DIFC LAW NO. 1 OF 2012, arts. 41, 44 & 45. Issuers that have issued only debt are not required to disclose half-year interim reports. DFSA MARKETS RULES, art. 5.1.7(1). Qualified Investor Funds are also exempt from the requirement of half-year interim reports unless there has been a material change. COLLECTIVE INVESTMENT RULES, art. 9.4.1(2).

35. DFSA MARKETS RULES, arts. 4.2.1(1) & 6.5.1(1).

36. DIFC LAW NO. 1 OF 2012, arts. 63(1)(a), (2).

37. DFSA MARKETS RULES, arts. 4.2.1(2) & 6.5.1(1)(b).

38. DIFC LAW NO. 1 OF 2004, art. 94.

39. DIFC LAW NO. 1 OF 2012, art. 55.

40. “Investment” for the purpose of anti-fraud provisions includes derivatives and securities, with securities including units of funds. DFSA GENERAL RULES, arts. A2.1.1 & 2.1.2.

41. DIFC LAW NO. 1 OF 2012, art. 60.

42. DIFC LAW NO. 1 OF 2012, art. 54(c).

43. These include: (1) engaging in conduct that gives a misleading impression of supply or demand for an investment, creates or is likely to create an artificial price for an investment, would distort the market, or that effects transactions or orders to trade employing fictitious devices or other deception, DIFC LAW NO. 1 OF 2012, art. 54(a)-(b), 56 & 57(a)-(b); (2) engaging in conduct likely to be regarded by market participants as a failure to observe a standard of behaviour reasonably expected of a

mented by prohibitions against trading on the basis of inside information,⁴⁴ including against disclosure of inside information except in the necessary course of business.⁴⁵

C. *The Regulation of Shari'ah Compliance*

In addition to the above provisions governing the functioning of securities markets in Dubai, which are generally applicable, there are specific regulations governing Islamic securities in order to ensure compliance with the principles of Shari'ah. As will be discussed later, these additional requirements may be seen as reflecting a “systems-based” model for the regulation of Islamic finance, providing for Shari'ah Supervisory Boards (“SSB”) at the level of the entity or transaction rather than relying on a centralized Shari'ah authority.⁴⁶ Different models of Islamic finance regulation and their features are discussed more in depth in Section III.

The Law Regulating Islamic Financial Business and the Islamic Finance Rules are principally responsible for regulating Islamic finance in the DIFC.⁴⁷ The Islamic Finance Rules cover entities that operate in three overlapping areas related to Islamic finance: (1) holding oneself out as a business providing Shari'ah-compliant financial services, (2) the offer of Shari'ah-compliant securities, and (3) Shari'ah-compliant investment funds offered to the public and domiciled or managed in the DIFC. In each case, the Rules do not actively proscribe what kinds of activities may or may not be Shari'ah compliant. Instead, they provide for supervision by entity-level SSBs that will monitor the activities of the business, securities, or fund,⁴⁸ and for a disclosure-based regime that allows investors, customers, and others to confirm Shari'ah-compliant status based on the opinion of the SSB. Generally speaking, the SSB is a committee of Islamic jurists that can issue a *fatwā* about whether or not a particular transaction or activity complies with Shari'ah.

In order for a provider of Islamic financial services—such as an Islamic bank—to hold itself out as being Shari'ah compliant, it must have obtained a license or license endorsement from the Dubai Financial Services Authority (“DFSA”) as

person in their position, DIFC LAW No. 1 OF 2012, art. 57(c) & 61(b). See DFSA CODE OF MARKET CONDUCT (amended 2015) for a non-exhaustive list of conduct which may be prohibited under the various laws.

44. An insider may not deal directly or indirectly in an investment on the basis of inside information, with an exception for commodity derivatives. DIFC LAW No. 1 OF 2012, arts. 58 & 59(2).
45. DIFC LAW No. 1 OF 2012, art. 59(1).
46. See, e.g., DFSA ANNUAL REPORT 2013 at 47 (describing itself as a “Shari'a systems-based regulator”). See *infra* Section III for a more detailed discussion of different models of Shari'ah regulation.
47. DIFC LAW No. 13 OF 2004 (amended 2014). DFSA RULEBOOK: ISLAMIC FINANCE RULES (amended 2014), promulgated pursuant to general authority in DIFC LAW No. 1 OF 2004, art. 23 (amended 2014) (providing the DFSA with power to make rules); DIFC LAW No. 13 OF 2004, art. 11 (providing the DFSA with power to make rules on licensing of Islamic Financial Businesses); DIFC LAW No. 1 OF 2012, art. 8 (amended 2012) (providing the DFSA with power to make rules concerning securities); DIFC LAW No. 2 OF 2010, art. 8 (amended 2012) (providing the DFSA with power to make rules concerning investment funds).
48. Generally, the SSB is composed of three members who must be competent in their functions. ISLAMIC FINANCE RULES, art. 3.5.1(a)-(b).

either an Islamic Financial Institution (“IFI”) or an Islamic Window.⁴⁹ The difference between the two options is that an IFI is a business that is entirely Shari’ah-compliant, whereas the Islamic Window describes the Shari’ah-compliant portion, such as a division, of a business that is not itself Shari’ah-compliant. The Islamic Window provides greater flexibility for international financial institutions looking to establish a Shari’ah-compliant arm in the DIFC, since conventional financial activities can be conducted in parallel as long as there is adequate separation of the two.⁵⁰ In either case, the business must appoint an SSB.⁵¹

IFIs and Islamic Windows are subject to numerous rules designed to ensure that they have certain processes in place for Shari’ah compliance. These businesses must implement and maintain policies regarding Shari’ah compliance and regarding the SSB,⁵² follow certain rules to prevent conflicts of interests in the SSB,⁵³ perform internal reviews of Shari’ah compliance in line with international standards,⁵⁴ and disclose certain additional pieces of information related to Shari’ah compliance in their financial statements.⁵⁵ These businesses must further disclose to their clients certain details regarding their SSB, and include information about their SSB in their marketing material.⁵⁶

With respect to Islamic securities, including *ṣukūk*, the prospectus for the offer of such securities in or from the DIFC must contain details regarding the SSB appointed by the issuer and its opinion as to whether the securities are Shari’ah-compliant,⁵⁷

49. DIFC LAW No. 13 OF 2004, art. 9. Note that this provision applies to Authorized Firms and Authorized Market Institutions (together, Authorized Persons)—the DIFC Regulatory Law provides that only Authorized Persons licensed for the particular activity may carry on a financial service in or from the DIFC. DIFC LAW No. 1 OF 2004, arts. 41(1), (9), arts. 42(3)(a)-(c). For a list of activities considered to be financial services, see DFSA RULEBOOK: GENERAL MODULE, art. 2.2.2 (amended 2014).

50. ISLAMIC FINANCE RULES, sec. 2.3 Guidance 5, 3.4.1(g), 3.8.3, 4.2.2.

51. DIFC LAW No. 13 OF 2004, art. 13.

52. ISLAMIC FINANCE RULES, sec. 3.4.1 (requiring policies regarding: (1) manner in which Shari’ah compliance will be undertaken, (2) how the SSB will oversee/advise the business, (3) how SSB *fatwās* will be issued/recorded/implemented, (4) how internal Shari’ah review will be conducted, (5) how disputes between the SSB and the business will be handled, (6) approval process for internal controls regarding Shari’ah compliance, (7) how, for an Islamic Window, conventional businesses will be kept separate from the Shari’ah-compliant business (see also ISLAMIC FINANCE RULES, sec. 3.8.3)), sec. 3.5.2 (requiring policies for: (1) appointments/dismissals/changes of the SSB, (2) determining suitability of SSB members, and (3) determining the remuneration of the SSB).

53. Including setting up policies for identifying and managing conflicts of interest and providing that no member of the SSB may be a director or 10% shareholder of the business. ISLAMIC FINANCE RULES, sec. 3.4.1(f), sec. 3.5.1(d).

54. ISLAMIC FINANCE RULES, sec. 3.7.

55. *Id.* at ch. 4.

56. *Id.* at arts. 3.8.1 & 3.8.2.

57. *Id.* at art. 7.2.3. Although the Islamic Finance Rules state that a prospectus for the offering of *ṣukūk* “must include . . . the opinion of the Shari’a Supervisory Board in respect of whether the Securities are Shari’a compliant,” ISLAMIC FINANCE RULES, art. 7.2.3(c)(i) (emphasis added), in practice the prospectuses do not contain the actual opinion. Instead, they contain only a general statement that the transaction structure has been approved by the relevant SSB. See DFSA, *Approved Prospectuses* (last accessed Mar. 10, 2015) available at <http://www.dfsa.ae/Pages/DFSAlistingauthority/ApprovedProspectuses.aspx>. It may be important to consider whether the exclusion of the actual

which opinion must have been filed with the DFSA.⁵⁸ The prospectus must also contain a description of the cash flow of the underlying transaction for an issuance of *shukūk*,⁵⁹ reflecting regulators' view that the complex steps involved in *shukūk* transactions warrant additional disclosure. Any issuer of listed securities or securities offered to the public must disclose material changes to the SSB on a continuous basis.⁶⁰

Similarly, with respect to Islamic funds domiciled or managed in the DIFC offered to the public in or from the DIFC, the fund or fund manager must have appointed an SSB⁶¹—with an exception for funds using a widely accepted Shari'ah screening process⁶²—and must disclose details regarding the SSB in their prospectus, which must have been approved by the SSB.⁶³ Such funds must also perform internal audits of Shari'ah compliance and its SSB must conduct an annual review, each in line with international standards.⁶⁴ The results of the annual review are then disclosed to investors of the fund via its annual report.⁶⁵

A development of note in the regulation of Islamic funds is the signing of a mutual recognition agreement between the Securities Commission in Malaysia and the DFSA, which allows Islamic funds approved in Malaysia to be offered to the public in the DIFC and vice versa.⁶⁶ Such funds are permitted to be offered as a Designated Fund from a Recognized Jurisdiction,⁶⁷ a designation without which they would normally be limited to offerings where there is a reasonable basis for suitability to a particular client, or to offerings which would meet Exempt Fund criteria.⁶⁸ Such funds must contain a disclosure in their prospectus that they are regulated by the Shari'ah approval process of the Securities Commission of Malaysia.⁶⁹

D. *The Tools of the Supervisory Authority*

Of course, promulgating these rules on securities and Islamic finance without the power to compel compliance would render such regulation toothless. As discussed above, one mechanism for inducing compliance is the imposition of civil

opinion is a material deficiency that should be addressed by amending the rules or how they are enforced in the *status quo*.

