EXHIBIT 4(a)

SHARI'AH'S "BLACK BOX": CIVIL LIABILITY AND CRIMINAL EXPOSURE SURROUNDING *SHARI'AH*-COMPLIANT FINANCE

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 Thanks and appreciation are due first to Professor Robert J. Loewenberg, president and founder of IASPS, who has been my teacher and mentor in matters of the greatest import for more than 30 years. Special appreciation is due to Frank J. Gaffney, Jr., the head and founder of CSP who has been generous in his support of my work and policy-legal counsel. All errors and opinions are, of course, the author's alone.

I. INTRODUCTION

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

Unfortunately, the history of the legal and accounting professions in guiding clients through the hazards of novel and complex transactions has been poor.[2] Perhaps nowhere is this more evident than in the professional treatment of *Shari'ah*-compliant finance (SCF), the practice of investing in conformity with Islamic law. In just the past three decades, financial institutions and finance-driven businesses have entered into countless SCF transactions, facilitated by their attorneys, accountants, and financial advisors. Due in part to the dependence of the SCF industry on *Shari'ah* authorities associated with the call for violent *Jihad* against the West, these transactions could potentially expose the parties involved to

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[1] The post-Enron "Sarbanes-Oxley" world is the recent result of this failure. *See, e.g.*, Harvey J. Goldschmid, Comm'r, Sec. & Exch. Comm'n, Address at the Third Annual A.A. Sommer, Jr. Corporate Securities & Financial Law Lecture: Post-Enron America: An SEC Perspective (Dec. 2, 2002), *available at* http://www.sec.gov/news/speech/spch120202hjg.htm.

[2] Beyond the Enron-era, the financial world is in the midst of the subprime mortgage securitization industry meltdown. *See, e.g.*, Ben S. Bernanke, Chairman, Fed. Reserve, Address at the Economic Club of New York, The Recent Financial Turmoil and its Economic and Policy Consequences (Oct. 15, 2007), *available at* http://www.federalreserve.gov/newsevents/speech /bernanke20071015a.htm. This meltdown is already being compared to the debacle of the savings & loan crisis. *See* Mike Larson, *The New Savings and Loan Crisis*, MONEY AND MARKETS, Nov. 27, 2007, http://www.moneyandmarkets.com/issues.aspx?Savings-and-loan-crisis-special-report-1224; *see also* Amy Waldman, *Move Over, Charles Keating — Causes of The Savings and Loan Scandal*, WASH. MONTHLY, May 1995, *available at* http://findarticles.com/p/articles/mi_m1316/ is_n5_v27/ai_16947718 (providing a retrospective on the "causes" of the savings and loan crisis).

significant civil and criminal liability in areas as diverse as securities fraud, sedition, antitrust, and racketeering. The lesson professionals should have learned from the past—but appear not to have, given what can only be described as the blind exuberance driving SCF—is that huge profits and explosive growth, massive public relations and marketing efforts, and popular appeal in the financial industry do not establish even a minimal baseline for legal compliance.

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

This article examines *Shari'ah*-compliant finance in light of existing U.S. law. It highlights and examines areas of civil liability and criminal exposure unique to SCF investments and transactions[3] in the United States as they have been developed and utilized by various financial institutions and facilitated and promoted by legal, accounting, and financial professionals.[4] Part II provides an introduction to SCF and explains why it should be subject to special scrutiny by lawyers, accountants, and other professional advisers. Part III discusses the role of the professional in SCF transactions and suggests an analytical framework for approaching the legal issues surrounding SCF in the U.S. This framework divides the world of potential liability into two groups: liability arising out of elements endogenous to SCF, involving issues about what *Shari'ah* actually is and requires, and liability arising out of elements exogenous to SCF, such as the impact of Western adaptations of *Shari'ah* principles. Part IV focuses in detail on the former, while Part V examines legal concerns related to the latter.

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[3] The distinction made throughout this article between an SCF "investment" and "transaction" is intended and important in this context. SCF expresses itself in fundamentally two ways: (a) "the investment" refers to the kind of investment or business *Shari'ah* is understood to permit (i.e., equity versus debt with interest; asset-based versus intangibles such as derivatives or hedging transactions based upon future contingencies; and commerce in permitted versus prohibited industries), and (b) "the transaction" refers to the way in which a permitted investment or business transaction is structured, typically through the use of nominate contracts (i.e., a loan with interest may be structured as an "interest-free" cost-plus sale or sale/lease back). *See infra* notes 172–174.

[4] This article uses the term "facilitator" (or in some cases "professional facilitator") to mean the range of legal, accounting, and financial advisor professionals who are intimately involved in the promotion and structuring of SCF investments and transactions. An example of this burgeoning cottage industry can be gleaned by looking at the promotional material for the myriad professional and business conferences dedicated to SCF. *See, e.g.*, Arab Bankers Association of North America, Related Events, http://www.arabbankers.org/shared/layouts/section.jsp?_event=view&_id=120130_U127360__132301 (last visited Sept. 12, 2008) (advertising events about Islamic finance).

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

Several traits of the SCF industry are particularly problematic. First, and most troubling, is the *Shari'ah* "black box" syndrome in which U.S. financial institutions and businesses involved in SCF risk grave consequences by willfully

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[5] While it is not the purpose of this article to detail the legal risks for the professional facilitators, there is substantial legal exposure for the legal, accounting, and financial professionals who provide the knowledge and expertise to develop the financial and legal instrumentalities of SCF. While "scheme liability" under a Rule 10b-5 private right of action has arguably been put to rest by the Supreme Court, to the extent that the lawyers get involved in drafting the "representations," liability will still apply. *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 128 S. Ct. 761, 770–74 (2008); *see* LOUIS LOSS & JOEL SELIGMAN, FUNDAMENTALS OF SECURITIES REGULATION 1329–32 (5th ed. 2004) (discussing "primary liability" for lawyers under Rule 10b-5); *id.* at 1465–69 (discussing the duty to report evidence of a material violation under Part 205 to Title 17 of the Code of Federal Regulations promulgated by the SEC pursuant to Section 307 of the Sarbanes-Oxley Act of 2002).

[6] This conclusion has been reached by a thorough review of the published proprietary and non-proprietary information disseminated by many of the financial institutions and the professional facilitators (i.e., the law firms, accounting firms, and financial advisors who promote SCF as a business model and marketing niche) and of the published academic and trade journals which have treated SCF in some detail over the past decade. *See* Islamic Finance Project, Sponsors, http://ifptest.law.harvard.edu/ifphtml/index.php?module=sponsors (last visited Sept. 12, 2008). Some of this material will be referenced throughout this article as its relevance to disclosure, due diligence, compliance, industry standards, and best practices are examined. Harvard's Islamic Finance Project ("IFP"), housed at the Harvard Law School, is an example of the legal profession's wholesale neglect of the legal risks and exposure associated with SCF. *See* Islamic Finance Project Homepage, http://ifptest.law.harvard.edu/ifphtml/index.php (last visited Sept. 18, 2008). Financially sponsored by various overseas Islamic banks and financial houses, the IFP has held eight separate multi-day forums over an eleven-year period and has produced a myriad of publications considered some of the most erudite on the subject. *See id.*, Islamic Finance Project, Conferences and Seminars, http://ifptest.law.harvard.edu/ifphtml/index.php?module=confsem (last visited Sept. 12, 2008). But not one single article or book produced by IFP or its scholars addresses in any substantive fashion the civil liability and criminal exposure inherent in a financial system built on a theo-legal system with intimate connections to Islamic terrorism and its call for the destruction of Western political and economic systems SCF considers heretical. *See* Islamic Finance Project, Conferences and Seminars, http://ifptest.law.harvard.edu/ifphtml/index.php?module=confsem (last visited Sept. 12, 2008).

ignoring the endogenous elements of *Shari'ah*.[7] Ignoring what *Shari'ah* is—both in theory and in practice—and its intimate connection to Islamic terror and *Jihad* against[8] the non-Muslim world amounts to corporate recklessness. Moreover, placing *Shari'ah* in a black box and treating its prohibitions as if they were benign, secular, and objective "screens" ignores the duty to disclose the most important elements of *Shari'ah*: its purposes and its ultimate methods.[9] Based on the materiality standards of contemporary securities and fraud laws, it is clear that a reasonable post-9/11 investor would consider *Shari'ah*'s connection to the Law of *Jihad* and the advocacy of violence and connection to terrorism by some of the world's leading *Shari'ah* authorities as material to their investment decision.

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

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

This analysis is a first of its kind in the published literature. To date, there has been no focused effort to identify and analyze the implications for civil liability and criminal exposure for U.S. financial institutions and other businesses engaged in any of the various manifestations of SCF. While some of the SCF professional and scholarly writings address broad regulatory concerns,[10] economic risks,[11] and

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[7] *See infra* Part IV.

[8] *Jihad* has a specific meaning in the *Shari'ah* literature. It has been translated as closer to "just war" than to "holy war" but most properly it applies to any political or violent struggle by Muslims to defend their realm or to expand it. *See* RUDOLPH PETERS, JIHAD IN CLASSICAL AND MODERN ISLAM: A READER 27–42 (2d ed. 2005); *infra* note 199.

[9] *See infra* notes 95–96 and accompanying text.

[10] *See generally* JOHN WILEY & SONS, ISLAMIC FINANCE: THE REGULATORY CHALLENGE (Simon Archer & Rifaat Ahmed Abdel Karim eds., 2007) [hereinafter ISLAMIC FINANCE] (discussing regulatory concerns); Ayman H. Abdel-Khaleq, *Offering Islamic Funds in the US and Europe*, INT'L FIN. L. REV., May 2004, at 55, *available at* http://www.iflr.com/?Page=17&ISS=16434&SID=515350 (concluding that "[d]espite regulatory burdens some of the world's most sophisticated commercial and legal jurisdictions are increasingly addressing the needs of Islamic investors").

transactional[12] and market-related hurdles,[13] scant attention has been paid to the specific civil and criminal liability implications of SCF. Necessarily, this is an introductory and preliminary effort.[14] Each specific area identified in this article requires and deserves a detailed treatment by academics and legal professionals, including government attorneys involved in financial regulation and compliance, policy specialists, and—most importantly—practitioners advising their clients on the advisability and the logistics of SCF.

II. OVERVIEW OF SHARI'AH-COMPLIANT FINANCE

A. What Is SCF?

According to the disclosures and representations of the financial institutions currently promoting SCF,[15] *Shari'ah* compliance means that a particular investment or financial transaction has been conducted or structured in a way that is considered "legal" or "authorized"[16] pursuant to Islamic law.[17] Compliance with

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[11] *See generally* EDINBURGH UNIVERSITY PRESS, THE POLITICS OF ISLAMIC FINANCE (Clement M. Henry & Rodney Wilson eds., 2004) [hereinafter POLITICS] (focusing on connections between Islamist finance and political movements); IBRAHIM WARDE, ISLAMIC FINANCE IN THE GLOBAL ECONOMY (2000) (focusing on the political and economic aspects of modern Islamic finance).

[12] *See generally* Michael J.T. McMillen, *Contractual Enforceability Issues:* Sukuk *and Capital Markets Development*, 7 CHI. J. INT'L L. 427 (2007) (discussing the developing Islamic capital market).

[13] *See generally* Jane Pollard & Michael Samers, *Islamic Banking and Finance: Postcolonial Political Economy and the Decentring of Economic Geography*, 32 TRANSACTIONS INST. BRIT. GEOGRAPHERS 313 (2007) (offering a post-colonial critique of Islamic banking and finance).

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

[15] A good yet basic recitation of SCF is provided by a U.S. Muslim academic who was the "Scholar-in-Residence: U.S. Department of Treasury" on SCF. *See* MAHMOUD AMIN EL-GAMAL, A BASIC GUIDE TO CONTEMPORARY ISLAMIC BANKING AND FINANCE (2000), http://www.ruf.rice.edu/~elgamal/files/primer.pdf.

[16] In classical and traditional Islamic law, extant and in use to this day by the recognized *Shari'ah* authorities, there are essentially five categories of normative assessments: obligatory, recommended, permitted, discouraged, and forbidden. LALEH BAKHTIAR, ENCYCLOPEDIA OF ISLAMIC LAW: A COMPENDIUM OF THE VIEWS OF THE MAJOR SCHOOLS xxxvii–xxxviii (adapted by Laleh Bakhtiar 1996) [hereinafter ENCYCLOPEDIA].

[17] While *Shari'ah* is often referred to as Islamic law, *Shari'ah* is, according to the *Shari'ah* authorities, the divine law of Allah which is articulated directly to man through the *Qur'an* and indirectly through the canonical stories of Mohammed's life as told through the *Hadith*. *See* Bernard Weiss, *Interpretation in Islamic Law: The Theory of Ijtihād*, 26

Shari'ah is achieved by having a *Shari'ah* authority—either an individual or group of individuals possessing authoritative status in matters relating to SCF[18]—approve the particular investment or type of transaction. Most financial institutions retain[19] a *Shari'ah* advisory board, which typically consists of three or more "*Shari'ah* scholars" who profess to be recognized as authorities in SCF.[20]

According to most financial institutions, SCF is achieved by the avoidance of interest,[21] risk (typically understood as uncertainty or speculation),[22] and certain

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AM. J. COMP. L. 199, 199–201 (1978). The jurisprudential rules developed by the *Shari'ah* authorities over time to arrive at finite legal rulings are often referred to as *usul al fiqh* or the roots of the law and *al fiqh* or just *fiqh* is the *corpus* of jurisprudential rules and principles. *See* FRANK E. VOGEL & SAMUEL L. HAYES, III, ISLAMIC LAW AND FINANCE: RELIGION, RISK, AND RETURN 299, 304 (1998). *Furu'* is the term used for the positive law rulings of individual jurists. *See infra* note 43. For purposes of this article, the word *Shari'ah* is used as a collective term to include all of these elements unless otherwise indicated.

[18] There is no universally recognized degree or examination to acquire the status of an SCF authority. Generally, the discipline in *Shari'ah* related, in part, to commerce is termed *fiqh al muamalat* and, while there are jurists who specialize in this area, the qualifications for such positions are quite varied. While the industry itself is undertaking to create standards and structures for uniformity and transparency, it has not been successful to date. An examination of these issues can be found in Wafik Grais & Matteo Pellegrini, *Corporate Governance and* Shariah *Compliance in Institutions Offering Islamic Financial Services*, 1–3 (World Bank Policy Research Working Papers, Paper No. 4054, 2006), *available at* http://www.wds.worldbank .org/servlet/WDSContentServer/WDSP/IB/2006/11/08/000016406_20061108095535/Rendered/PDF/wps4054.pdf.

[19] The manner in which a *Shari'ah* advisor is employed or contracted for by the financial institution bears on several of the legal complications and risks discussed herein. *See infra* notes 318–325 and accompanying text (discussing criminal *respondeat superior*); *see also supra* note 17 and accompanying text.

[20] *See* VOGEL & HAYES, *supra* note 17, at 48–49. The number of *Shari'ah* scholars sufficiently versed in the disciplines necessary to be gainfully employed by "blue chip" financial institutions engaged in SCF is quite limited. It is generally represented that there are only about 20 competent *Shari'ah* scholars who have mastered *Shari'ah*, finance, and English well enough to be considered both an SCF scholar and employable. Richard C. Morais, *Don't Call It Interest*, FORBES.COM, July 23, 2007, http://www.forbes.com/business/global/2007/0723/104.html. For the general problem of the dearth of qualified *Shari'ah* scholars, see Grais & Pellegrini, *supra* note 18, at 7–8 & nn.17–18.

[21] In Arabic, the term used is *riba*, which literally means "increase." MERVYN K. LEWIS & LATIFA M. ALGAOUD, ISLAMIC BANKING xi (2001). In the past, there has been debate among *Shari'ah* authorities and Islamic academic scholars over the prohibition against *riba* in financial and commercial transactions. *Id.* at 34–38. Some scholars point to the fact that the prohibition against interest in the *Qur'an* is not simple interest but usurious interest and specifically a default interest prevalent in pagan pre-Islamic Arabia. *Id.* Today, the debate is academic because there is broad consensus that interest of all kinds is forbidden by *Shari'ah*. *Id.* For the consensus view of the prohibition against interest, see VOGEL & HAYES, *supra* note 17, at 77–87. *But see* TIMUR KURAN, ISLAM & MAMMON:

types of prohibited industries (relating to activities considered *haram* or "forbidden," such as the pork and alcohol-beverage industries, pornography, gambling, and interest-based financing).[23] In addition, SCF also includes a focus on "purification," which has two separate elements.[24] One is a form of obligatory charitable contribution called *zakat*, where the act of supporting the less fortunate is considered a spiritual purification;[25] the other is the purification of a *Shari'ah*-compliant investment or financial transaction that has been tainted with forbidden

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THE ECONOMIC PREDICAMENTS OF ISLAMISM 14 (2004) (advancing a contrary position that the prohibition on interest was geared more toward social purposes, such as preventing enslavement of debtors, than in fulfilling a prohibition of the *Qur'an*); Alex Alexiev, *Islamic Finance or Financing Islamism?* 6–7 (The Center for Security Policy, Occasional Papers Series No. 29, 2007) (reflecting on the most reactionary elements of Islam and its reflection in *Shari'ah*). For a discussion of how contemporary SCF has perverted the underlying "Islamic" principles of *Shari'ah* relative to social economics, see generally Mahmoud A. El-Gamal, *"Interest" and the Paradox of the Contemporary Islamic Law and Finance*, 27 FORDHAM INT'L L.J. 108 (2003); Chibli Mallat, *The Debate on Riba and Interest in Twentieth Century Jurisprudence*, *in* ISLAMIC LAW AND FINANCE 69–85 (Chibli Mallat ed., 1988).

[22] The *Qur'an* forbids gambling or *maysir*; the *Sunna* includes *gharar* or risk in the prohibition. VOGEL & HAYES, *supra* note 17, at 87–88. Since all business includes an element of risk, the jurisprudential task for the *Shari'ah* authorities is to take the specific examples found in the canonical literature, such as "[d]o not buy fish in the sea, for it is *gharar*," and to translate that command into principles, then rules, and finally into finite rulings and contract forms which are considered *halal* or permitted. *See generally* VOGEL & HAYES, *supra* note 17, at 87–95 (discussing the prohibitions related to risk).

[23] NIZAM YAQUBY, FOURTH HARVARD ISLAMIC FINANCE FORUM: HARVARD UNIVERSITY, PARTICIPATION AND TRADING IN EQUITIES OF COMPANIES WHICH MAIN BUSINESS IS PRIMARILY LAWFUL BUT FRAUGHT WITH SOME PROHIBITED TRANSACTIONS 21 (2000), http://www.djindexes.com/mdsidx/downloads/yaquby.pdf. While there is general agreement about most of these industries as absolutely forbidden, some such as the tobacco business and military and defense industries are typically forbidden in SCF in Western countries but not considered an absolute *Shari'ah* prohibition. For an exploration into the *Shari'ah* motives for forbidding defense industry investments in the West, see *infra* notes 323–324 and accompanying text.

[24] YUSUF TALAL DELORENZO, *SHARI'AH* SUPERVISION OF ISLAMIC MUTUAL FUNDS 4–5, http://www.djindexes.com/mdsidx/downloads/delorenzo.pdf (last visited Sept. 13, 2008).

[25] *See id. Zakah* (sometimes referred to as *zakat*), which literally means purification, is a form of religious tax for assisting the less fortunate and those that "struggle for Allah." The amount is between 2.5% and 20%, depending upon the source of the wealth, but it is typically on the lower end (2.5%) of the scale. The amounts also vary based upon which of the four Sunni schools of jurisprudence one follows. Shi'a Muslims also follow their own jurisprudence, which accounts for some of the variation. For a fuller discussion of this religious tax and its use to support those who "struggle for Allah" or fight against non-Muslims in holy war (i.e., *Jihad*), see generally John D.G. Waszak, *The Obstacles to Suppressing Radical Islamic Terrorist Financing*, 36 CASE W. RES. J. INT'L L. 673 (2004).

revenue, whether from interest, illicit speculation, or a forbidden commercial enterprise such as the pork industry.[26] In the latter meaning of purification, the forbidden funds must be disgorged by donating the money to an acceptable charity, but this charitable gift will not count towards a Muslim investor's *zakat* requirement.[27]

A rudimentary understanding of *Shari'ah* is required to grasp the implications of SCF relative to U.S. law. To begin, *Shari'ah*, or the "proper way," is considered the divine will of Allah as articulated in two canonical sources.[28] The first is the *Qur'an*, which is considered the perfect expression of Allah's will for man.[29] Every word is perfect and unalterable except and unless altered by some subsequent word of Allah.[30] While most of the *Qur'an*'s 6,236 verses[31] are not considered legal text, there are 80 to 500 verses[32] considered instructional or sources for normative law. However, the *Qur'an* is only one source of Allah's instruction for *Shari'ah*. The *Hadith*[33]—stories of Mohammed's life and

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[26] For an extended discussion on purification by a well-known American *Shari'ah* authority, see generally DeLorenzo, *supra* note 24 (linking and distinguishing between the charitable tax called *zakah*, which literally means purification, and the spiritual or moral purification of illicit profits).

[27] Yusuf Talal DeLorenzo, Dow Jones University Questions and Answers, Question 32, http://www.central-mosque.com/fiqh/dow.htm (last visited Sept. 13, 2008).

[28] *See supra* note 17.

[29] *See* HARVARD UNIVERSITY PRESS, THE ISLAMIC SCHOOL OF LAW: EVOLUTION, DEVOLUTION, AND PROGRESS viii (Peri Bearman, Rudolph Peters & Frank E. Vogel eds., 2005) [hereinafter ISLAMIC SCHOOL OF LAW].

[30] For a thorough discussion from a "moderate" *Shari'ah* authority on the full theological and jurisprudential analysis of *Shari'ah*, see generally MOHAMMAD HASHIM KAMALI, PRINCIPLES OF ISLAMIC JURISPRUDENCE (3d ed. 2003). For the specific discussion of "abrogation," which is the juridical view of latter *Qur'an*ic verses that contradict earlier ones, see generally *id.* at 202–27. For an analytical and "objective" analysis of Islamic jurisprudence and its implications for Muslim-non-Muslim relations, see STEPHEN COLLINS COUGHLIN, "TO OUR GREAT DETRIMENT": IGNORING WHAT EXTREMISTS SAY ABOUT JIHAD (WITH APPENDICES) 83–133 (2007), http://www.strategycenter.net/docLib/20080107_Coughlin_ExtremistJihad.pdf.