58. ISLAMIC FINANCE RULES, art. 7.4.1.

59. *Id.* at art. 7.2.3(c)(ii).

60. *Id.* at art. 7.3.1 & 7.3.2.

61. *Id.* at art. 6.2.1.

62. *Id.* at art. 6.2.1(3). Examples include the S&P, FTSE, and Dow Jones Islamic Indexes. For a discussion of Shari'ah screens, see, e.g., RODNEY WILSON, LEGAL, REGULATORY AND GOVERNANCE ISSUES IN ISLAMIC FINANCE 187-90 (2012).

63. ISLAMIC FINANCE RULES, arts. 6.1.3 & 6.5.1.

64. *Id.* at arts. 6.3.1, 6.3.2, 6.4.1.

65. *Id.* at art. 6.3.2.

66. *Malaysia and Dubai Sign Milestone Pact to Allow Cross-Border Flow of Islamic Funds*, SECURITIES COMMISSION (Mar. 27, 2007), http://www.sc.com.my/post_archive/malaysia-and-dubai-sign-milestone-pact-to-allow-cross-border-flow-of-islamic-funds/.

67. DFSA RECOGNIZED JURISDICTION NOTICE NO. 3, DIFC LAW NO. 2 OF 2010, art. 54(a).

68. Meaning that the fund must have less than 100 investors, no retail clients, an initial investment threshold of at least \$50,000, and be privately placed. DIFC LAW NO. 2 OF 2010, art. 54(b)-(c).

69. ISLAMIC FINANCE RULES, art. A1.2.1.

liabilities for losses arising from misleading statements and omissions in the prospectus, as well as civil liabilities arising out of contraventions of DFSA-administered laws generally.

However, there is reason to suspect that civil liabilities might be inadequate in ensuring Shari‘ah compliance. In particular, the opinion of an SSB that a particular transaction or activity is Shari‘ah compliant may be treated solely as an opinion, not a statement of fact which may form the basis of liability.⁷⁰ Since DIFC Courts have not addressed such an issue to date, it is unclear whether such an argument would be accepted. For instance, although auditors generally give an “opinion” that audited financial statements fairly represent the financial condition of a company, they may still be held liable for misleading statements in a prospectus.⁷¹ On the other hand, accounting principles like GAAP provide a set of rules that makes it easier for courts to determine when auditors have acted improperly. Conversely, it may be much more difficult to determine whether a Shari‘ah scholar acted improperly in issuing a *fatwā*, which is a product of greater discretion given the diversity of interpretations of Shari‘ah that are often permissible.

Moreover, even if it could be established that a *fatwā* was misleading, it may be difficult to prove that a loss arose out of that misstatement or omission. Since the Shari‘ah-compliant status of a security is generally unrelated to the economic substance of the transaction, a misleading *fatwā* may not result in a loss to investors, at least in tangible economic terms.⁷² Without a causal connection to a loss, civil liability appears to be an economically hollow deterrent.

Countervailing such concerns, the DFSA has numerous other powers at its disposal to ensure compliance with its rules. First, the DFSA has certain powers via the licensing of firms, since firms may not carry on financial services in the DIFC

70. This view was expressed by some interviewees. Interview Notes (on file with the author). Furthermore, although the Islamic Finance Rules state that a prospectus for the offering of *sukūk* “must include . . . the opinion of the Shari‘a Supervisory Board in respect of whether the Securities are Shari‘a compliant,” ISLAMIC FINANCE RULES, art. 7.2.3(c)(i) (emphasis added), in practice the prospectuses do not contain the actual opinion but only a statement that the transaction structure has been approved by the relevant SSB. See *Approved Prospectuses*, DFSA (last accessed Mar. 10, 2015), <http://www.dfsa.ae/Pages/DFSAlistingauthority/ApprovedProspectuses.aspx>. It may be important to require that the actual opinion be made available. Some practitioners mentioned that there may be intellectual property concerns in requiring the full text of an SSB opinion to be published, given that it would allow rival firms to copy the transactional structure. However, it appeared that Shari‘ah scholars often drafted two copies of a Shari‘ah compliance opinion in practice—one detailed copy to be kept on record to justify their analysis, for instance in the advent of a litigation, and a summary copy that could be provided to various parties to the transaction who needed to verify that the transaction had been approved. See Interview Notes (on file with the author). It seems that the latter could easily form the basis of the opinion to be included in the prospectus.

71. See, e.g., *In re Worlds of Wonder Sec. Litig.*, 35 F.3d 1407, 1423 (9th Cir. 1994) (denying summary judgment where plaintiffs alleged that auditors improperly recognized revenues); *SEC v. Arthur Young & Co.*, 590 F.2d 785, 788-89 (9th Cir. 1979) (stating that even “compliance with Generally Accepted Accounting Principles (GAAP) would not immunize an accountant when he consciously chose not to disclose on a financial statement a known material fact.”).

72. One exception may be where a contract becomes invalidated by reason of failing to comply with Shari‘ah—however, where the lawyers have carefully drafted the choice of law and forum provisions, this result is unlikely.

without a license or license endorsement,⁷³ including those wishing to carry on Islamic financial services as an IFI or Islamic Window.⁷⁴ These powers include: (1) refusing to grant a license or endorsement,⁷⁵ for instance in cases where an institution appears to be lacking adequate supervision and controls; (2) imposing or amending certain restrictions or conditions on a license or endorsement;⁷⁶ (3) suspending a license or endorsement for up to twelve months;⁷⁷ and (4) withdrawing a license or endorsement.⁷⁸ The DFSA may also prohibit specific transactions⁷⁹ or issue prudential orders on capital or risk exposure.⁸⁰ Analogously, the DFSA also has powers to refuse to grant, condition, restrict, suspend, or withdraw licenses for certain senior and compliance personnel of authorized firms, who must be licensed by the DFSA to carry out their functions.⁸¹

Second, the DFSA has certain information-gathering powers designed to aid it in the exercise of other powers. It may require an authorized firm to provide a report,⁸² or require authorized firms, domestic funds, registered auditors, and certain businesses or professions such as law firms, as well as the directors, officers, or employees of such firms to provide information. It may also enter the premises of such firms during regular business hours to procure information.⁸³ If it has reason to suspect that a law or rule may have been breached, it may commence an investigation,⁸⁴ pursuant to which it may enter the premises of a firm to gather information, require the production of information or documents, require persons to attend an interview under oath, or otherwise give assistance to the investigation.⁸⁵

73. DIFC LAW No. 1 OF 2004, arts. 41(1) & 42(3).

74. DIFC LAW No. 13 OF 2004, art. 9. Note, however, that the act of underwriting Islamic securities may not in itself be considered an Islamic finance activity, requiring IFI or Islamic Window status. See Andrew Henderson, *Limiting the Regulation of Islamic Finance: Lessons from Dubai*, 1 L. & FIN. MKT. REV. 213, 218 (2007).

75. DIFC LAW No. 1 OF 2004, art. 47(1); DIFC LAW No. 13 OF 2004, art. 11(5A).

76. Conditions and restrictions may be imposed or amended at any time by written notice. DIFC LAW No. 1 OF 2004, art. 49(1); DIFC LAW No. 13 OF 2004, art. 12(1).

77. Suspensions may be imposed at the request of an authorized firm, or by the DFSA's own initiative if: (1) the firm in question is in breach of conditions or restrictions on its license, (2) in breach of DFSA-administered laws or regulations, (3) no longer fit and proper, or (4) suspension is desirable in the interests of the DIFC. DIFC LAW No. 1 OF 2004, art. 52(1)-(3).

78. Authorizations for specific activities in licenses and endorsements may be withdrawn at the request of an authorized firm, or by the DFSA's own initiative if: (1) the firm in question is in breach of conditions or restrictions on its license, (2) in breach of DFSA-administered laws or regulations, (3) no longer fit and proper, or (4) withdrawal is desirable in the pursuit of the DFSA's objectives. DIFC LAW No. 1 OF 2004, art. 50(1)-(3), DIFC LAW No. 13 OF 2004, art. 12(3). A license may be withdrawn if (1) as a consequence of the above, the firm is no longer authorized to carry on any financial service, (2) the firm is no longer fit or proper, (3) the firm failed to comply with a DFSA order regarding unacceptable controllers, or (4) if asked by the firm to withdraw its license. DIFC LAW No. 1 OF 2004, art. 51(1).

79. DIFC LAW No. 1 OF 2004, art. 75.

80. *Id.* at art. 75A.

81. *Id.* at ch. 5.

82. *Id.* at arts. 74(1)-(2).

83. *Id.* at arts. 73(1)-(2).

84. *Id.* at art. 78(1).

85. *Id.* at, art. 80.

Third, the DFSA has two tools to compel compliance before resorting to sanctions, which are: (1) to appoint a manager to a firm in order to address the solvency, transition of control, or liquidation of a firm, or in cases where it reasonably suspects the firm has contravened a law;⁸⁶ and (2) to accept a written agreement from a person, which may be enforced by a court order if breached.⁸⁷ The DFSA then has the power to impose certain sanctions for a contravention of a law, including: (1) a fine, (2) a censure, (3) restitution to a third party, (4) disgorgement of profits, (5) a cease and desist order, (6) an act to remedy the contravention, and (7) prohibiting a person from being employed by an authorized firm.⁸⁸

The exercise of the above powers by the DFSA, with a few exceptions,⁸⁹ is subject to review by the Financial Markets Tribunal (“FMT”) if challenged.⁹⁰ The FMT is a panel of lawyers experienced in financial services regulation that may not be staffed by anyone related to the DFSA.⁹¹ While the FMT appears to have been in existence since the creation of the DFSA, it is only recently that it has become the main body for reviewing decisions of the DFSA. Prior to amendments in 2014, this responsibility fell to the Regulatory Appeals Committee of the DFSA’s Board of Directors.⁹² The rationale for reallocating the powers of review appears to be that the FMT should be more independent and efficient at handling regulatory appeals than a committee of the board,⁹³ and this consolidation of authority is characterized as a positive development for the regulatory infrastructure in the DIFC.

Finally, the DFSA has two remedies that are supervised by the DIFC Courts rather than the FMT: (1) to obtain an injunction to prevent a contravention of a law or to minimize losses resulting from a contravention,⁹⁴ and (2) to require the liquidation of an authorized firm or someone carrying out unauthorized financial activities in the DIFC.⁹⁵

These powers complete a diverse toolkit that provides the DFSA with a range of options for enforcing compliance with securities and Islamic finance laws and rules, and the DFSA appears to have availed itself of them as needed. For instance in 2013, the DFSA commenced 10 investigations, received 3 enforceable written

86. *Id.* at art. 88.