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

[32] WAEL B. HALLAQ, A HISTORY OF ISLAMIC LEGAL THEORIES 3, 10 (1997) (noting that Muslim jurists and scholars generally agree that there are "500 verses with legal content"). There is also a healthy debate over which verses in the *Qur'an* are actually legal sources (*ayat al-ahkam*) such that laws are directly or indirectly derived from them. According to most scholars, the debate centers on the context of the appearance of a verse which has within it a connection to normative or instructional language. Some include all such verses while others only count those verses which are clearly "legal" in that they address authorized or prohibited behavior. *See* KAMALI, *supra* note 30, at 25–27.

[33] *Hadith* is singular for "tradition." *Ahadith* is the plural. This article uses *Hadith* as the collective body of traditions.

behavior—are also considered a legal and binding authority for how a Muslim must live.[34] The *Hadith* were collected by various authors in the early period after Mohammed's death.[35] Over time, Islamic legal scholars vetted the authors for trustworthiness and their *Hadith* for authenticity, and there is now a general consensus across all Sunni schools that there are six canonical *Hadith*.[36] The legal or instructional portions of the *Hadith* together make up the *Sunna*.[37] While the

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[34] *See* MARSHALL G. S. HODGSON, 2 THE VENTURE OF ISLAM: CONSCIENCE AND HISTORY IN A WORLD CIVILIZATION 453 (1974).

[35] *See* KAMALI, *supra* note 30, at 5.

[36] The *Hadith* were not formally collected until approximately 100 to 200 years after the death of Mohammed. *See* ISLAMIC SCHOOL OF LAW, *supra* note 29, at viii–xii (discussing the informal process by which *Hadith* were originally handed down, and the impact on Islamic law and scholarship of collecting the *Hadith*); *see also* Coughlin, *supra* note 30, at 55–56 n.90 (describing the passing on of the *Hadith*).

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

Id.

[37] ISLAMIC LEGAL THEORIES, *supra* note 32, at 1–35 (analyzing the "formative period" of *Shari'ah* and the transformation from custom, to Prophetic normative instruction, to the basis for Islamic law through the development of the *Hadith*); *see also* NOAH FELDMAN, THE RISE AND FALL OF THE ISLAMIC STATE 23–27 (2008) (characterizing the *Hadith* as one of the "bas[es] for a legal system"). The debate over the role the *Hadith* should play as the secondary basis for *Shari'ah* is in fact the debate between the traditionalists who follow the millennium-old doctrine of the Islamic legal schools versus the progressives, typically in academia. The former account for the "*Shari'ah* authorities"

Shari'ah authorities from the Shi'a Muslim world also accept the *Hadith* as authoritative, they do not accept certain authors' authority—a belief based mostly upon theological grounds.[38] For all *Shari'ah* authorities, however, the *Qur'an* is considered the primary and direct revelation of Allah's will, while the *Sunna* is the indirect expression of that will and secondary.[39] Both sources are generally considered absolutely infallible and authoritative.[40]

In order to divine the detailed laws, norms, and customs for a Muslim in all matters of life, the *Shari'ah* authorities over time developed schools of jurisprudence to guide their interpretations of the *Qur'an* and *Sunna*. While there is broad agreement among the schools about the jurisprudential rules, important distinctions between the schools result in different legal interpretations and rulings, albeit typically differences of degree, not of principle.[41] The rules of interpretation

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and the latter for university professors who wish to distance themselves and Islam from the quite bellicose legal-military doctrines derived from the *Hadith*. The subject is fascinating and rich with drama but not one this article can take up. The interested reader should begin with Coughlin, *supra* note 30, at 83–133, and then turn to one of the founders of the academic study of *Shari'ah* and Islamic jurisprudence, Joseph Schacht. A must-read for anyone interested in the subject is JOSEPH SCHACHT, AN INTRODUCTION TO ISLAMIC LAW (1982) [hereinafter SCHACHT, ISLAMIC LAW], and JOSEPH SCHACHT, MUHAMMADAN JURISPRUDENCE (1950) [hereinafter SCHACHT, MUHAMMADAN JURISPRUDENCE]. Revisionists abound and two interesting versions are ISLAMIC LEGAL THEORIES, *supra* note 32, and WAEL B. HALLAQ, THE ORIGINS AND EVOLUTION OF ISLAMIC LAW (2005) on the one hand; and M. MUSTAFA AL-AZAMI, ON SCHACHT'S ORIGINS OF MUHAMMADAN JURISPRUDENCE (1996) on the other hand. Useful also would be KAMALI, *supra* note 30.

[38] Shi'a Islam differs from Sunni Islam theologically on whom they consider to be legitimate successors to Mohammad's reign as leader of the Muslim *Umma* or nation; this difference has jurisprudential consequences because Shi'a Muslims, who await the return of the Twelfth Imam or Caliph following Mohammed, consider their Imams who have followed in the Twelfth Imam's footsteps to be his stand-in until his return and as such they share his infallibility. *See* FELDMAN, *supra* note 37, at 128–29; Coughlin, *supra* note 30, at 237–39. Thus, the leading contemporary Shi'a Imams are considered by their followers as inerrant and their legal rulings take on the perfection one would expect from inerrant beings. *See* Coughlin, *supra* note 30, at 27 & n.52.

[39] M. Cherif Bassiouni & Gamal M. Badr, *The Shari'ah: Sources, Interpretation, and Rule-Making*, 1 UCLA J. ISLAMIC & NEAR EASTERN L. 135, 138–39 (2002).

[40] *See id.* at 141 & n.12, 151, 171.

[41] As noted, the *Shari'ah* authorities developed different schools of legal interpretation. These schools are called *maddhahib* (or *maddhab* in the singular form). *See id.* at 161. Early in their development, there were many schisms and new schools, but over time, the main body of legal scholarship and almost all *Shari'ah* authorities have long come to recognize only four extant schools among Sunni Muslims and one dominant school (some cite two) among Shi'a Muslims. *See id.* at 161–62. While there are important jurisprudential and theological differences between the Sunni and Shi'a, see *supra* note 38, and indeed between the schools themselves within the respective Sunni and Shi'a traditions, the specific rulings among all schools on the fundamental issues regarding the purposes of *Shari'ah*, the point of the individual Muslim's life, and the integrity and unity

and their application to finite factual settings in the form of legal rulings are collectively termed *al fiqh* (literally "understanding").[42] *Usul al fiqh*, or the "sources of the law," is what is normally referred to as jurisprudence.[43] Technically, *Shari'ah* is the overarching divine law and *fiqh* is the way *Shari'ah* authorities have interpreted that divine law in finite ways.[44] It is important to note, however, that the word *Shari'ah* appears only once in the *Qur'an* in this context,[45] yet it has gained currency in the Islamic world by virtue of *Shari'ah* authorities, over a period of more than a millennium, creating a *corpus juris* (i.e., *al fiqh*) based upon their interpretative understandings of the *Qur'an* and *Sunna*.[46] As such, this article uses the word *Shari'ah* to mean all of Islamic jurisprudence, doctrine, and legal rulings.

Prior to the twentieth century, there was no discipline termed *Shari'ah*-compliant financing or even a *Shari'ah* sub-code regarding commercial transactions.[47] There are rulings by *Shari'ah* authorities permitting certain contract

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of the Muslim nation as a whole and the methodologies to achieve those ends are remarkably consistent. *See generally* Coughlin, *supra* note 30 (describing similar views among different Muslim schools on *jihad*).

[42] *See* VOGEL & HAYES, *supra* note 17, at 299.

[43] *See* VOGEL & HAYES, *supra* note 17, at 304. *Furu'* is the Arabic word most often associated with positive law or the particular rulings in any given case. *See* VOGEL & HAYES, *supra* note 17, at 299. For a discussion of *furu'* and *usul al-fiqh*, see Wael B. Hallaq, Usul al-Fiqh: *Beyond Tradition*, 3:2 J. ISLAMIC STUD. 172–202 (1992).

[44] *See* VOGEL & HAYES, *supra* note 17 at 23–24; *see also* Bassiouni & Badr, *supra* note 39, at 135.

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

[46] *See generally* Bassiouni & Badr, *supra* note 39, at 135–71 (discussing the process and evolution of Islamic jurisprudence).

[47] The legal verses of the Qur'an are typically broken down into those verses dealing with religious rites and worship (*ibadat*) and those dealing with civil relations including commerce, political life, and the Law of *Jihad* (*mu'amalat*). *See* KAMALI, *supra* note 30, at 26; VOGEL & HAYES, *supra* note 17, at 299, 301. What is confusing to many is that academics writing on the subject of SCF often define *mu'amalat* as civil or commercial relations giving the impression that there is in fact some sub-code of strictly commercial matters devoid of broader implications. *See, e.g.*, Yusuf Talal DeLorenzo & Michael J.T. McMillen, *Law and Islamic Finance: An Interactive Analysis*, *in* ISLAMIC FINANCE, *supra* note 10, at 132, 142 (characterizing *mu'amalat* as "transactions" and stating that *mu'amalat* is "highly articulated . . . precisely" because of the commercial context in which it developed). *But cf.* VOGEL & HAYES, *supra* note 17, at 301 (defining "*mu'amalat*" as "dealings or transactions among human beings; compare '*ibādāt*'"). Thus, while the "glossary" definition is technically correct and properly juxtaposes *mu'amalat* against *ibadat*, the reader who would need such a glossary is not likely to understand that *mu'amalat* is as much the Law of *Jihad* as it is commercial dealings. *See* KAMALI, *supra* note 30, at 26.

forms dating back hundreds of years, but as late as the 1900s, there was still some debate among *Shari'ah* authorities as to whether the prohibition against interest was absolute or just against usurious interest.[48] When contemporary Islamic political thinkers began to confront the collapse of the Ottoman Empire after the First World War and the intrusion of Western modes of social, political, and commercial life into the heart of the Muslim world, *Shari'ah* authorities followed their lead and began to issue legal rulings to confront this new reality.[49] Beginning with the early political-theological writings of men such as Maulana Abul Ala Mawdudi—who argued for an Islamic political resurgence and a unique Islamic political economy—*Shari'ah* authorities followed suit by issuing authoritative legal rulings forbidding interest on deposits and calling for the establishment of "Islamic banks."[50] Over time, these rulings have incorporated prohibitions against transactions considered too uncertain or speculative and also rulings to prevent Muslims from investing in businesses engaged in un-Islamic behavior.[51]

The development of these rules and the formalization of SCF have matured over the past three decades so that today there are entire university departments in the Middle East, Asia, and even in Western universities dedicated to the study of SCF.[52] Most observers connect this recent development to the emphasis of *Shari'ah* in the oil-producing Arab states and their wealth-driven influence throughout the Muslim world and the West.[53]

Effectively, SCF is an attempt to embrace modern interest-based commerce and finance, but developed within a framework of *Shari'ah*-approved structures. For example, while almost all *Shari'ah* authorities forbid any transaction or investment which provides for interest income, SCF rules allow for interest in two ways. One way is to rule that a Muslim can invest in a permitted business that

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[48] *See* Walid S. Hegazy, *Contemporary Islamic Finance: From Socioeconomic Idealism to Pure Legalism*, 7 CHI. J. INT'L L. 581, 581 (2007).

[49] *See generally supra* note 21 (discussing *riba* and the prohibition on interest). For the "socio-economic" impetus for SCF, see Hegazy, *supra* note 48, at 583–88.

[50] *See* LEWIS & ALGAOUD, *supra* note 21, at 119–20.

[51] *See generally* DeLorenzo & McMillen, *supra* note 47, at 132–97 (discussing the implications of modern Islamic commercial jurisprudence).

[52] *See* Muslim-Investor.com, Resources - Education/Curricula in Islamic Finance, Economics and Banking, http://muslim-investor.com/mi/education.phtml (last visited Sept. 13, 2008) (listing university departments); *see also supra* note 6 (discussing Harvard's IFP).

[53] *See generally* WARDE, *supra* note 11, at 72–89 (theorizing of a "First and Second Aggiornamento" to suggest a first movement driven by a centralization of power and influence flowing from Arab oil wealth and a second movement driven by decentralized social, political, and financial constituencies). For a media rendition of the oil wealth-driven industry, see Wayne Arnold, *Islamic Banking Grows with Oil Wealth Infusion: Sharia-based Loans Draw Non-Muslims*, INT'L HERALD TRIB., Nov. 22, 2007, at 12, *available at* http://www.iht.com/articles/2007/11/22/business/islamic.php.

earns or pays interest but only if the amount is below a maximum level.[54] Any profit earned by the Muslim from that interest component, however, must be purified by contributing that portion to a *Shari'ah*-approved charity.[55] A second way to accommodate modern commercial transactions is to structure the forbidden transaction within *Shari'ah*-approved contract forms.[56] These nominate contracts are based upon contract forms found in the classical rulings of the *Shari'ah* authorities prior to the advent of contemporary finance.[57] Thus, a loan might be structured as a "cost-plus sale" where the lender buys the property and immediately sells it back to the borrower for a "profit." This profit is the interest component in the typical loan transaction. The purchase price with the profit component included can be paid over time to resemble an amortized loan repayment schedule. Other forms are available to deal with interest and also with unduly speculative transactions, including sale or lease-back contracts, and partnerships with variations and combinations.[58] For the more complex transactions, these *Shari'ah*-approved nominate contracts are often pieced together and used in combination to arrive at a *Shari'ah*-compliant modern commercial deal.[59]

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[54] The first order of business for determining whether a business is *Shari'ah* compliant is to make certain that it is not involved in a "vice" industry such as interest-based financing, the pork industry, various forms of the entertainment industry, and gambling. The question for *Shari'ah* authorities is how much "involvement" in a prohibited business amounts to a violation of *Shari'ah* such that an investor must not invest in that company. The same question applies to a permitted business that might earn interest on deposits or accounts payable and pay interest on debt: how much interest is too much interest? For a discussion of the *Shari'ah* authority opinions on this matter by one of the leading *Shari'ah* authorities, see generally Yaquby, *supra* note 23.

[55] *See* DeLorenzo, *supra* note 24, at 4–5.

[56] *See, e.g.*, Haider Ala Hamoudi, *Muhammad's Social Justice or Muslim Cant?: Langdellianism and the Failures of Islamic Finance*, 40 CORNELL INT'L L.J. 89, 90–91 (2007).

[57] *See* DeLorenzo & McMillen, *supra* note 47, at 144–45.

[58] *See* VOGEL & HAYES, *supra* note 17, at 181–200; *see also* DeLorenzo & McMillen, *supra* note 47, at 143–45 (discussing nominate contracts).

[59] *See* DeLorenzo & McMillen, *supra* note 47, at 143–50. Since the development of SCF, the debate among Islamic, economic, and *Shari'ah* scholars continues over the propriety of this new field of *Shari'ah* scholarship. Some argue that the industry is nothing more than form over substance and an abuse of *Shari'ah*. Others contend that SCF is a convoluted way for *Shari'ah* to effect its purposes in modern Western financial institutions. For the former, the debate is over the perversion of *Shari'ah* and its pre-modern ethic and economic principles. This group of critics would prefer that *Shari'ah* be used to modify the existing political economies to move away from interest-based debt and highly speculative and leveraged derivative transactions. For the latter group of critics, SCF is more than just an attempt to mollify the *Shari'ah* authorities; it is a "Trojan horse" to legitimatize and to institutionalize *Shari'ah*, the purpose of which is the destruction of Western societies as such. For an example of the former group, see generally Hamoudi, *supra* note 56, at 89–

B. Why Is SCF Important?

As a burgeoning industry, SCF is touted as "[o]ne of the fastest growing" sectors in the global financial markets.[60] Total funds committed to SCF investments are estimated to be $800 billion worldwide,[61] with $200 billion of assets under management in *Shari'ah*-compliant banks.[62] Annual growth in this sector is estimated at 15 percent,[63] based presumably upon current trends fueled mainly by profits in the Muslim oil- and gas-producing countries and by a worldwide Muslim population reported to be growing faster than the population of any other of the world's major religions.[64]

Within the SCF market, *Shari'ah*-compliant bonds, known in Arabic as *sukuk*,[65] are the most explosive segment driven by huge petrodollar profits creating enormous sovereign wealth and liquidity.[66] There is reportedly "$1.3 trillion looking for high-quality Islamic assets" with only $37.3 billion in *Shari'ah*-

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133; El-Gamal, *supra* note 21, at 108–11. For the latter group, see generally Alexiev, *supra* note 21, at 13; Timur Kuran, *The Genesis of Islamic Economics; A Chapter in the Politics of Muslim Identity*, SOC. RES., Summer 1997, at 301, *available at* http://findarticles.com/p/articles/mi_m2267/is_n2_v64/ai_19652892/pg_1 (reviewing the recent origins of "Islamic economics").

[60] Drake Bennett, *The Zero Percent Solution: A Renaissance for 'Islamic Finance' -- A Version of Capitalism that Avoids Interest -- Offers Innovative Financial Tools to Muslim and Non-Muslim Alike*, BOSTON GLOBE, Nov. 4, 2007, at C1, *available at* http://www.boston.com/news/education/higher/articles/2007/11/04/the_zero_percent_solution/.

[61] Alexiev, *supra* note 21, at 1.

[62] *See* Inst. of Islamic Banking and Ins., Islamic Banking - Status of Islamic Banking, http://www.islamic-banking.com/ibanking/statusib.php (last visited Sept. 13, 2008).

[63] *See* Mohammed El Qorchi, *Islamic Finance Gears Up*, FIN. & DEV., Dec. 2005, at 46, 46, *available at* http://www.imf.org/external/pubs/ft/fandd/2005/12/qorchi.htm. Growth is reported to have reached almost 30% annually. *See* Karina Robinson, *No Subprime Crunch for Islamic Banking*, INT'L HERALD TRIB., Nov. 6, 2007, at 13, *available at* http://www.iht .com/articles/2007/11/05/business/bankcol06.php.

[64] Gayle Young, *Fast Growing Islam Winning Converts in Western World*, CNN INTERACTIVE, Apr. 14, 1997, http://www.cnn.com/WORLD/9704/14/egypt.islam/. The Executive Vice President and General Counsel of the Federal Reserve Bank of New York cited a White House report that Islam is the "fastest growing faith in the United States." Thomas C. Baxter, Jr., Executive Vice President & Gen. Counsel, Fed. Reserve Bank of N.Y., Welcome Speech to the Seminar on Legal Issues in the Islamic Financial Services Industry (March 1, 2005), *available at* http://www.newyorkfed.org/newsevents/speeches/2005/bax050301.html.

[65] *Sukuk* in Arabic is plural for bonds; *sakk* is the singular form. McMillen, *supra* note 12, at 427–28 n.1.

[66] Mark Bendeich, *Islamic Finance: Safe Haven or Irrational Exuberance?* REUTERS, Dec. 10, 2007, http://www.reuters.com/article/bankingfinancial-SP-A/idUSKLR2770822 0071210.

compliant bonds issued in the third quarter—double the amount issued during the same period the previous year.[67] These facts lead one to the conclusion that, despite the increase in the amount of Shari'ah-compliant bonds issued, there is still a much greater demand for them waiting to be quenched

All of this growth, underwritten mostly by the mobile, highly liquid capital flowing out of the GCC states,[68] has generated an industry of financial institutions, law firms, accounting firms, financial advisors, and money managers establishing domestic and international links with the key investment figures in the GCC states in an effort to exploit the opportunity for substantial profits.[69] This enthusiasm has spread to domestic U.S. financial industries, and expresses itself in many forms.[70]

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[67] *Id.* Growth in this industry is best illustrated graphically. For growth data on *Shari'ah* compliant bonds, see *infra* app. A. To put the *Shari'ah* compliant bond issuance in context, the total net issuances of all international bonds and notes for the third quarter of 2007 was $396 billion, which represents a significant downturn in worldwide demand for such debt instruments. *See* Ryan Stever et al., *Highlights of International Banking and Financial Market Activity*, BIS Q. REV. Dec. 2007 at 19, 19–21, *available at* http://www.bis.org/publ/qtrpdf/r_qt0712.pdf. That *Shari'ah* compliant bonds were showing spectacular growth in the same quarter and representing approximately 10 percent of worldwide demand speaks volumes for the popularity and the liquidity of this particular market segment.

[68] *See* Bendeich, *supra* note 66. The principal oil-producing Muslim states are located in and around the Persian Gulf: Bahrain, Kuwait, Qatar, Oman, Saudi Arabia, the United Arab Emirates, Iraq, and Iran. These countries, sans Iraq and Iran, formed the Cooperation Council for the Arab States of the Gulf in February 1981. *See* Cooperation Council for the Arab States of the Gulf Charter art. 22, May 25, 1981, *available at* http://www.gcc-sg.org/eng/index.php?action=Sec-Show&ID=1.

[69] For some of the promotional literature naming several of the "facilitators," see, e.g., John Butcher, *Shariah Funds Inc Introduces the First Islamic Hedge Fund Aided by Scholars*, HEDGE FUNDS REV., http://www.shariahfunds.com/news/images/Hedge_Funds-Rev.pdf (last visited Sept. 13, 2008). For an example of an international law firm offering such services in Qatar, see Patton Boggs LLP, Attorneys at Law, Offices, Doha, http://www.pattonboggs .com/Locations/Office .aspx?office=4 (last visited Sept. 13, 2008). For Patton Boggs promotional material indicating the law firm is also a registered agent for lobbying on behalf of the Saudi Arabian government, see Patton Boggs LLP, Attorneys at Law, Middle East Region, http://www.pattonboggs.com/ middleeast/ (last visited Sept. 13, 2008). The law firm of King and Spaulding also highlights its activities in the area on its Internet site. *See* King & Spaulding, Islamic Finance & Investment: Overview, http://www.kslaw.com/portal/server.pt?space=KSPublicRedirect&control=KSPublicRedirect&PracticeAreaId=141&us_more=0 (last visited Sept. 13, 2008); *see also* Brian O'Connell, *Gulf's Super Rich Return Home*, MIDDLE E. ECON. DIG., Dec. 21, 2007, at 48–50 (discussing the growth of Gulf wealth management services).