87. *Id.* at art. 89.

88. *Id.* at art. 90.

89. Requests for information, an investigation and investigation-related powers, and written undertakings do not have a provision for FMT review.

90. DIFC LAW No. 1 OF 2004, art. 47(3), DIFC LAW No. 1 OF 2004, art. 49(4), DIFC LAW No. 1 OF 2004, art. 50(5), DIFC LAW No. 1 OF 2004, art. 51(3), DIFC LAW No. 1 OF 2004, art. 52(6), DIFC LAW No. 13 OF 2004, art. 11(7), DIFC LAW No. 13 OF 2004, art. 12(5), DIFC LAW No. 1 OF 2004, art. 74(8), DIFC LAW No. 1 OF 2004, art. 75(4), DIFC LAW No. 1 OF 2004, art. 75A(9), DIFC LAW No. 1 OF 2004, art. 88(5),

91. See DIFC LAW No. 1 OF 2004, art. 26; *Financial Markets Tribunal*, DFSA (last accessed Mar. 8, 2015), <http://www.dfsa.ae/Pages/AboutUs/WhoWeAre/BoardofDirectors/FMT.aspx>.

92. See, e.g., DFSA ANNUAL REPORT 2013 at 31 & 49 (2013).

93. See DFSA CONSULTATION PAPER No. 90 (Sep. 16, 2013) available at http://dfsa.complinet.com/net_file_store/new_rulebooks/d/f/DFSA_CP90.pdf.

94. DIFC LAW No. 1 OF 2004, art. 92.

95. *Id.* at art. 93.

agreements, imposed 1 fine, 1 notice of restriction, and 1 withdrawal of authorization.⁹⁶ In one interesting case, the DFSA obtained an injunction against individuals purporting to run a fictitious Dubai Options Exchange.⁹⁷

III. THREE MODELS FOR REGULATING SHARĪ'AH COMPLIANCE IN ISLAMIC FINANCE

Having laid out the regulatory infrastructure governing securities and Islamic finance in the Dubai International Financial Centre, this Section now explores different models of Islamic finance regulation that have been adopted by various jurisdictions and their relative costs and benefits. In particular, it looks to Islamic finance regulation in Malaysia and the U.S. and U.K. to draw out certain archetypes for the regulation of Sharī'ah compliance. It then compares these to the model of the DIFC in assessing their relative advantages and disadvantages.

A. *Towards a Typology of Islamic Finance Regulation*

The regulatory systems of the DIFC, Malaysia, and the U.S. and U.K. are chosen to exemplify three different models of Islamic finance regulation. For these purposes, this paper uses the terms (1) systems-based model, (2) centralized model, and (3) a model of competitive equality, derived in part from an International Organization of Securities Commissions (“IOSCO”) report on Islamic securities.⁹⁸

The term systems-based model, also taken from language used by the DFSA,⁹⁹ indicates an approach of regulating Sharī'ah compliance via certain procedural requirements, including monitoring, audit, and disclosure—without delving into questions on the interpretation of Sharī'ah with respect to a particular activity or transaction. As such the DFSA does not, and a regulator in a pure systems-based model would not, have a means of issuing its own *fatāwā* on Islamic financial activities. Instead, this responsibility falls to the Sharī'ah Supervisor Boards at the level of the various entities involved in an activity or transaction. As may be evident, this paper takes the DIFC as a prototype for the systems-based model.

Conversely, the term centralized model is used to describe an approach involving the presence of a single authority that can make a substantive determination on whether a particular financial activity or instrument is Sharī'ah-compliant. For instance, in Malaysia, although Islamic finance participants may need their own

96. DFSA ANNUAL REPORT 2013 at 1.

97. DIFC COURT OF FIRST INSTANCE, Case No. 1/2007.

98. IOSCO, *Analysis of the Application of IOSCO's Objectives and Principles of Securities Regulation for Islamic Securities Products* 17 (Sept. 2008), available at <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD280.pdf> (observing jurisdictions have adopted models of regulations that fall into: (1) a systems approach, (2) a centralized approach, (3) a conventional approach, and (4) other.). The term competitive equality is borrowed from the regulation of banks in the U.S., where the law recognizes a principle that state-chartered and federally-chartered banks should have equal competitive footing. See, e.g., Daniel R. Fischel et al., *The Regulation of Banks and Bank Holding Companies*, 73 VA. L. REV. 301, 335-37 (1987).

99. See DFSA, *supra* note 47.

Shari'ah Committees or Shari'ah Advisors, they must ultimately follow the *fatāwā* issued by the regulatory authorities as described below.

Finally, the model of competitive equality is used to describe approaches in Western jurisdictions that lack a separate regulatory system for Islamic finance,¹⁰⁰ instead aiming for equal treatment of Islamic finance and conventional finance—as described in the section on the U.S. and the U.K. below.

This breakdown of regulatory approaches is not mutually exclusive. For instance, Malaysia's requirement for Shari'ah Committees at the institutional level could be seen as a partial amalgamation of the systems-based and centralized models. Similarly, Bahrain, Kuwait, and the UAE (as distinguished from the DIFC), have national Shari'ah authorities in addition to institutional level SSBs—with the ability to issue *fatāwā* on matters where there is conflict among institution-level SSBs in the case of Kuwait and the UAE, and to issue purely advisory *fatāwā* in the case of Bahrain.¹⁰¹ This could be seen as incorporating elements of a centralized model.

Relatedly, the three models offered here may not be exhaustive, and it would be possible to adopt different classifications. For instance, one commentator distinguishes between five models: (1) a reactive approach in the U.K. and Turkey; (2) a passive approach, indicating the complete absence of a regulatory response, unique to Saudi Arabia; (3) a minimalist approach in the other GCC countries; (4) a pro-active approach in Malaysia; and (5) an interventionist approach, referring to the ability of the Pakistani Shari'ah Federal Court to make final rulings on Shari'ah matters despite the establishment of a national Shari'ah board at the State Bank of Pakistan.¹⁰²

This author considered but rejected such a typology—first, because terms such as “pro-active” and “minimalist” may give a misleading impression of regulatory attention to Islamic finance. Second, because the three models that form the focus of this paper, as evidence by the IOSCO report, aligned more closely with terminology used by regulators themselves.¹⁰³ And third, because it was felt that the systems-based and centralized model distinction allowed for a more analytically beneficial means of comparing the costs and benefits of different models.

B. THE CENTRALIZED MODEL IN MALAYSIA

As opposed to the approach of the DIFC described in Section II, Malaysia provides for centralized authorities to make substantive determinations on whether and how particular activities may comply with Shari'ah. The regulation of Islamic finance in Malaysia falls under the purview of two principal authorities: the Bank Negara Malaysia (the “**Bank**”)—Malaysia's Central Bank—and the Securities Commission of Malaysia (the “**Commission**”).¹⁰⁴ Both the Bank and the Commission

100. The term competitive equality is borrowed from the regulation of banks in the U.S., where the law recognizes a principle that state-chartered and federally-chartered banks should have equal competitive footing. See, e.g., Fischel et al., *supra* note 98.

101. See Grassa, *supra* note 6 at 341-42.

102. See Hasan, *supra* note 6, at 83-84.

103. See ISOCO, *supra* note 98.

104. With the exception of Labuan International Offshore Financial Centre. See, e.g., NIK NORZRUL THANI,

may issue compulsory guidelines on Sharī‘ah compliance,¹⁰⁵ and both have their own Sharī‘ah Advisory Council (“SAC”) for the purpose of advising and ruling on matters related to Islamic finance.¹⁰⁶

Generally, the Malaysian SACs are responsible for determining Sharī‘ah compliance with regards to different types of market actors. For instance, the SAC of the Bank has authority over “Islamic financial businesses,”¹⁰⁷ covering entities subject to laws enforced by the Bank.¹⁰⁸ This category includes a variety of Islamic Financial Institutions including Islamic banks, *takāful*

(Islamic insurance) operators, Islamic financial advisory businesses, and Islamic payment system operators.¹⁰⁹ Conversely, the SAC of the Commission has authority over “Islamic capital market businesses and transactions.”¹¹⁰ This category includes anyone issuing, listing, or offering securities, operating stock and derivatives markets, dealing in securities and derivatives, fund management, corporate finance advice, investment advice, financial planning, and private retirement schemes.¹¹¹

In particular, IFIs may refer matters to the SAC of the Bank for a ruling on whether its operations are Sharī‘ah-compliant.¹¹² Similarly, anyone licensed by the Commission including stock and derivatives exchanges, clearing and depository institutions, listed corporations, and any other person—for example issuers, underwriters or fund managers—may refer matters to the SAC of the Commission.¹¹³ These rulings are binding on the person referring the matter.¹¹⁴ Furthermore, courts and arbitrators must taken into account the published rulings of the SACs in proceedings brought before them, and where necessary, may refer matters to the SACs for a ruling.¹¹⁵ As with referrals by market actors, such rulings are then binding on the court or arbitrator.¹¹⁶ In fact, several cases have upheld the validity of referral to the SAC

LEGAL ASPECTS OF THE MALAYSIAN FINANCIAL SYSTEM 233-82 (2001). The Labuan IOFC was originally established by a combination of the following pieces of legislation: Offshore Banking Act 1990, Offshore Companies Act 1990, Labuan Trust Companies Act 1990, Labuan Offshore Business Activity Tax Act 1990, Offshore Insurance Act 1990, Income Tax Amendment Act 1990. *See id.* at 240. Its principal regulator is the Labuan Offshore Financial Services Authority. *See id.* at 236. *See also* LABUAN OFFSHORE FINANCIAL SERVICES AUTHORITY ACT 1996, art. 4. Labuan IOFC has its own securities and Islamic finance laws, which will not be discussed here. *See* LABUAN OFFSHORE FINANCIAL SERVICES AND SECURITIES ACT 2010, LABUAN ISLAMIC FINANCIAL SERVICES AND SECURITIES ACT 2010. Also, it should be noted that in some instances Malaysian laws apply in Labuan, *see, e.g.*, ISLAMIC FINANCIAL SERVICES ACT 2013, sec. 280.

105. CENTRAL BANK OF MALAYSIA ACT 2009, sec.59; CAPITAL MARKETS AND SERVICES ACT 2007, sec. 316 & 377 [hereinafter MALAYSIA ACT and CAPITAL MARKETS, respectively].

106. MALAYSIA ACT, *supra* note 105, at sec. 51 & 52; CAPITAL MARKETS, sec. 316A & 316B (AMENDED 2012).

107. MALAYSIA ACT, *supra* note 105, at sec. 51.

108. *Id.* at sec. 2.

109. *See, e.g.*, ISLAMIC FINANCIAL SERVICES ACT 2013, subd. 8 & sched. 2 pt. 1.

110. CAPITAL MARKETS, *supra* note 105, sec. 316.

111. *Id.* at sec. 2, 212 & sched. 2 pt. 1.

112. MALAYSIA ACT, *supra* note 105, at sec. 55(2).

113. CAPITAL MARKETS, *supra* note 108, at sec. 316E.

114. MALAYSIA ACT, *supra* note 105, at sec. 57; *Id.* at sec. 316G(a).

115. MALAYSIA ACT, *supra* note 105, at sec. 56; CAPITAL MARKETS, *supra* note 105, at sec. 316F.

116. MALAYSIA ACT, *supra* note 105, at sec. 57; CAPITAL MARKETS, *supra* note 105, at sec. 316G(b).

for a ruling, against objections that such referral was an unconstitutional usurpation of a court's power and that it violated a party's substantive right to call expert witnesses on Sharī'ah issues.¹¹⁷

Not unlike the Sharī'ah Supervisory Boards in the DIFC, IFIs must appoint a Sharī'ah Committee for the purposes of ensuring Sharī'ah compliance.¹¹⁸ Likewise, issuers of *ṣukūk*¹¹⁹ must appoint a Sharī'ah Advisor to issue a *fatwā* on whether a particular issuance complies with Sharī'ah.¹²⁰ However, unlike the autonomy provided to SSBs in the DIFC, Sharī'ah Advisors must ensure that the transaction complies with rulings of the SAC.¹²¹ To the extent that a *fatwā* given by the Sharī'ah Committee of an IFI or a Sharī'ah Advisor to the transaction is inconsistent with a ruling of the SACs, it is pre-empted by the SAC ruling and thus rendered invalid.¹²² Furthermore, the respective SACs must approve the appointment of a Sharī'ah Committee member¹²³ or the registration of a Sharī'ah Advisor,¹²⁴ as well as any new Islamic financial products (except for those that meet certain requirements for a "launch-and-file" system).¹²⁵

The ability of the SACs to issue binding rulings that actors making a referral (including courts and arbitrators) as well as Sharī'ah Committees and Advisors must follow, creates a uniform framework for the conduct of Islamic financial activities. The SAC resolutions on Islamic finance lay out not only the types of transactions deemed Sharī'ah-compliant, but may also contain substantive requirements or limitations for such transactions.¹²⁶

For example, the Bank's SAC resolutions lay out certain conditions for an "ijārah-plus-sale" (*al-ijārah thumma al-bay*) contract,¹²⁷ including that such a contract must include a "will purchase" clause for the asset at the end of the lease.¹²⁸

117. See Adnan Trakic, *The Adjudication of Sharī'ah Issues in Islamic Financial Contracts: Is Malaysian Islamic Finance a Litigation Solution?*, 29 HUMANOMICS 260, 272 (2013).

118. ISLAMIC FINANCIAL SERVICES ACT 2013, art. 30. See also SHARIAH GOVERNANCE FRAMEWORK FOR ISLAMIC FINANCIAL INSTITUTIONS (amended 2010) (discussing the cases of Tan Sri Abdul Khalid Ibrahim v. Bank Islam Malaysia Bhd., 3 CLJ 249 (2012) and Mohd Alias Ibrahim v. RHB Bank Bhd & Anor 4 CLJ 654 (2011)).

119. *Ṣukūk* is defined to mean securities issued following the principles of Sharī'ah. SUKUK GUIDELINES, art. 2.01 (amended 2014).

120. SUKUK GUIDELINES, sec. 5.01. These guidelines are compulsory and issued pursuant to CAPITAL MARKETS AND SERVICES ACT 2007, art. 377.

121. SUKUK GUIDELINES, sec. 5.01(c).

122. MALAYSIA ACT, *supra* note 105, at sec. 58; CAPITAL MARKETS, *supra* note 105, at sec. 316H.

123. BANK NEGARA MALAYSIA, GUIDELINES ON THE GOVERNANCE OF SHARIAH COMMITTEE, sec. 8 (2005).

124. SECURITIES COMMISSION, REGISTRATION OF SHARI'AH ADVISOR GUIDELINES, sec. 1.02 (Aug. 10, 2009).

125. See BANK NEGARA MALAYSIA, INTRODUCTION OF NEW PRODUCTS (Mar. 7, 2014); see also Tun Abdul Hamid Mohamad, *Malaysia as an Islamic Finance Hub: Malaysian Law as the Law of Reference & Malaysian Courts as the Forum for Settlement of Disputes* (Dec. 7, 2011) available at http://www.bnm.gov.my/index.php?ch=en_lhc&pg=lhc_newsroom&ac=979&lang=en.

126. See BANK NEGARA MALAYSIA, SHARIAH RESOLUTIONS IN ISLAMIC FINANCE, (2d ed. 2010); RESOLUTIONS OF THE SECURITIES COMMISSION SHARIAH ADVISORY COUNCIL (2007).

127. In an *ijārah* contract, the lender purchases the property and leases it to the borrower at a rate that economically resembles a conventional loan. At the end of the lease, the lender transfers the property to the borrower. See, e.g., EL-GAMAL, *supra* note 5 at 98-99.

128. BANK NEGARA SHARIAH RESOLUTIONS, *supra* note 126, at 3-4.

This illustrates a substantive requirement for a Sharī'ah-compliant transaction. The resolutions also provide for circumstances when parties may terminate an *ijārah* contract, for instance if the asset loses its usufruct.¹²⁹ This is an instance where the SAC has limited the rights of the transacting parties in accordance with Sharī'ah, since an inconsistent contractual provision would likely be pre-empted.

This example highlights how the SAC as a central authority, rather than the SSBs of various entities, is the final arbiter of the requirements and limitations imposed by Sharī'ah. By contrast, in the systems-based model, the SSBs of the relevant entities would determine substantive requirements or limitations on a transaction-by-transaction or activity-by-activity basis, and such requirements or limitations would need to be incorporated into the relevant transaction documents.

C. *The Model of Competitive Equality in the U.S. and the U.K.*

As a counterpoint to the systems-based and centralized models of the DIFC and Malaysia, Western jurisdictions like the U.S. and U.K. embody a third and distinct approach to the regulation of Islamic finance: competitive equality model. The overarching rationale of the U.S. and U.K. regulatory frameworks is to promote parity between conventional and Islamic finance.¹³⁰ While such a model aims to remove penalties and prohibitions that inhibit the practice of Islamic finance, it may lack sensitivity to additional Sharī'ah compliance requirements when contrasted with the more comprehensive models of regulation discussed above. It may also be that the competitive equality model necessarily incorporates a systems-based approach to some extent, since parties undertaking Islamic finance activities may need some variation of an SSB to supervise and make Sharī'ah compliance determinations as a practical matter.¹³¹

The various regulatory rulings, amendments, and court decisions described below suggest that the practice Islamic finance in Western jurisdictions may face challenges in three respects: (1) functional prohibitions on activities undertaken by certain financial institutions, like banks, (2) additional taxation due to the multiple steps involved in certain Islamic financial structures that are not present in their conventional counterparts, and (3) ensuring enforcement of contracts that attempt to follow Sharī'ah principles. To achieve equal footing between Islamic finance and conventional modes of finance, competitive equality requires that regulators in Western jurisdictions enable the permissibility and enforceability of Islamic finance

129. *Id.* at 6-7.

130. For instance, the U.K. Financial Services Authority (“FSA”) describes its goal as promoting a “‘level playing field’ in dealing with applications from conventional and Islamic firms.” FINANCIAL SERVICES AUTHORITY, *ISLAMIC FINANCE IN THE U.K.: REGULATION AND CHALLENGES* 11 (Michael Ainley et al. eds., Nov. 2007). See also Andrew Henderson, *Islamic Financial Institutions*, *ISLAMIC FINANCE: LAW AND PRACTICE* 54, 56 (Craig R. Nethercrott & David M. Eisenberg eds., 2012) (stating that the approach to regulation in the U.K. “rests on the principle of non-discrimination or equal treatment”).

131. See, e.g., *Sharia Compliance*, AL RAYAN BANK, (Mar. 8, 2015) <http://www.alrayanbank.co.uk/useful-info-tools/islamic-finance/sharia-compliance/#SSC>. The Al Rayan Bank, formerly the Islamic Bank of Britain, was the first approved Islamic bank in the U.K.

contracts, and specifically provide for equivalent taxation where ordinary law would entail additional levels of taxation.

Several amendments and regulatory rulings in the U.S. and the U.K. do indeed make Islamic finance contracts permissible. In the U.S., OCC Interpretive Letters #806 and #867, as well as N.Y. Department of Financial Services Banking Interpretations from 1999 and 2001, permit *ijārah*- and *murābahah*-based home financing, with the OCC also permitting *murābahah*-based commercial equipment and inventory financing.¹³² These interpretations confirm that properly structured *ijārah* and *murābahah* transactions would be included in the “business of banking.”¹³³ Relatedly, a U.S. bankruptcy court has approved in one instance a *murābahah*-based transaction, which allows a bankrupt debtor to exit bankruptcy, as a source of exit financing.¹³⁴

Similarly, in the U.K., the FSA has regulated *murābahah*-based home financing as Regulated Mortgage Contracts since 2004,¹³⁵ and *ijārah*- and diminishing *mushārakah*-based financing has been under regulation as Home Purchase Plans since 2007.¹³⁶ Additional amendments in 2010 allowed certain Islamic finance structures to avoid unintentionally being labelled a “collective investment scheme,” thereby restricting to whom such products could be offered.¹³⁷

The above rulings and amendments enhanced clarity about the permissibility of certain Islamic finance activities under U.S. and U.K. law and brought them within the purview of regulators.¹³⁸ Even more important to the success of Islamic finance in

132. OCC INTERPRETIVE LETTER #806 (Dec. 1997), OCC INTERPRETIVE LETTER #867 (Nov. 1999), NY DFS BANKING INTERPRETATION (Apr. 12, 1999), NY DFS BANKING INTERPRETATION (Aug. 27, 2001). For a brief description of an *ijārah* contract, see *supra* note 127. In a *murābahah* contract, the lender purchases the property and resells it to the borrower at a mark-up, to be paid in instalments, that economically reflects conventional interest rates. See, e.g., EL-GAMAL, *supra* note 5 at 67-68.