[70] For information on GCC sovereign wealth funds purchasing U.S. assets, see generally David Enrich, *Oil-Rich Persian Gulf Countries Show Growing Financial Clout,* DOW JONES NEWSWIRES, Oct. 22, 2007, http://www.zawya.com/story.cfm/sidDN20070920015851. For the push to establish SCF in the U.S., see generally Wayne Arnold, *Adapting Finance to Islam*, N.Y. TIMES, Nov. 22, 2007, at C1, *available at*

For instance, U.S. companies now seek to invest in *Shari'ah*-compliant bonds domestically and globally;[71] Dow Jones and Company[72] and Standard & Poor's[73] have both established *Shari'ah*-compliant indexes that screen equities based upon software filters meant to eliminate *Shari'ah*-non-compliant businesses; *Shari'ah*-compliant, U.S.-based managed equity funds[74] and off-shore hedge funds[75] managed or advised by entities related to U.S. financial institutions have been established and can now peg their performances against these indexes;[76] and U.S. banks have begun to offer *Shari'ah*-compliant home loans and other credit facilities[77] (with federal banking authorities opining about their legality and at least one state tax authority issuing a ruling on the tax implications of a *Shari'ah*-compliant transaction).[78]

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http://www.nytimes.com/2007/11/22/business/worldbusiness/22islamic.html?ei=5087&em=&en=d6f0821c05a1d02f&ex=1195880400&pagewanted=all.

[71] Karen Lane, *Islamic-Bond Market Becomes Global by Attracting Non-Muslim Borrowers*, WALL ST. J., Nov. 16, 2006, at C1; *see also* Press Release, Dow Jones, Dow Jones Indexes and Citigroup to Launch First Islamic Bond Index (Mar. 6, 2006), *available at* http://www.dj.com/Pressroom/PressReleases/Other/US/2006/0306_US_DowJones Indexes_1095.htm (announcing a new index that measures the performance of *Shari'ah* compliant bonds).

[72] *See* Dow Jones Indexes, Dow Jones Islamic Market Indexes, http://www.djindexes.com/mdsidx/?event=showIslamic (last visited Sept. 13, 2008).

[73] *See* STANDARD & POOR'S, S&P SHARIAH INDICES: INDEX METHODOLOGY (2007), *available at* http://www2.standardandpoors.com/spf/pdf/index/SP_Shariah_Indices_ Methodology_Web.pdf.

[74] *See* The Iman Fund, Comparisons with Market Indexes, http://halastock.com/cgi-bin/client_product.cgi?userid=&password=&member=55&product_id=527 (last visited Sept. 13, 2008) [hereinafter Iman Fund].

[75] *See* Joanna Slater, *Growing Interest: When Hedge Funds Meet Islamic Finance*, WALL ST. J., Aug. 9, 2007, at A1, *available at* http://online.wsj.com/article/SB118661926443492441 .html?mod=todays_us_page_one.

[76] *See* Iman Fund, *supra* note 74.

[77] *See, e.g.*, Devon Bank, Devon Bank Offers Islamic Financing Services Designed to Avoid Conventional Interest Common in Traditional Banking Products, http://www.devonbank.com/Islamic/ (last visited Sept. 13, 2008) (promoting Chicago-based Devon Bank's Islamic finance products).

[78] *See, e.g.*, Shirley Chieu, *Islamic Finance in the United States: A Small but Growing Industry*, CHI. FED LETTER, May 2005, No. 214, *available at* http://www.chicagofed.org/publications/fedletter/cflmay2005_214.pdf (addressing the demand for and availability of financial products catered to Muslim communities); Letter from Jonathan H. Rushdoony, District Counsel, Comptroller of the Currency: Administrator of National Banks, to [Redacted] (June 1, 1999), *available at* http://www.occ.treas.gov/interp/nov99/int867.pdf (opining on whether *Murabaha* financing is part of the business of banking); Letter from Jonathan H. Rushdoony, District Counsel, Comptroller of the Currency: Administrator of National Banks, to Steven T. Thomas, General Manager, United Bank of Kuwait (Oct. 17, 1997), *available at* http://www.occ.treas.gov/interp/dec97/int806.pdf (opining on the compliance of the United Bank of Kuwait's net lease home financing

C. The Need for Heightened Scrutiny

When investing or entering into financial transactions, why should adherence to the normative principles of *Shari'ah* require any special or heightened scrutiny in relation to civil liability or criminal exposure? The most immediate answer is that, according to the proponents and practitioners of SCF, *Shari'ah* is not simply an approach to interest-free, ethical investing. Instead, SCF is invariably described by SCF proponents, practitioners, and scholars as the contemporary Islamic legal, normative, and communal response to the demands of modern finance and commerce.[79]

As understood on its own terms or by the many constituencies who interpret it, *Shari'ah* is not predicated upon a personal or subjective understanding of what it means to be a Muslim neither is it simply an objective formal law or behavioral code regulating finance and commercial transactions. *Shari'ah* has been described as "holistic,"[80] as "designating good order, much like nomos,"[81] and definitively by Joseph Schacht, one of the founding fathers of modern scholarship regarding Islamic jurisprudence: "The sacred Law of Islam is an all-embracing body of religious duties . . . ; it comprises on an equal footing ordinances regarding worship and ritual, as well as political and (in the narrow sense) legal rules."[82]

In one of the first academic presentations of this new industry, Professors Frank Vogel and Samuel Hayes explain that *Shari'ah* is not a personalized, subjective, pietistic approach to Islam, but an institutionalized legal-political-normative doctrine and system:

> Islamic legal rules encompass both ethics and law, this world and the next, church and state. The law does not separate rules enforced by

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product for Muslim customers with the United States Code); *see also* Advisory Opinion of the State of N.Y. Comm'r of Taxation and Fin., Petition No. M010821A, at 1–2 (July 26, 2002) , *available at* http://www.tax.state.ny.us/pdf/advisory _opinions/real_estate/a02_ 4r.pdf (opining on the real estate transfer tax consequences on Islamic financing products).

[79] *See generally* VOGEL & HAYES, *supra* note 17, at 4–5 (explaining the shift from the "centuries-old practice of finance in Islamic form" to the "revival of Islamic finance"). SCF is "legal" in the sense that it includes aspects of binding law, especially in Muslim countries where *Shari'ah* is considered both constitutional and statutory, such as Saudi Arabia, Iran, and Sudan; "normative" in the sense that *Shari'ah* is considered an all-encompassing way of life; and "communal" in the sense that communities of Muslims have in fact embraced *Shari'ah* as authoritative at some level. *See id.* at 23–47.

[80] *See* Bassiouni & Badr, *supra* note 39, at 135 (noting that Islam, as a religion, is holistic as a means of describing the workings of Shari'ah).

[81] WARDE, *supra* at note 11, at 33 (citing AZIZ AL-AZMEH, ISLAM AND MODERNITIES 12 (1993)) (quotations omitted). 'Nomos' refers to the overarching internal and external principles which provide order to the world.

[82] SCHACHT, ISLAMIC LAW, *supra* note 37, at 1.

> individual conscience from rules enforced by a judge or by the state. Since scholars alone are capable of knowing the law directly from revelation, laypeople are expected to seek an opinion (fatwa) from a qualified scholar on any point in doubt; if they follow that opinion sincerely, they are blameless even if the opinion is in error.[83]

This classical understanding of *Shari'ah* has been echoed by a leading professor of finance in Australia and a senior official in the Bahrain Ministry of Finance and National Economy:

> Since Islamic law reflects the will of God rather than the will of a human lawmaker, it covers all areas of life and not simply those which are of interest to a secular state or society. It is not limited to questions of belief and religious practice, but also deals with criminal and constitution [sic] matters, as well as many other fields which in other societies would be regarded as the concern of the secular authorities. In an Islamic context there is no such thing as a separate secular authority and secular law, since religion and state are one. Essentially, the Islamic state as conceived by orthodox Muslims is a religious entity established under divine law.[84]

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[83] VOGEL & HAYES, *supra* note 17, at 23.

[84] LEWIS & ALGAOUD, *supra* note 21, at 24. While the authors attempt to "tone down" this absolute statement of *Shari'ah* by suggesting that as a practical matter *Shari'ah* has in fact lived side-by-side with secular law and in some cases even incorporated it into *Shari'ah*, they honestly but almost unnoticeably add the following to their effort to soften *Shari'ah*:

> The continuation of a custom of a particular place or community is allowable under Islamic law, and may in fact be assimilated into the law, as were many of the customs of the Arabs. *To be permissible a custom must not be contrary to revealed injunctions*, and this point remains highly controversial in some areas, for example the treatment of women.

Id. at 25 (emphasis added). What the authors mean by "revealed injunctions" are the legal rulings of *Shari'ah* authorities where there is consensus among the authorities that any particular ruling is based on an explicit verse in the Qur'an or Sunna. *See infra* notes 94, 201 and accompanying text (discussing jurisprudential force of "consensus"). What is intriguing is that of all of the fixed unalterable laws of *Shari'ah*, the authors are concerned about the treatment of women. While many certainly argue that *Shari'ah* demeans and subordinates the Muslim woman, one might have thought that the fixed death penalty for an apostate—a Muslim who wishes to leave Islam—would have captured their concern sufficiently for articulation. Apparently, it is not, in the authors' views, "highly controversial" among the *Shari'ah* faithful.

Shari'ah is therefore not a religious legal code in which offensive[85] areas of law can be isolated and removed from a cauterized *corpus juris*. Instead, *Shari'ah* is understood by authorities and scholars as an indivisible "way of life"[86] that informs a *Shari'ah*-adherent Muslim's entire being and identity as a Muslim,[87] including his relationship to his family, the poor, the stranger, the visitor, national political life, the Muslim *Umma* (or "nation"), religious ritual, business and financial dealings, and the enemy.[88] While *Shari'ah* includes more than a millennium of legal decisions developed through Islamic jurisprudence and informal, code-like compilations developed by the different "schools of jurisprudence,"[89] *Shari'ah* proper is the overarching authoritative architecture for all Islamic jurisprudence and the specific legal decisions that make up the *corpus* of a juristic body of Islamic dictates and norms.[90]

Understood in its proper context, anything deemed *Shari'ah*-compliant by Islamic legal authorities must first and foremost be within the gestalt of *Shari'ah*. It is not enough, according to *Shari'ah*, that a Muslim conducts his own affairs and business according to some narrow definition of Islamic ethical business practices.[91] For a *Shari'ah*-adherent Muslim to conduct his business and financial affairs properly, he must not knowingly promote through his business dealings any forbidden action or violation of a fundamental precept of *Shari'ah* or the legal rulings promulgated thereunder.[92] This is what the scholars mean when they describe *Shari'ah* as "holistic" or a fully integrated religious, moral, and legal code.[93]

It has been the duty of the *Shari'ah* legal scholars over the ages to understand these precepts and to apply them to new and changing circumstances. The degree to which individual Muslims or the political powers ruling over them have adhered to *Shari'ah* as determined by the authoritative Islamic jurists has varied tremendously. It can be said with some historical confidence that *Shari'ah* has

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[85] By "offensive," it is meant contrary to Anglo-American norms and laws. An example of an offensive, yet classical and still authoritative *Shari'ah* ruling might include the imposition of capital punishment for apostasy. *See, e.g.*, Coughlin, *supra* note 30, at 50–51 nn.77–79.