133. Under 12 U.S.C. § 24(7), which lays out what activities are permissible for federally chartered banks (“national banks”) to engage in, and N.Y. BANKING L. § 96(1), which does the same for N.Y. state-chartered banks.

134. In re Arcapta Bank B.S.C. et al., 2013 WL 3789388 (Bkrcty. S.D.N.Y., May 27, 2013).

135. See FINANCIAL SERVICES AUTHORITY, MORTGAGES: CONDUCT OF BUSINESS RULES, ann. 1 (amended 31 Oct., 2004). The rules were promulgated pursuant to authority granted in FINANCIAL SERVICES AND MARKETS ACT 2000 (REGULATED ACTIVITIES) ORDER 2001, arts. 25B & 61 (amended 2014).

136. See MORTGAGES AND HOME FINANCE: CONDUCT OF BUSINESS SOURCEBOOK ch. 2.6A (amended Apr. 6, 2007). The rules were promulgated pursuant to authority granted in FINANCIAL SERVICES AND MARKETS ACT, 2000, (REGULATED ACTIVITIES) ORDER 2001, art. 25C & 63F. See also FINANCIAL SERVICES AUTHORITY, JUST THE FACTS ABOUT HOME PURCHASE PLANS (Sep. 2007), available at http://webarchive.nationalarchives.gov.uk/20080814090308/moneymadeclear.fsa.gov.uk/pdfs/home_purchase_plans_ink.pdf. In a diminishing *mushārakah* contract, the lender and the borrower purchase property as a partnership with the lender owning the bulk of the partnership interest, and the borrower buys out the lender over time in payments that economically resemble a conventional loan. *Id.*

137. This was done by creating a category of Alternative Finance Investment Bonds which would be exempt from the definition of collective investment schemes. FINANCIAL SERVICES AND MARKETS ACT 2000 (REGULATED ACTIVITIES) ORDER 2001, art. 77A. See also SIMON SINCLAIR ET AL., REGULATING *Sukuk* IN THE U.K.: THE NEW FRAMEWORK (CLIFFORD CHANCE, Jan. 27, 2010), http://www.cliffordchance.com/briefings/2010/01/regulating_sukukintheukthenewframework.html.

138. As one counterexample, it should be noted that *muḍārabah*-based deposit accounts have generally presented more problems for regulators due to the loss-sharing nature, given that banking laws generally provide that depositors are entitled to a return of the full amount of their deposits. See

these jurisdictions, however, is the removal of certain adverse tax consequences. For example, *ijārah* and *murābahah* transactions involve multiple sales of the same asset to create a Sharī'ah-compliant structure. With home-financing, each sale of a house would incur a discrete real estate transfer tax (known as Stamp Duty Land Tax in the U.K.). As such, those transactions would be taxed twice, whereas their conventional finance equivalents involve only a single asset sale and would be taxed once. Both the U.S. and U.K. have provided tax relief in various instances remove such redundancies, thereby taxing Islamic finance in the same manner as their conventional counterparts.¹³⁹

In addition to the issues of permissibility and taxation, parties to an Islamic finance contract often have struggle with the enforceability of the intended terms because there is generally no single, codified “Sharī'ah law” that can be enforced. Although legislators in the U.K. have promoted certainty through their explicit role in shaping the Islamic finance landscape, the U.K. scheme still suffers from some uncertainty. U.K. courts have held that a contract cannot subscribe to both U.K. law and Islamic law, and that Islamic law itself is not a valid choice of law given that the Rome Convention, which generally governs choice of law in Europe, applies to the choice between “laws of different countries.”¹⁴⁰ However, in at least one case, the parties created a triable issue by arguing that a non-Sharī'ah-compliant contract is *ultra vires*, or “beyond the powers” of U.K. jurisdiction. Because U.K. law provides that the law of the place of incorporation governs a corporation, the argument was that where the laws of the country of incorporation provide that non-Sharī'ah-compliant contracts are beyond the powers of the corporation, such contracts would be invalid in the U.K. as well.¹⁴¹ Conversely, where U.K. law is unambiguously applied, a supposedly Sharī'ah-compliant contract may be enforced on terms that appear to

ISLAMIC FINANCE IN THE U.K., *supra* note 130 at 14; Victoria Lynn Zyp, Islamic Finance in the United States: Product Development and Regulatory Adoption 18 (Apr. 21, 2009) (unpublished M.A. thesis, Georgetown University) available at <https://m.repositary.library.georgetown.edu/bitstream/handle/10822/552821/ZypVictoriaLynn.pdf?sequence=1>.

139. See N.Y. STATE DEPARTMENT OF TAXATION AND FINANCE ADVISORY OPINION TSB-A-08(2)R (28 Apr., 2008); FINANCE ACT 2003, art. 71A, 72, & 73B (amended by FINANCE ACT 2007). These amendments also removed the potential for a third tax when the lender sells or assigns their interest in the mortgage. See also UK SUKUK ISSUES AND SHARIAH-COMPLIANT SECURITIZATION: TAX ASPECTS, NORTON ROSE FULBRIGHT (Jun. 2008), <http://www.nortonrosefulbright.com/knowledge/publications/15508/uk-sukuk-issues-and-shariah-compliant-securitisation-tax-aspects>.
140. Beximco Pharmaceuticals Ltd. et al. v. Shamil Bank of Bahrain E.C. (2004) EWCA Civ 19, 40, 43 (emphasis added). See also Convention on the Law Applicable to Contractual Obligations arts. 1.1 & 3.1, June 19, 1980, O.J. (L 266) 1. This leaves open the question of whether a party could choose Sharī'ah law by choosing the law of a country where Sharī'ah law is in force. Furthermore, it should be noted that the Rome Convention has since been amended and the reference to “the laws of different countries” no longer appears in art. 1.1. Commission Regulation 593/2008, 2008 O.J. (L 177) 6. See also Julio C. Colón, *Choice of Law and Islamic Finance*, 46 Tex. Int'l L.J. 411, 424-27 (2011).
141. The Investment Dar Company KSCC v. Blom Development Bank SAL (2009) EWHC 3545, 16. The Investment Dar Company was incorporated in Kuwait and one of its articles of incorporation stated the company could not practice any non-Sharī'ah compliant activities. *Id.* at 3. However, even if the plaintiff ultimately lost the issue of whether the contract in question was *intra vires*, it would have had little outcome on the case since he would have been entitled to a restitutionary remedy. *Id.* at 21.

violate well-established principles of Sharī'ah,¹⁴² undermining confidence in the market for Islamic finance.

In the U.S., results differ across states. However, at least one court decided a case according to Islamic law where the parties had formed a contract under Saudi Arabian choice of law. Finding that a Saudi Arabian court would apply Islamic law, a federal district court in New Jersey applied the principle of *gharar* to preclude expectation damages because the expected value of the contract was uncertain.¹⁴³ Sharī'ah-based arbitration in the U.S. provides an even more direct route to enforcement of Islamic law contracts¹⁴⁴ because courts will generally enforce agreements to arbitrate and resulting awards. States have upheld agreements to arbitrate “according to the Islamic rules of law,”¹⁴⁵ and similarly-worded agreements.¹⁴⁶

Thus, judicial rulings in the U.S. and U.K. have occasionally created inconsistency and uncertainty for Islamic finance. However, with respect to the issues of permissibility and taxation, the model of competitive equality in these countries

142. For instance in a *murābahah* transaction where the lender had purchased diamonds for the borrower and the diamonds were lost in transit to the borrower, the lender was nevertheless entitled to installment payments from the borrower because the contract provided that the borrower would remain obligated to pay even in the event of a failure to deliver—such a result would normally contravene the notion that the lender must retain the risk of asset ownership until sold to the borrower, which is what makes the *murābahah* transaction permissible under Sharī'ah. Islamic Investment Company of the Gulf (Bahamas) Ltd v. Symphony Gems N.V. & Ors, 2002 WL 346969 (Q.B. Com. Ct. Feb. 13, 2002). See Kilian Bälz, *A Murābahah Transaction in an English Court: The London High Court of 13th February 2002 in Islamic Investment Company of the Gulf (Bahamas) Ltd. v. Symphony Gems N.V. & Ors*, 11 ISLAMIC L. & SOC. 117 (2004).

143. The court, relying on expert testimony, used a well-known *ḥadīth* as a basis for its decision, stating that: “it is clear to this Court that in Saudi Arabia, the Board of Grievances would not award damages based on Plaintiff’s valuation of the Projects Department. To do so would be equivalent to placing a value on fish in the sea, or purchasing food that has not yet been weighed.” Nat’l Grp. for Commc’ns & Computers, Ltd. v. Lucent Technologies Int’l, Inc., 331 F. Supp. 2d 290, 301 (D.N.J. 2004). The court did not, and this paper will not, address the argument that the application of a religious law by a court violates the First Amendment. See Colón, *supra* note 140, at 429-30.

144. See Colón, *supra* note 140. See also Andrew White, *Dispute Resolution and Specialized ADR for Islamic Finance*, ISLAMIC FINANCE: LAW AND PRACTICE 306 (Craig R. Nethercrott & David M. Eisenberg eds., 2012) for an interesting discussion on the possibility of an arbitration procedure based on Sharī'ah.

145. *Jabri v. Qaddura*, 108 S.W.3d 404, 412 (Tex. App. 2003). See also Colón, *supra* note 140, at 427-28.

146. Although *Jabri* was based on a Texas arbitration statute, Tex. Civ. Prac. & Rem. Code Ann. § 171.001 (West), other states are likely to rule the same way since state legislation not enforcing arbitration is pre-empted by the Federal Arbitration Act. 12 U.S.C. §2; *Southland Corp. v. Keating*, 465 U.S. 1 (1984). Recently, there have been many instances of states trying to, and several instances of states passing, amendments “banning” foreign law; however, such amendments are unlikely to substantially alter the *status quo* since they are generally qualified by references to existing statutory and constitutional rights, and because the federal arbitration statutes would likely pre-empt. See, e.g., the Alabama constitution stating that “[a] court, arbitrator, administrative agency . . . shall not apply or enforce a foreign law if doing so would violate any state law or a right guaranteed by the Constitution of this state or of the United States.” Ala. Const. § 13.50. See also Liz Farmer, *Alabama is the Latest State to Try to Ban Foreign Law in Courts*, GOVERNING THE STATES AND LOCALITIES (Aug. 29, 2014), <http://www.governing.com/topics/politics/gov-is-alabamas-proposed-foreign-law-ban-anti-muslim.html>.

generally allows Islamic finance transactions on an equivalent footing with their conventional counterparts.

D. *The Costs and Benefits of Different Approaches*

The centralized model in Malaysia and the model of competitive equality in the U.S. and U.K. have their respective advantages and disadvantages for regulators, issuers, and investors when compared to the systems-based model in the DIFC. These models vary across the following dimensions: (1) transaction and monitoring costs, (2) innovation and customization, (3) need for qualified scholars, and (4) effectiveness in ensuring Sharī'ah compliance.

Generally speaking, transaction costs capture the payments to financial, legal, and Sharī'ah advisors to structure and draft documents for a transaction, whereas monitoring costs pertain to ongoing oversight of activities by an SSB or other compliance personnel. These costs are likely to be lowest for Islamic finance participants within a centralized model because of the model's relative standardization. Because the relevant SAC makes binding determinations on questions of Sharī'ah compliance in Malaysia, it perpetuates a uniform understanding of Islamic finance and thereby drives down compliance costs.¹⁴⁷ These cost reductions result from, *inter alia*, the ease of finding precedential documents, the ease of negotiation, and the ease of finding or training Sharī'ah compliance personnel. Participants also face less risk that an activity will be deemed non-compliant, sometimes termed "Sharī'ah risk."¹⁴⁸

Although standardization via the use of precedential transactions is also a potential cost-saver in the systems-based model, the systems-based model in the DIFC is still more expensive due to added costs of hiring SSBs and advisors in those countries.¹⁴⁹ Similarly, to the extent that a model of competitive equality would require, in practice, various entity-level SSBs and advisors to structure and approve a transaction, it is likely to have higher costs as well. Standardization in a centralized model may account for the relatively large size of the Malaysian domestic market, and particularly its ability to handle small- and mid-cap issuances that would be cost-prohibitive in a jurisdiction like the DIFC.¹⁵⁰

Conversely, a centralized determination of Sharī'ah compliance reduces opportunities and incentives for individual parties to innovate in the transaction-structuring process, and makes it more difficult for parties to customize the transaction to the needs of a specific issuer or investor. In a systems-based model, parties are able to make their own determinations of Sharī'ah compliance, allowing for a greater

147. This view was expressed by various practitioners in interviews. Interview Notes (on file with author).

148. See Nikan Firoozye, *Tawarruq: Shariah Risk or Banking Conundrum?*, OPALESQUE (Jul. 3, 2009), http://www.opalesque.com/OIF112/Featured_Structure_Tawarruq_Shariah_Risk_or_Banking438.html.

149. *Id.*

150. Interview Notes (on file with the author). These issuances are for smaller amounts of funds, meaning that transaction costs of hiring bankers, lawyers, and scholars would comprise a larger part of the amount being raised—thereby making them uneconomical.

innovation and customization in each transaction.¹⁵¹ This freedom similarly allows parties to cater transactions more specifically to individual issuers or investors. The popularity of the DIFC for international issuers and investors, in spite of the higher transaction costs, may be due in part to this greater ability to innovate and customize. To the extent that a model of competitive equality would rely on SSBs and advisors, it is likely to possess the same potential for innovation and customization.

On the other hand, the need for qualified scholars on SSBs may uniquely present additional challenges for systems-based and competitive equality models. In these models, scholars must be capable of issuing their own opinions rather than simply complying with the *fatāwā* of a national authority or referring controversial issues to the national authority. Such scholars must be experts in Islamic law and also have some knowledge of finance, should ideally be fluent in Arabic and English, and must possess sufficient reputational capital such that other scholars respect their *fatāwā*.¹⁵² The scarcity of qualified scholars has led to a limited number of scholars sitting across enormous numbers of SSBs.¹⁵³ Where one scholar sits across, and is paid by, two or more sides of a transaction, the potential for conflicts of interests is significant,¹⁵⁴ as is the risk that scholars will be unable to exercise due diligence by virtue of being stretched too thin.¹⁵⁵

The requirement of an SSB could also have the effect of discouraging one-time or occasional issuers of Islamic securities, where, for example, it would not make economic sense to appoint a permanent SSB as opposed to a temporary Shari'ah Advisor, given the costs that may be associated with maintaining an additional board-level body in the issuer's governance structure. However, this issue appears to have been largely mitigated by the advent of Shari'ah advisory firms, which maintain a qualified SSB that can serve as a one-time board for a transaction.¹⁵⁶ Although some

151. Practitioners consistently mentioned innovation as a benefit of the DIFC approach. *Id.*

152. For a great discussion of the challenges in meeting the need for qualified scholars, see Sayd Farook & Mohammad Omar Farooq, *Shari'ah Governance, Expertise and Profession: Educational Challenges in Islamic Finance*, 5 INT'L J. ISLAMIC FIN. 137 (2013).

153. See David Bassens et al., *Setting Shari'a Standards: On the Role, Power and Spatialities of Interlocking Sharia Boards in Islamic Financial Services*, 42 GEOFORUM 94, 99 (2011) (showing that 97 scholars created 583 interlocking relationships between boards); FUNDS@WORK, *The Small World of Islamic Finance* 8 (Oct. 5, 2010), http://ae.zawya.com/researchreports/p_2009_10_01_11_50_15/2_0101006_p_2009_10_01_11_50_15_062625.pdf (noting that the top 10 scholars hold 450 of 1141 board positions, and the top 100 account for 953). The AAOFI, an international standard setting body, is considering proposals for guidelines limiting the number of boards scholars may sit on. Dana El Baltaji & Haris Anwar, *Scholar on More Than 50 Boards Opposes Limits: Islamic Finance*, BLOOMBERGBUSINESS (Nov. 23, 2010), <http://www.bloomberg.com/news/articles/2010-11-23/shari-ah-scholar-on-more-than-50-boards-opposes-limit-plan-islamic-finance>.

154. See, e.g., Matthias Casper, *Sharia Boards and Sharia Compliance in the Context of European Corporate Governance* 11 (2012), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2179412. The issue of conflicts of interest is discussed more in detail later in this subsection.

155. Farook & Farooq, *supra* note 152, at 143.

156. See, e.g., Humayon Dar, *Models of Sharia Advisement in Islamic Finance*, GULFBASE (Aug. 16, 2008), <http://www.gulfbase.com/newarticles/specialarticledetail/372>; *Sharia Documentation and Fatawa*, DAR AL SHARIA, <http://daralsharia.ae/sharia-documentation-and-fatawa/> (last visited Mar. 8, 2015). Dar Al Sharia, a subsidiary of the Dubai Islamic Bank, was mentioned by practitioners as the predominant Shari'ah advisory firm in the DIFC. Interview Notes (on file with the author).

practitioners were hopeful that Shari'ah advisory firms could help fill the growing need for qualified Shari'ah scholars, the proliferation of low-quality Shari'ah advisory firms, with a few well-established exceptions, has undermined its potential impact on supply.¹⁵⁷ Additionally, the mere existence of Shari'ah advisory firms cannot single-handedly address the shortage of scholars where the pipeline for such scholars is the limiting factor.

Finally, in competitive equality jurisdictions, the lack of Shari'ah-specific regulation may result in lower levels of compliance. Although no one understanding of which activities comply with Shari'ah exists, loose Shari'ah interpretations can manifest in lower levels of compliance, and outright misrepresentations of a transaction may result in an affirmative compliance determination where a large majority of jurists would consider an activity non-compliant. In jurisdictions without explicit rules addressing standards for how Shari'ah could or should be interpreted by scholars, such scholars would face only reputational penalties for certifying as compliant those transactions that most jurists deem non-compliant.

Similarly, the systems-based model may also be weaker than a centralized model in ensuring Shari'ah compliance. Most significantly, commentators have suggested that because clients select arbiters who are most likely to make affirmative Shari'ah-compliance determinations, arbiters may make determinations based not on bona fide opinions but rather financial pressure to maintain popularity with clients.¹⁵⁸ Some commentators, most notably El-Gamal, have further argued that this leads to a broader phenomenon of Shari'ah arbitration, where:

“[B]ankers, lawyers and jurists commonly start with an existing conventional product . . . replacing its various conventional components that are deemed un-Islamic with others that can be presented to the public and defended as Islamic . . . In many cases, the contemporary practice marketed under some premodern Arabic name bears only very superficial similarity to the premodern financial practice discussed in classical jurisprudence.”¹⁵⁹

This problem is further exacerbated by the potential for *fatwā*-shopping, where a client contemplating a transaction shops around for a scholar willing to approve the transaction.¹⁶⁰

Although these concerns are very real for a systems-based model (and a model of competitive equality, to the extent it relies on SSBs as a practical matter), there are a few mitigating factors not often discussed in the literature. First, scholars face countervailing incentives due to the need to maintain their reputational capital. The *fatwā* of a scholar who is known to issue opportunistic opinions is likely to face higher scrutiny from other scholars, reducing demand for that scholar's services.

157. Interview Notes (on file with the author). See also Humayon Dar, *The Future of Sharia Advisory*, GULFBASE (Aug. 30, 2009), <http://www.gulfbase.com/newarticles/specialarticledetail/411> (arguing for the regulation of Shari'ah advisory firms).

158. See, e.g., Farook & Farooq, *supra* note 152, at 140-41.

159. EL-GAMAL, *supra* note 5, at 11-12. He further argues that the additional costs imposed in fees for bankers, lawyers, and jurists in Shari'ah arbitration reduces efficiency (reducing total social welfare). *Id.* at 11.

160. Farook & Farooq, *supra* note 152, at 152.

Furthermore, in a transaction between sophisticated parties, not only the SSB of the issuer, but also the SSBs of the underwriters and investors will need to be satisfied that a contemplated transaction is Shari'ah compliant. The presence of multiple SSBs should have the effect of constraining opportunistic *fatāwā* in the issuance of Islamic securities. Relatedly, practitioners described the ultimate structure of an Islamic finance transaction as a negotiated outcome between the scholars and the other parties,¹⁶¹ meaning that there was some give and take in order to reach a mutually agreeable form rather than pure opportunistic behavior by issuers. For instance, a scholar could have the issuer restructure parts of the transaction in order to be satisfied that the transaction would in fact be Shari'ah-compliant.