[86] The literal meaning of *Shari'ah* is "the way"—especially to the source of water (i.e., life). *See* Coughlin, *supra* note 30, at 86.

[87] *See, e.g.*, DeLorenzo & McMillen, *supra* note 47, at 136–37.

[88] *See* Coughlin, *supra* note 30, at 85–86 (emphasizing that the principles of Islam encompass the believer's entire life).

[89] Coughlin, *supra* note 30, at 100 n.185. For a detailed discussion of the schools of jurisprudence see *supra* note 41.

[90] *See* Bassiouni & Badr, *supra* note 39, at 135–38.

[91] *See* DeLorenzo, *supra* note 24, at 1–3.

[92] *See* DeLorenzo, *supra* note 24, at 4–6 (explaining the functions of a *Shari'ah* Supervisory Boards).

[93] *See generally* DeLorenzo, *supra* note 26, at 1–13 (demonstrating the holistic approach by the need to have *Shari'ah* Supervisory Boards).

been honored more in the breach than in its observance.[94] But the breaches have not diminished the absolute authority of *Shari'ah* and its jurisprudence, as articulated by Islamic legal scholars and the institutions they have established over the past 1200 years, to define the legal limits of permitted and proscribed behavior among the hundreds of millions of Muslims worldwide who consider *Shari'ah* a way of life, as much religion and moral guide as civil and criminal code.[95]

The implication of this more complete understanding of *Shari'ah* is that one cannot speak of *Shari'ah*-compliant finance, business, or economics in the U.S. without understanding *Shari'ah* as articulated by the *Shari'ah* authorities and its ramifications for the U.S. investor. This is especially true given the legal implications surrounding the duty to disclose for financial institutions contemplating an SCF transaction. Consider, for example, a mutual fund that promotes itself as *Shari'ah*-compliant. Having licensed the use of the Dow Jones Islamic Market Index (DJIMI), which utilizes a software filtering protocol determined to be *Shari'ah*-compliant by the *Shari'ah* advisory board retained by Dow Jones & Company, the mutual fund selects a subset of the indexed, listed equities for its portfolio. A careful reading of the DJIMI's marketing material and of the registration statements filed by DJIMI-utilizing funds indicates that disclosure issues abound.[96]

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[94] There is no shortage of academic literature on the political and religious turmoil that existed in the Muslim empires from soon after the death of Mohammed and the battles between the "traditionalists" who sought a *Shari'ah*-centered political world and those who opposed it for one reason or another. A good, deep history of Islam may be found in the three volume work of HODGSON, *supra* note 34, and, of course, in the required reference to BERNARD LEWIS, THE MIDDLE EAST: A BRIEF HISTORY OF THE LAST 2,000 YEARS (1995). For the narrative of the failures in Islamic history by the political leaders to abide by *Shari'ah* from the "traditionalist" vantage, see SAYYID QUTB, SOCIAL JUSTICE IN ISLAM 169–260 (Hamid Algar trans., rev. ed., 2000). For the classic statement on this "theory" versus "practice" and the dominant role of *Shari'ah* authorities to determine the theory and even the practice when *Shari'ah* is put into practice, see SCHACHT, ISLAMIC LAW, *supra* note 37, at 76–85. For the lament of a "moderate" *Shari'ah* academic scholar who would like to see *Shari'ah* and *usul al-fiqh* modernized so that it might be used to govern modern societies, and suggesting that the failure of *Shari'ah* to keep pace with modernity was precisely because it often was not fully integrated into Islamic society but rather developed as a private affair among *Shari'ah* authorities, see KAMALI, *supra* note 30, at 500–21.

[95] This is evident in SCF itself. The sole authorities for determining *Shari'ah* compliance or even what is "Islamic" regarding finance and commerce are the traditional *Shari'ah* scholars. Whatever qualms some critics might have for the "Islamist" bent of SCF, there is no serious challenge to the absolute authority of the traditionalists in this discipline. *See, e.g.*, VOGEL & HAYES, *supra* note 17, at 9–10, 23 (discussing the practical implementation and role of "the law" in the lives of adherents).

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

For example, in the registration statement filed with the Securities and Exchange Commission (SEC) for one of the first such funds, the Dow Jones Islamic Market Index Portfolio[97] ("DJIMIP") makes no mention of *Shari'ah* other than a reference to certain "*Shari'ah* screens" or "filters" limiting the universe of acceptable investments. For the investing public, all that is learned about *Shari'ah* in the context of this *Shari'ah*-compliant mutual fund is that equities of companies involved in interest-driven profits, companies dealing with commodities such as alcohol or pork, or companies engaged in the "vice" industries such as entertainment and gambling, are prohibited.[98] In addition, the standard disclosures include references to various financial ratios that work to eliminate companies that might generate too much interest income on its cash reserves or pay too much interest on its debt.[99] In other words, the DJIMI and the mutual funds utilizing such an index appear in many ways like other "socially responsible investing" or customized "values-based" and "faith-based" indexes.

But this is hardly the case. In a "secular" or even "ideologically driven" values-based index, a screen that filters out all tobacco and weapons businesses is just that. Even if the background social or political activism animating the screen is a "smoke-free environment" and "pacifism," the screen is marketed only as a screen that filters out tobacco and weapons industries. It does not purport to be based upon some universal theological-moral-legal system existing independently of the filters.[100]

When the mutual fund, however, markets its product as "Islamic" or "*Shari'ah*-compliant," it is making a claim that goes well beyond the disclosed

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[97] This fund was begun in 1999 and liquidated in 2002. For access to its SEC filings online, see Securities and Exchange Commission, Dow Jones Islamic Market Index Portfolio, http://www.sec.gov/cgi-bin/browse-edgar?action=getcompany&CIK=000108 86 54&owner=include&count=40 (last visited Sept. 13, 2008).

[98] *See* Mahmoud A. El-Gamal, *An Economic Explication of the Prohibition of* Gharar *in Classical Islamic Jurisprudence*, ISLAMIC ECON. STUD., Apr. 2001, at 29, 33 (explaining the prohibition of gambling).

[99] M. H. KHATKHATAY & SHARIQ NISAR, INVESTMENT IN STOCKS: A CRITICAL REVIEW OF DOW JONES *SHARI'AH* SCREENING NORMS 2–4 (2007), *available at* http://www.djindexes.com/mdsidx/downloads/Islamic/articles/DowJonesShariahScreening Norms.pdf.

[100] Thus, even if it promoted itself as ethical equity-based investing, if it was based upon *Shari'ah*, the disclosure issue would remain. Further, it is different than the so-called Catholic indexes. Even in the case of the "Catholic values" funds, there is no representation that there is an underlying legal code requiring certain investment behavior by adherent Catholics. Instead, the funds follow "Catholic values" as they and their advisors determine them to be based upon the doctrine of the Catholic church (i.e., the magisterium), but there is no representation that there is a specific Catholic doctrine which obligates Catholics to invest only in companies that meet the funds criteria for "Catholic values." It is also noteworthy that the typical Catholic advisory board consists of lay persons. *See, e.g.*, SCHWARTZ INVESTMENT TRUST, AVE MARIA MUTUAL FUNDS PROSPECTUS 29 (2007), *available at* http://www.avemariafund.com/pdf/prospectus.pdf.

screens or filters, even if all that is applied to make it "Islamic" or "*Shari'ah*-compliant" are the filters themselves. A cursory reading of the registration statement filed pursuant to the Investment Act of 1940[101] for the Dow Jones Islamic Portfolio Fund suggests that the lawyers tasked with writing the risk section of the document understood this reality, at least at some rudimentary level,[102] and sought to eliminate the problem with one broad brushstroke. It states:

> The investment objective of the Dow Jones Islamic Market Index Portfolio (the Portfolio) is to seek long-term capital gains by matching the performance of the Dow Jones Islamic Market Index(SM) (the "Index") – a globally diversified compilation of equity securities **considered by Dow Jones' *Shari'ah* Supervisory Board to be in compliance with *Shari'ah* principles**.[103]

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

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[101] Investment Company Act of 1940, Pub. L. No. 76-768, 54 Stat. 789 (1940).

[102] The lawyers' imputed knowledge is "rudimentary" because very few of the lawyers acting as facilitators in the SCF industry fully understand or acknowledge what *Shari'ah* is beyond thinking of it as just another "value-based screen."

[103] Dow Jones Islamic Market Index Portfolio, Registration Statement, Form N-1A, (Sept. 1, 1999) (emphasis added), *available at* http://www.sec.gov/Archives/edgar/data/1088654/ 0000935489-99-000014.txt (disclosing information pursuant to the Investment Company Act of 1940, Part B, Item 12). In addition, in Part A of the of the registration statement, there are warranty disclaimers relative to the DJIMI, the most important of which is:

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

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

that be important for a U.S. investor to know prior to investing in a business that promotes *Shari'ah*-compliant investing?

The point of this example is not to analyze the liability exposure of the registration statement of the now defunct Dow Jones Islamic Portfolio Fund, but rather to illustrate how marketing an investment product as *Shari'ah*-compliant incorporates a set of factual predicates, many of which are material to the investment decision. According to the *Shari'ah* authorities themselves, *Shari'ah*—of which SCF is only a small, integrated component—is more than just a half-dozen filters operating in the background to eliminate interest, speculation, and vice. Rather, it is a motivating force and mark of Muslim identification for hundreds of millions of adherents throughout the world, a *corpus juris* that incorporates a 1200-year-old history of jurisprudence, of institutionalized legal schools with published legal decisions and other scholarly writings, together with more than a millennium of religious and political implications, all of which have generated a body of literature on the import of *Shari'ah* in the ancient and contemporary world.[104]

These realities comprise a dangerous minefield for the naïve or willfully ignorant financial institution seeking to capitalize on the alluring new universe of investment vehicles marketed to *Shari'ah* adherents. This minefield includes questions these financial institutions and their professional facilitators have not even begun to ask, much less answer.[105] This article begins the analysis and the necessary discussion of SCF's implications for the U.S. financial industry, the professionals advising their clients on SCF, and the policy makers in and out of government. Policy makers especially have an obligation to consider the ominous implications for U.S. national and financial security of a fully integrated *Shari'ah*-compliant financial industry.

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[104] *See generally* Bassiouni & Badr, *supra* note 39, at 135–78 (explaining the origins and modes of interpretation of the *Shari'ah*).

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

III. TOWARD AN ANALYTICAL TAXONOMY

A. The Lawyer's Role in SCF

As indicated above, *Shari'ah*-compliant financing is nomenclature describing the contemporary Islamic legal, normative, and communal response to the demands of modern-day finance and commerce.[106] *Shari'ah*-adherent Muslims desire to maintain their commitment to the normative demands of *Shari'ah*. At the same time, they wish to participate in the benefits and opportunities afforded by investment in international and Western financial structures that are neither *Shari'ah*-centric nor *Shari'ah*-compliant, at least according to the overwhelming majority of *Shari'ah* authorities.[107]

Transactional lawyers are often required to opine on the transaction's compliance with existing law and the enforceability of the underlying agreements in a court of law or, in some cases, before an arbitrator.[108] These legal opinions assure the parties that there are no hidden issues that might create obstacles to enforcement. In addition, lawyers are required by professional ethics to investigate compliance, disclosure, and due diligence issues in order to understand their clients' legal exposure when an innovative approach to existing financial or commercial transactions is contemplated.[109] Lawyers and accountants themselves have direct exposure to liability for documents submitted by a client to the SEC under several laws, including the Sarbanes-Oxley Act of 2002.[110]

A fundamental predicate of a lawyer's opinion is the knowledge that the basic transactional building blocks of the deal are well-known, predictable, and do not pose any significant risk that a court will refuse to enforce them as intended by the

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[106] *See supra* note 79 and accompanying text.

[107] *See* VOGEL & HAYES, *supra* note 17, at 24–28. Vogel and Hayes note especially the minority view that interest is not prohibited: "But such Muslims, though numerous, appear to be in the minority. A much larger number, *supported by a near-unanimity of traditional scholars*, seem certain that modern bank-interest falls within the revealed prohibitions and entails a major sin, tolerable only in the throes of necessity." VOGEL & HAYES, *supra* note 17, at 25 (emphasis added).

[108] In some complicated cases, both judicial and arbitration venues are chosen depending upon the specific issue litigated or the type of enforcement sought. *See, e.g.*, McMillen, *supra* note 12, at 433 (outlining the likely development of *sukuk* issuance).

[109] MODEL RULES OF PROF'L CONDUCT R. 1.2(d) (2002); ANNOTATED MODEL RULES OF PROF'L CONDUCT R. 1.2(d) cmt. n.13, 39–40 (5th ed. 2003); *see* David S. Ruder, *Lessons from Enron: Director and Lawyer Monitoring Responsibilities*, Oct. 10, 2002, at 18–19, *available at* http://www.law.northwestern.edu/professionaled/documents/Ruder_Lessons_Enron.pdf (paper presented to the 41st Annual Corporate Counsel Institute, Chi., Ill.).

[110] *See* 15 U.S.C. § 7245 (2006) (explaining that the attorney has a duty to report violations of securities laws).

parties. In simple terms, this means that the deal is structured in a way that has certainty, consistency, predictability, and transparency.[111]

The problems legal counsel faces when attempting to analyze a specific SCF transaction and to opine on compliance and enforceability issues are often related to the *Shari'ah* "black box" phenomenon. Attorneys, accountants, and financial advisors who wish to structure a transaction to be *Shari'ah*-compliant do so by treating *Shari'ah* precisely as *Shari'ah* demands. For the *Shari'ah* faithful, *Shari'ah* is first and foremost the divine and perfect will of the ultimate lawgiver and there are strictures and obligations imposed on its adherents which are not subject to reasoned critique or discourse.[112] As to *Shari'ah* being open to human analysis, it is reserved for *Shari'ah* authorities who can only be challenged by other equally accepted *Shari'ah* authorities.[113] Further, because *Shari'ah* is understood as divine and the *Shari'ah* authorities are considered the trustees of its authority, integrity, and interpretation, the application of *Shari'ah*'s well-established and ancient doctrines to the modern practice of SCF necessarily lacks transparency.

Shari'ah's inability to provide transparency is systemic. Any legal or normative system that is not articulated and enforced within a political structure of codified laws, procedures, courts, binding legal opinions, and effective enforcement mechanisms will, by definition, lack transparency. *Shari'ah* is at its core a divinely ordained law, which can never be subordinated to a secular political, legal, or regulatory system.[114] SCF is an attempt by the participants—financiers, businesspeople, facilitators, and *Shari'ah* authorities—to fit the divine

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[111] While the terms "certainty, consistency, predictability, and transparency" are oft-used in the law in this context, this article borrows these precise terms and their meanings from one of SCF's biggest advocates and one of the most influential of the legal practitioners making a career of SCF. Michael J.T. McMillen, *Islamic Shari'ah-Compliant Project Finance: Collateral Security and Financing Structure Case Studies*, 24 FORDHAM INT'L L.J. 1184, 1207 (2001).

[112] *See* Coughlin, *supra* note 30, at 88–90.

[113] As discussed *supra* at note 18 and in the accompanying text, there is no universal standard of authority or hierarchy for *Shari'ah* authorities. This fact alone and the development of authoritativeness is part of the black box of *Shari'ah*.

[114] *See, e.g.*, McMillen, *supra* note 111, at 1197 (showing the constraints on secular governance in Saudi Arabia by *Shari'ah*). For an interesting example of the notion that *Shari'ah* refuses to subject itself to secular interpretation, see Saudi Basic Indus. Corp. v. Mobil Yanbu Petrochemical Co., 866 A.2d 1, 30–32 (Del. 2005). There, the trial court was asked by the parties to rule on damages in a commercial dispute where the underlying contract applied the law of Saudi Arabia, which the court determined to be *Shari'ah*. *Id.* at 6–7, 30–32. The plaintiff's expert, Professor Vogel of the Harvard Law School Islamic Finance Project (the same Vogel from *supra* note 17) argued that no judge or even secular academic *Shari'ah* "expert" could opine on *Shari'ah*—this role was within the exclusive domain of a qualified *Shari'ah* authority. *Id.* at 32. The court was quite put out by this proposition, especially since it was the plaintiff's expert making this argument after plaintiff had chosen the forum. *Id.*

law within a modern, secularly political, legal, and financial system. But if a secular court or legislature attempts to codify *Shari'ah*'s precepts as they apply to SCF in an effort to establish transparency, it would fail its fundamental purpose because *Shari'ah* cannot be rendered subservient to secular law.[115]

In contrast, domestic finance, commerce in the U.S., and even international financial transactions are based upon Western legal structures that provide transparency.[116] It is transparency that renders a complex transaction manageable and viable. When the parties to a transaction and the professionals facilitating it know that a given transaction format has been used before successfully, the risks of the deal are then limited to the specific business terms and market conditions rather than the formalities of the documents and their enforcement. In these transactions,

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[115] According to *Shari'ah* doctrine rooted directly and firmly in the *Qur'an*, and agreed upon by all legal schools, no secular law can take precedence over Allah's divine law: "[w]hoever does not follow the revealed law and does not judge according to it is counted an unbeliever." *See, e.g.*, AL-AZAMI, *supra* note 37, at 12; *see also supra* notes 84–85 (discussing some of the effects of not believing); Coughlin, *supra* note 30, at 88 ("Known among Islamic jurists to take a more 'liberal' view toward Islamic law, Mohammad Hashim Kamali, in his Principles of Islamic Jurisprudence, nonetheless comes down four-square on the notion of the absolute sovereignty of Allah that necessarily pre-empts all other forms of sovereignty – including the democratic concept of sovereignty of the people.").

The blending of secular law and *Shari'ah* as it has unfolded in many Muslim countries would appear to be *ipso facto* evidence of the failure to tame *Shari'ah* since there are no Muslim dominated countries that one might call "mostly free" with real representative governments except possibly Turkey and Indonesia. Most observers recognize Turkey's success has come at the expense of "religious freedom" since the Kemalists and their use of the army to suppress the public expression of Islam and *Shari'ah* is well documented. *See* Freedom House, Country Reports: 2007 Edition, http://www.freedomhouse.org/template.cfm?page=21&year=2007 (last visited Sept. 13, 2008) [hereinafter Freedom Survey 2007]. Indonesia is changing for the worse due in large part to the growing violence against non-Muslims which in turn is due in large part to the increasing influence of *Shari'ah*. *See id*. For a careful analysis of the extent to which *Shari'ah* is codified as the law of the land in Muslim countries, see generally Tad Stahnke & Robert C. Blitt, *The Religion-State Relationship and the Right to Freedom of Religion or Belief: A Comparative Textual Analysis of the Constitutions of Predominantly Muslim Countries*, 36 GEO. J. INT'L L. 947 (2005). For an examination of "religious freedom" in such Muslim countries as Indonesia, Egypt, Iran, Saudi Arabia, see U.S. COMM. ON INT'L RELIGIOUS FREEDOM, ANNUAL REPORT (2005), *available at* http://www.uscirf.org/countries/publications/currentreport/2005annualrpt .pdf#page=1. For the growing influence of *Shari'ah* in Indonesia, see Tom A. Peter, *At Massive Rally, Hizb Ut-Tahrir Calls for a Global Muslim State*, CHRISTIAN SCI. MONITOR, Aug. 14, 2007, http://www.csmonitor.com/2007/0813/p99s01-duts.html. For a good discussion of "modernist legislation" vis-à-vis *Shari'ah* in Muslim countries, albeit somewhat dated, see SCHACHT, ISLAMIC LAW, *supra* note 37, at 100–11.

[116] *See* McMillen, *supra* note 12, at 432–35 (discussing the role of transparency in financial systems and in *Shari'ah* compliance).

the lawyer can opine with confidence because she knows the rules of the game and knows that she is not subject to fiat or challenge.[117]

This is not the case when a lawyer confronts a high-stakes, complex SCF transaction. In order to render a legal opinion that will satisfy both those involved in the transaction and necessary third parties such as a rating agency for a bond securitization, a number of issues arise that cannot be rationally addressed for at least two reasons: certain transaction restrictions applicable to SCF are considered divine and unalterable; those aspects of a transaction subject to human reason are not subject to *any* human reason, but to the reason of a *Shari'ah* authority.[118] For example, most *Shari'ah* authorities understand interest income as forbidden today.[119] The result has been that SCF utilizes all sorts of *Shari'ah*-compliant transactional structures to convert the exact same income stream from interest to something else such as lease payments.[120] In legal parlance, this is the application of "form over substance."[121]

The use of legal fictions to change the form or the consequence of a transaction without changing its substance is not new to secular law. Liability is often determined by the form rather than the substance of a transaction.[122] The idea is to use a legal fiction to convert a problematical "form" to an acceptable one. In the secular context, the problem itself and the mechanisms to overcome it can be understood, challenged openly, debated, and ultimately modified by lawyers, judges, and legislatures to fit changing circumstances.

The debate within *Shari'ah*, however, is effectively closed. Its principles remain divine and unalterable[123] and the application of these principles to changing

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

[118] McMillen, *supra* note 111, at 1189–90; *see supra* note 114.

[119] *See* El-Gamal, *supra* note 98, at 30.

[120] *See, e.g.*, McMillen, *supra* note 111, at 1220–25 (describing how transactions are structured in Saudi Arabia).

[121] For a SCF-friendly practitioner's view of these problems, see generally McMillen, *supra* note 111, at 1220–25 (explaining and providing examples of the way financing and transactions are structured so as to not violate the standards of *Shari'ah*).

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

[123] Even this claim is not exactly true. According to some scholars, interest was once not divinely prohibited *per se*. *See* KURAN, *supra* note 21, at 39–40; *see also* WARDE, *supra* note 11, at 48 (asserting that the prohibition has been subject to varying

circumstances are subject only to what the *Shari'ah* authorities acting independently of a secular legal and political system determine to be permitted and forbidden. Thus, *Shari'ah* informs the *Shari'ah*-adherent participants in a finance transaction that interest is divinely forbidden. The participants are also told it is forbidden because it is evil and causes the destruction of society.[124] Somehow though, interest—wrapped up in a different form where all of the elements of interest exist except for the name—exits the "black box" of *Shari'ah* as permissible and presumably good for society.[125]

Thus a lawyer involved in a complex SCF transaction confronts challenges at many different levels. In this effort, the diligent lawyer would likely focus on four distinct phases of an SCF transaction: (1) determining if the generic investment or type of transaction is prohibited; (2) developing an alternative (i.e., *Shari'ah*-compliant) transactional structure necessary to achieve the financial or commercial goal of the "secular" or *Shari'ah*-non-compliant investment or transaction; (3) drafting the necessary legal agreements and documents to implement the alternative transaction; and (4) preparing the filing of regulatory documents with government agencies.