Second, to the extent that the Islamic capital markets of different jurisdictions are themselves engaged in a competition to attract issuers and investors, they may have incentives to relax their interpretation of Shari'ah principles. For instance, organized *tawarruq*, a very controversial transactional structure in Islamic finance,¹⁶² is permissible and widely used in Malaysia.¹⁶³ Just as competition between scholars reinforces the concern that interpretation of Shari'ah principles will be relaxed, competition between jurisdictions may result in centralized model jurisdictions adopting interpretations of Shari'ah principles that are no more strict than systems-based jurisdictions.

Therefore, although the centralized model appears more effective in terms of ensuring Shari'ah compliance, one might expect that the difference is not large in practice. Consequently, a systems-based model might be seen as sacrificing cost-effectiveness and efficient use of scholars for greater innovation and customization. A similar distinction might apply to a model of competitive equality when compared to a centralized model, except that on the whole the model of competitive equality is likely to be the least effective in ensuring compliance with Shari'ah.

However, jurisdictions are subject to political or economic constraints in their choice of models. Regulators in Western jurisdictions may not have the authority to create a fully-functioning regime for the regulation of Islamic finance, and their legislatures are unlikely to change the status quo given the current political climate.¹⁶⁴

161. Interview Notes (on file with the author).

162. In a *tawarruq* transaction, the bank purchases a commodity other than gold or silver, sells it to the borrower at a deferred price marked-up to reflect conventional interest, and the borrower sells the commodity in the market to obtain the desired liquidity. In organized *tawarruq* the bank handles this final step of sale to a third-party as an agent for the borrower—a form traditionally deemed impermissible. See, e.g., EL-GAMAL, *supra* note 5, at 69-70. See also Rafe Haneef, *Is the Ban on "Organised Tawarruq" the Tip of the Iceberg?* (2009), <http://kantakji.com/media/7310/b107.pdf> (discussing the ban on organised *tawarruq* by the International Islamic Fiqh Academy of the Organisation of the Islamic Conference). The Fiqh Academy is one of two international *fatwā* issuing bodies for Islamic finance, the other being the Shari'ah board of the AAOIFI. See, e.g., WILSON, *supra* note 62, at 228.

163. See Nikan Firoozye, *Tawarruq: Shariah Risk or Banking Conundrum?* OPALESQUE (Jul. 3, 2009), http://www.opalesque.com/OIF112/Featured_Structure_Tawarruq_Shariah_Risk_or_Banking438.html. See also BANK NEGARA MALAYSIA, *SHARIAH RESOLUTIONS IN ISLAMIC FINANCE* (2d ed., 2010) at 96.

164. In this respect, the U.K. can be seen as much more receptive to Islamic finance than the U.S., since

Consequently, their aim may justifiably be to establish equal treatment between Islamic and conventional finance. By contrast, jurisdictions like Malaysia and the DIFC have few political constraints in explicitly regulating Islamic finance, and have thus been able to implement more comprehensive regimes. Even without political constraints, economic forces may play a significant role in the choices these jurisdictions make between systems-based and centralized models.

A comparison between Malaysia and Dubai illuminates that the two markets cater strongly to different types of issuers and investors. Between 2001 and 2014, Malaysia accounted for a massive 78% of domestic *ṣukūk* issuances globally, whereas the UAE represented only 1.5% of domestic *ṣukūk*.¹⁶⁵ Conversely, the UAE accounted for 39% of international *ṣukūk* issuances compared to 14% for Malaysia, and was the biggest player in the international *ṣukūk* market (also surpassing Saudi Arabia at 18%).¹⁶⁶ Domestic *ṣukūk* is denominated in local currency and therefore likely to be attractive to domestic issuers and investors, whereas international *ṣukūk* is denominated in a hard currency like U.S. dollars, and is therefore likely to be attractive to international issuers and investors.¹⁶⁷ Thus, Malaysia's success may be attributable in part to the incredible depth of its domestic market, whereas the UAE's success may hinge more on its attractiveness to international issuers and investors.

The implication is that jurisdictions relying on international issuers and investors may be more likely to adopt a systems-based model, whereas jurisdictions relying on domestic issuers and investors may be more likely to adopt a centralized model. While domestic issuers and investors may show deference to their national authorities in the interpretation of Sharī'ah, international issuers and investors may prefer more autonomy—and in fact, may be driven away by a national authority trying to assert its interpretation of Sharī'ah. For instance, it is unclear whether an interpretation by a national-level Sharī'ah board in the UAE, let alone the DIFC, would be accepted by international issuers and investors as determinative. A systems-based model eliminates the risk that a determination by a centralized authority might alienate such international clientele. Furthermore, such national-level determinations of Sharī'ah may not be as useful to international issuers and investors in any event, since they are likely to end up litigating disputes in a different forum applying different law.¹⁶⁸

One quick gauge of whether a jurisdiction relies, or intends to rely, on domestic or international issuances may be its population, since more populous countries are likely to have deeper domestic markets. It is telling that countries with sizeable

the U.K. legislature has passed several Islamic finance-specific amendments—legislative action on Islamic finance is probably a nonstarter in the current U.S. political climate. *See, e.g., supra* note 146 for a discussion of states enacting anti-foreign law amendments.

165. INTERNATIONAL ISLAMIC FINANCE MARKET, *Sukuk Report: A Comprehensive Study of the Global Sukuk Market* (4th ed., 2014), <http://www.iifm.net/documents/iifm-sukuk-report-4th-edition>.

166. *Id.* at 15.

167. *Id.* at 116.

168. *See, e.g.,* Beximco Pharmaceuticals Ltd. et al. v. Shamil Bank of Bahrain E.C. (2004) EWCA Civ. 19 (U.K.), *supra* note 140.

populations like Malaysia, Sudan, and Pakistan have opted for centralized models,¹⁶⁹ whereas the less populous GCC countries like Bahrain, Kuwait, Qatar and the UAE have opted for systems-oriented models.¹⁷⁰ Any debate over regulatory choices must consider the political and economic constraints imposed by the circumstances of a particular jurisdiction on what may be feasible, and perhaps more importantly what may be successful. The following Section will argue that these constraints are likely to create path-dependency in the regulation of Islamic finance.

IV. IMPLICATIONS FOR LEGAL TRANSPLANTS, CONVERGENCE AND COMPETITION

A final contribution to the state of academic literature from an examination of the Dubai International Financial Centre relates to the discussion of legal transplants, convergence, and regulatory competition. Legal transplantation describes the phenomenon of rules or systems of law moving from one country to another.¹⁷¹ Similarly, legal convergence alludes to the notion that globalization would lead regulatory systems to move towards a single, most effective form due to competitive forces.¹⁷² Relatedly, scholars have debated whether competition between regulators promotes stricter or laxer standards, leading to a “race to the top” or a “race to the bottom.”¹⁷³

It can be a sensible approach to analyze these concepts together. For instance, to the extent that regulators are engaged in a race to the top or the bottom, one might expect competitive forces to drive convergence towards the highest or lowest common denominator. Furthermore, to the extent that transplantation is spurred

169. See, e.g., MOHAMED BEN YOUSSEF, EXISTING CENTRAL SHARIAH SUPERVISORY MODELS (last visited Mar. 9, 2015), https://www.academia.edu/4689012/Existing_Central_Shariah_Supervisory_Models.

170. See, e.g., Grassa, *supra* note 6.

171. See ALAN WATSON, LEGAL TRANSPLANTS: AN APPROACH TO COMPARATIVE LAW (1974); *but cf.* Pierre Legrand, *The Impossibility of ‘Legal Transplants’*, 4 MAASTRICHT J. EUR. & COMP. L. 111 (1997) (arguing that because the way rules are given meaning depends inevitably on culture, changes in the law on the books does not really result in legal transplants).

172. See, e.g., Ronald J. Gilson, *Globalizing Corporate Governance: Convergence of Form and Function*, 49 AM. J. COMP. L. 329 (2001); *cf.* John C. Coffee Jr., *The Future as History: The Prospects for Global Convergence and Its Implications*, 93 NW. U. L. REV. 641 (1999) (arguing that path dependency prevents convergence); Lucian Bebchuk & Mark Roe, *A Theory of Path Dependence in Corporate Ownership and Governance*, 52 STAN. L. REV. 127 (1999) (laying out a theory for why ownership structures are path dependent); *but see* Henry Hansmann & Reinier Kraakman, *The End of History for Corporate Law*, 89 GEO. L. REV. 439 (2000) (arguing that a large degree of convergence had already occurred by the nineteenth century).

173. See, e.g., John C. Coffee Jr., *Racing Towards the Top?: The Impact of Cross-Listings and Stock Market Competition on International Corporate Governance*, 102 COLUM. L. REV. 1757, 1811-14 (2002) (discussing theories for why competition between exchanges on corporate governance standards might lead to a race to the top or the bottom); Howell E. Jackson, *Centralization, Competition, and Privatization in Financial Regulation*, 2 THEORETICAL INQUIRIES L. 649, 650-54 (2001) (discussing the state of the literature on whether competition between states on corporate law is a race to the top or the bottom); Steven Huddart et al., *Disclosure Requirements and Stock Exchange Listing Choice in an International Context*, 26 J. ACCT. & ECON. 237 (1999) (predicting a race to the top in stock exchange disclosure requirements); Shelley Thompson, *The Globalization of Securities Markets: Effects on Investor Protection*, 41 INT’L LAW 1121, 1123-26 (2007) (arguing that globalization has led to a race to the bottom among securities markets).

by efficiency considerations, one might expect regulatory systems to converge¹⁷⁴—whereas if transplantation is dependent on political or social factors,¹⁷⁵ one might expect a greater degree of path-dependency.

This debate of convergence versus path-dependence has not left the topic of Islamic finance untouched,¹⁷⁶ and an analysis of the DIFC demonstrates that two types of legal transplants are likely to drive convergence with respect to Islamic financial markets: (1) the imitation of well-developed securities markets, even if non-Islamic, with respect to securities rules, and (2) the adoption of international standards with respect to Sharī'ah compliance rules. These two venues of direct legal transplantation and international harmonization are more generally in line with the way other commentators have conceived of forces for reform.¹⁷⁷

With respect to securities regulation in the DIFC, regulators actively sought to model certain provisions after U.K. and E.U. rules, or sometimes other jurisdictions where appropriate.¹⁷⁸ In fact, the securities regulation provisions of the DIFC bear a close resemblance to some of the provisions in the U.K. and the E.U. For instance, the DIFC and the U.K. have substantially similar definitions of “inside information” as information of a precise nature related to an investment which is not generally available and would be likely to have a significant effect on the price of the investment or related investment,¹⁷⁹ and similarly exempt commodity derivatives from the inside dealing provisions.¹⁸⁰ The U.K. also had at one time a Financial Services and Markets Tribunal, not too dissimilar to the DIFC’s Financial Markets Tribunal, for hearing appeals of regulatory decisions.¹⁸¹ In addition, the E.U. Prospectus Directive contains similar exemptions from prospectus requirements for offers made to fewer than 100 persons, offers to investors acquiring at least 100,000 EUR, or offers of securities denominated in at least 100,000 EUR.¹⁸² Likewise, the distinction between debt and equity securities as manifested by the special treatment for director liability in the case of debentures may be derived from the E.U. model of securities regulation.¹⁸³

174. See, e.g., Ugo Mattei, *Efficiency in Legal Transplants: An Essay in Comparative Law and Economics*, 14 INT’L REV. L. ECON. 3, 16-18 (1994).

175. See, e.g., Frederick Schauer, *The Politics and Incentives of Legal Transplantation* (2000).

176. See, e.g., ALI A. IBRAHIM, CONVERGENCE OF CORPORATE GOVERNANCE AND ISLAMIC FINANCIAL SERVICES INDUSTRY (2006) (arguing that convergence with modern corporate governance standards is likely in the market for Islamic finance), http://schlarhsip.law.georgetown.edu/gps_papers/3.

177. See Stephen J. Choi, *Law, Finance, and Path Dependence: Developing Strong Securities Markets*, 80 TEX. L. REV. 1657, 1696 (2001) (stating that “[c]ountries can choose to deploy legal protections transplanted from another country . . . “[or] “choose to harmonize their regulations with other countries seeking to establish a unified form of regulation.”).

178. Interview Notes (on file with the author) (regulators also mentioned Hong Kong and Singapore as relevant jurisdictions).

179. FINANCIAL SERVICES AND MARKETS ACT 2000, art. 118C; DIFC LAW No. 1 OF 2012, art. 63.

180. FINANCIAL SERVICES AND MARKETS ACT 2000, art. 118C; DIFC LAW No. 1 OF 2012, art. 58(2).

181. See FINANCIAL SERVICES AND MARKETS ACT 2000, art. 132-33. This Tribunal was abolished in 2010 and its authority was transferred to the Upper Tribunal. TRANSFER OF TRIBUNAL FUNCTIONS ORDER 2010.

182. Council Directive 2001/34/EC, art. 3, 2003 O.J. (L. 345) 64, 69 (EU) (amended 2012).

183. See Felicia H. Kung, *The Regulation of Corporate Bond Offerings: A Comparative Analysis*, 26

With respect to Islamic finance rules, regulators had looked to standards issued by international bodies including IOSCO, the Islamic Financial Stability Board (“IFSB”) and the Accounting and Auditing Organization for Islamic Financial Institutions (“AAOIFI”) for guidance.¹⁸⁴ Although these standards are not statutes enacted by any sovereign entity, and so would not lead to transplantation in the sense of one legal system being imitated by another, they nevertheless represent one set of rules being emulated by another jurisdiction. A good example may be the definition of Islamic Windows provided by IFSB guidelines,¹⁸⁵ which surfaces in the regulation of Islamic Windows in the DIFC.¹⁸⁶ International bodies may also facilitate transplantation by providing a forum for regulators to establish dialogue and share best practices.¹⁸⁷

The prevalence of transplants is one reason to suspect that convergence will occur in the market for Islamic finance.¹⁸⁸ This may be true if jurisdictions continue to adopt international standards—commentators discussing convergence with respect to Islamic securities markets have considered international institutions to be drivers of convergence.¹⁸⁹ Furthermore, the experience of the DIFC and its emulation of the U.K. and Europe suggests that the imitation of already developed Western capital markets may be a strong force for convergence, at least with respect to securities regulations that are not specific to Islamic finance. Especially for jurisdictions relying on international issuers and investors, such transplants may further attract their target clientele, some of whom may be more familiar with Western rules.

To the contrary, path-dependency could be expected to persist with respect to Islamic finance rules. Although international standards appear to promote convergence, the model of Sharī‘ah compliance that is adopted appears contingent on political and socioeconomic factors. As described previously, Western regulators may face significant political constraints on what they are able to accomplish. They

U. Pa. J. Int’l Econ. L. 409, 428 (2005) (distinguishing the EU’s differentiated treatment between debt and equity with the U.S., where debt securities have the same types of requirements as equity securities).

184. See Interview Notes (on file with the author); see also Henderson, *supra* note 130, at 57-59 (for a discussion of these bodies).

185. See IFSB, GUIDANCE ON KEY ELEMENTS IN THE SUPERVISORY REVIEW PROCESS OF INSTITUTIONS OFFERING ISLAMIC FINANCIAL SERVICES 12-13 (2007) available at <http://www.ifsb.org/standard/ifsb5.pdf>.

186. See *supra* Section II.C; note 49.

187. See, e.g., IFSB ET AL., DISCLOSURE REQUIREMENTS FOR ISLAMIC CAPITAL MARKET PRODUCTS (2013) available at <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD428.pdf>.

188. One caveat here is that an analysis of the empirical literature demonstrates that mere transplantation of laws or harmonization may not be effective. Choi, *supra* note 177, at 1701-02. Instead, the way the laws on the books play out in practice may be crucial. For instance, it was the *enforcement*, not *adoption*, of insider trading laws that had a statistically significant effect on the cost of equity. See Uptal Bhattacharya & Hazem Daouk, *The World Price of Insider Trading*, 57 J. Fin. 75 (2002); see also Berkowitz et al., *The Transplant Effect*, 51 AM. J. COMP. L. 163 (2003) (showing that countries that transplanted unfamiliar laws without adapting them to local conditions underperformed countries that were familiar with transplanted laws or adapted them to local conditions). In this respect, there is much to be said about the DIFC’s practice of hiring common law trained judges.

189. See Ibrahim, *supra* note 176, at 9 (stating that “[a]s these institutions emerge and develop, standardization is likely to follow.”).

may have neither the authority nor the political incentive to adopt a centralized or a systems-based regulation for Islamic finance. Consequently, to the extent they choose to regulate Islamic finance, a model of competitive equality may be the only acceptable outcome.

By contrast, certain jurisdictions like the DIFC may cater to international issuers and investors because of their limited domestic market. As discussed in Section III, these jurisdictions may find that a systems-based model is the only sensible choice, given that international clientele may not agree with, nor benefit from, a national determination of what constitutes Sharī'ah compliance. Conversely, jurisdictions with deep domestic markets for Islamic finance, especially populous Muslim countries, may find that a centralized model makes the most sense because it achieves a greater level of certainty and standardization for issuers and investors. To the extent these economic forces prevail, different jurisdictions are unlikely to converge towards a single model for the regulation of Islamic finance.

Finally, the experience of the DIFC and its emulation of well-developed capital markets like the U.K. and E.U. suggest that markets for Islamic finance may be engaged in a race to the top rather than to the bottom. As regulators in developing markets seek to adopt international best practices and emulate well-developed markets, one would expect regulation to improve across the board. With regards to regulatory competition, however, it may be more difficult to draw analogies from the experience of one jurisdiction. In particular, some commentators have argued that a separating equilibrium might prevail, with some markets racing towards the top and some markets racing towards the bottom—leading to fragmentation rather than conformity.¹⁹⁰ If this is true, the experience of one market may be evidence of only one half of the separating equilibrium, with other markets racing towards the bottom.

Nevertheless, there is reason to think that a race to the top may be the most sensible interpretation, at least with respect to markets of greater economic significance. The argument for a separating equilibrium suggests that an important determinant of a race to the bottom scenario may be the presence of captive domestic issuers and captive domestic investors.¹⁹¹ Unlike domestic issuers and investors, international issuers and investors are by definition more mobile in their selection of securities markets, and may be drawn to jurisdictions providing sophisticated regulation.

For a developing market with free capital flows, it may be quite difficult to rely on domestic issuers and investors being captive. Not only might domestic opportunities be limited, increasing the need to attract an international clientele, the most successful companies and the wealthiest investors may prefer to issue or invest abroad if the domestic market is underdeveloped. In that vein, the literature has found that

190. See, e.g., John C. Coffee Jr., *Competition Among Securities Markets: A Path Dependent Perspective* at 6-7 (Colum. L. Sch. L. & Econ. Working Paper No. 192), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=283822; see also Stephen J. Choi & Andrew T. Guzman, *National Laws, International Money: Regulation in a Global Capital Market*, 65 *Fordham L. Rev.* 1855, 1874-82 (1977) (arguing that heterogeneous investors, issuers, and countries will lead to the persistence of different regulatory regimes).

191. See Choi & Guzman, *supra* note 195 at 1881-82 (discussing whether a pooling or separating equilibrium prevails depends in part on the mobility of issuers and the mobility of investors).

jurisdictions with poor investor protection tend to have smaller capital markets.¹⁹² Thus, even if some regulators may be engaged in a race to the bottom, those jurisdictions are less likely to be of economic significance.

The DIFC, with its larger appeal to international issuers and investors, is a good example of how a sophisticated regulatory infrastructure goes hand in hand with increased global significance. Indeed, even commentators discussing a separating equilibrium tend to agree that the dominant effect may be a race towards the top.¹⁹³ Given this state of affairs, it may be safe to say that the experience of the DIFC lends support for the proposition that Islamic securities markets are likely engaged in a race to the top, at least in proportion to their global economic significance.

V. CONCLUSION

Beginning with a technical exposition of the laws and regulations in Dubai, this paper used the model of Shari‘ah compliance in the Dubai International Financial Centre to compare the costs and benefits of three different approaches to the regulation of Islamic finance: a systems-based model, a centralized model, and a model of competitive equality. It then drew out the implications of the experience of the DIFC for the notions of legal transplants, convergence, and regulatory competition. It is hoped that this paper will not only add to the state of academic knowledge about the functioning of securities and Islamic finance regulation in the DIFC, but that it will add to a larger debate about the costs and benefits of different models of Shari‘ah regulation and to the discussion of these comparative law notions.

192. See La Porta et al., *Legal Determinants of External Finance*, 52 J. FIN. 1131 (1997).

193. Coffee, *supra* note 190, at 4 (stating that “[t]his article agrees that strong legal standards tends to attract, rather than repel.”). See also Howell E. Jackson & Eric J. Pan, *Regulatory Competition in International Securities Markets*, 56 Bus. L. 653 (2001) (showing that despite the ability of issuers to choose between high- and low-disclosure regimes, few firms chose the latter).