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

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interpretations, including a prohibition only on usurious lending). But the debate about the divinity of this prohibition as it exists today does not appear open to a societal or political discussion and conclusion. Rather, it is confined to the *Shari'ah* black box entrusted to the *Shari'ah* authorities. *See* KURAN, *supra* note 21, at 7–19; El-Gamal, *supra* note 21, at 108–49 (discussing the paradox between the *Shari'ah's* prohibition on interest and the actual functioning of *murabaha* financing which in name is not interest but in result is very similar to traditional interest financing).

[124] *See* Albalagh, Text of the Historic Judgment on Interest Given by the Supreme Court of Pakistan, http://www.albalagh.net/Islamic_economics/riba_judgement.shtml (last visited Sept. 16, 2008).

[125] Islamic scholars in academia have given this issue much attention. *See* Mahmoud A. El-Gamal, *An Economic Explication of the Prohibition of* Ribā *in Classical Islamic Jurisprudence*, May 2, 2001, http://www.ruf.rice.edu/~elgamal/files/riba.pdf; *see also* KURAN, *supra* note 21, at 7–19 (recounting the techniques for lending without charging interest, and commenting that would-be lenders developed "various ruses" for "endow[ing] with legitimacy" various practices that are substantially the same as interest bearing loans); McMillen, *supra* note 111, at 1186–87 n.2 (citing a host of scholars discussing the forms); Kuran, *supra* note 59, at 301–02 (discussing the lack of analysis of the origins of "Islamic Economics," but recognizing the realities of its growth).

B. The Legal Landscape

1. Common Law Tort Action for Deceit or Fraud

The regulation of disclosures by businesses, and by the financial industry in particular, has a long and storied history in U.S. jurisprudence. In most states, the common law incorporated the tort action of deceit, which is commonly referred to as fraud, to allow private rights of action for misrepresentation in the context of what is now referred to as commercial speech.[126] The essential elements of a common law fraud action are: (1) a false representation (2) of a material fact (3) which the defendant knew to be false and (4) with the intent to induce the plaintiff to rely upon it and (5) the plaintiff in fact justifiably relied upon the representation (6) thereby suffering damages as a result.[127]

Most states have relaxed or altered many of the elements of common law fraud. For example, certain relationships under the common law might also give rise to a claim for constructive fraud, which allows recovery for an omission of material fact.[128] The scienter elements have also been relaxed. Thus, the intent elements noted above in (3) and (4), have been "defined to mean everything from knowing falsity with an implication of *mens rea*, through various gradations of recklessness, down to such non-action as is virtually equivalent to negligence or even liability without fault (and would be better treated as creating a distinct species of liability not based on intent)."[129]

2. Federal Securities Laws

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

In the main, the securities laws relating to fraud and misrepresentation were modeled after common law fraud.[130] But it is equally true that Congress intended the securities fraud statutes to have a broader reach than the common law.[131] As a result, securities law sought to include within its enforcement orbit

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[126] *See* Nike, Inc. v. Kasky, 539 U.S. 654, 656–65 (2003) (per curiam) (Stevens, J., concurring) (discussing commercial versus non-commercial speech and suggesting that the case was disposed of summarily on procedural grounds).

[127] LOSS & SELIGMAN, *supra* note 5, at 910.

[128] *Id.* at 910–11.

[129] *Id.* at 911.

[130] *Id.* at 1182–94.

[131] *Id.*

misrepresentations, omissions, schemes, and artifices that would not otherwise be captured by traditional common law fraud.[132] In addition, many of the specific elements of common law fraud were relaxed or in some cases eliminated.[133] While recent federal legislation aimed at curbing abusive class action litigation and subsequent Supreme Court case law have suggested a trimming of the broad reach previously granted federal securities laws, these efforts have been counterbalanced by a concomitant movement at the state level to extend the reach of the state securities laws and to interpret them more liberally than the federal counterparts.[134]

There are principally seven federal statutes that govern securities transactions: the Securities Act of 1933; the Securities Exchange Act of 1934; the Trust Indenture Act of 1939; the Investment Company Act of 1940; the Investment Advisors Act of 1940; the Securities Investor Protection Act of 1970; and the Sarbanes-Oxley Act of 2002.[135] Civil and criminal liability under the federal securities statutes for failure to disclose are regulated by the SEC and its principal weapons are the Securities Act of 1933 ("1933 Act") and the Securities Exchange Act of 1934 ("1934 Act").[136] The 1933 and 1934 Acts target different markets in that the 1933 Act regulates initial offerings, whereas the 1934 Act regulates all

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[132] *Id.*

[133] *Id.*

[134] *Id.* at 1187–92.

[135] Securities Act of 1933 (Truth in Securities Act), 15 U.S.C. §§ 77a–77aa (2006) (focusing on initial distribution of securities); Securities Exchange Act of 1934, 15 U.S.C. §§ 78a–78mm (West 1997 & Supp. 2008) (focusing on ongoing post-distribution trading of trading); Trust Indenture Act of 1939, 15 U.S.C. §§ 77aaa–77bbbb (West 1997 & Supp. 2008) (supplementing the 1933 Act and focuses on distribution of debt securities); Investment Company Act of 1940, 15 U.S.C. §§ 80a-1–64 (West 1997 & Supp. 2008) (governing activity of publicly owned companies that invest in and trade securities); Investment Advisers Act of 1940, 15 U.S.C. §§ 80b-1–21 (West 1997 & Supp. 2008) (requiring regulation and registration of those in business of advising others on securities investments); Securities Investor Protection Act of 1970, 15 U.S.C. §§ 78aaa–78lll (West 1997 & Supp. 2008) (creating non-profit membership corporation designed to cover customer losses when broker-dealer firms cannot cover their customer accounts); Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (2006) (codified as amended in scattered sections of 11, 15, 18, 28, and 29 U.S.C.) (adding several additional layers of corporate reporting and ethics oversight). The Public Utility Holding Company Act of 1935, 15 U.S.C. §§ 79–79z-6, which governed public utilities, was repealed by the Energy Policy Act of 2005, Pub. L. No. 109-58, 119 Stat. 594 (2006).

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

subsequent trading. However, the overriding public policy is the same: "full disclosure of every essentially important element attending the issue of a new security" and a "demand that the persons, whether they be directors, experts, or underwriters, who sponsor the investment of other people's money should be held to the high standards of trusteeship."[137]

Although both the 1933 and the 1934 Acts proscribe various types of conduct, including incomplete or inaccurate disclosure of material information, the SEC dictates the specific kinds of minimal (and in some cases maximal) disclosure required by the specific provisions as an administrative matter.[138] Beyond the routine administrative functions granted the SEC, the main weapons against securities fraud are the civil and criminal remedies.[139] Thus, the SEC has access to civil courts to seek injunctive relief, disgorgement, and even civil fines, in addition to ancillary equity-like relief.[140]Also, the Department of Justice, often as a result of an SEC administrative investigation and criminal referral, is authorized to file criminal charges for violations of the federal securities laws when it appears the offending party had the requisite intent.[141]

Finally, private plaintiffs have express and implied rights of action under several provisions. The most used and abused of all such provisions is Rule 10b-5,[142] promulgated under the 1934 Act,[143] which provides for civil litigation[144] and criminal prosecutions.[145] Considering that the class action mechanism, although limited by recent legislation,[146] is available to Rule 10b-5 claimants, the weapons available to prosecute claims for misstatements and omissions of material fact in SEC filings and elsewhere in the public domain are considerable.

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[137] H.R. REP. NO. 73-85, at 3 (1933); *see* 15 U.S.C. § 78b (2006) (stating that one purpose of securities law is "to insure the maintenance of fair and honest markets").

[138] *See* LOSS & SELIGMAN, *supra* note 5, at 1018–31.

[139] *See Id.*

[140] *See Id.*

[141] *See Id.*

[142] Employment of Manipulative and Deceptive Devices, 17 C.F.R. § 240.10b-5 (1997); *see* Herman & MacLean v. Huddleston, 459 U.S. 375, 380 (1983) ("The existence of this implied remedy is simply beyond peradventure.").

[143] 15 U.S.C. § 78j (2006).

[144] *See generally* LOSS & SELIGMAN, *supra* note 5, at 910, 1273–1301 (discussing the implied right of action under Rule 10b-5).

[145] 15 U.S.C. § 78ff(a) (2006) (criminal penalties); *see* LOSS & SELIGMAN, *supra* note 5, at 1418–25. For a survey of criminal liability under the securities acts, see generally Nic Heuer, Les Reese & Winston Sale, *Securities Fraud*, 44 AM. CRIM. L. REV. 956 (2007).

[146] *See* Jeffrey T. Cook, *Recrafting the Jurisdictional Framework for Private Rights of Action Under the Federal Securities Laws*, 55 AM. U.L. REV. 621, 642–46 (2006).

3. State Securities Laws

State securities laws, usually referred to as blue sky laws, essentially track the development of securities disclosure law and securities fraud liability in federal securities law.[147] As noted above, as a result of Congress's efforts to curb private securities fraud litigation and recent Supreme Court rulings regarding the new pleadings requirements, the state securities laws will take on ever greater importance in the securities plaintiff's arsenal of litigation weapons.[148]

4. Federal and State Consumer Protection and Anti-Fraud Laws

Consumer protection statutes, which exist in most states, provide additional weapons to combat fraud. While the Federal Trade Commission Act ("FTC Act")[149] does not apply to securities, it might be implicated where businesses market consumer products and represent that their businesses are run according to *Shari'ah*. Further, modeled in part after the FTC Act, the "little FTC Acts" enacted by most states are often more broadly interpreted than the FTC Act and many have an express or implied private right of action allowing the consumers themselves to battle fraud in the marketplace.[150]

In California, for example, a private plaintiff sued Nike,[151] an Oregon corporation, on behalf of all California residents under the California Unfair Competition Law.[152] The suit was filed after Nike allegedly made false and misleading public statements in the wake of media reports suggesting abuse at its foreign factories.[153] Nike claimed its speech was protected under the First Amendment.[154] The case went to the U.S. Supreme Court after Nike's arguments to get the case dismissed on First Amendment grounds did not persuade the California Supreme Court.[155] But the U.S. Supreme Court sent it back down to the California courts after it determined that certiorari had been improvidently

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[147] *See supra* note 134 and accompanying text.

[148] *See supra* note 134 and accompanying text.

[149] 15 U.S.C. §§ 41–58 (2006).

[150] For a discussion of the broad sweep of state consumer fraud statutes, *see* Victor E. Schwartz & Cary Silverman, *Common-Sense Construction of Consumer Protection Acts*, 54 U. KAN. L. REV. 1, 15–32 (2005).

[151] *See* Kasky v. Nike, Inc., 45 P.3d 243, 247 (Cal. 2002).

[152] *Id.* at 249. The law, referred to by the California Supreme Court in *Kasky* as the Unfair Competition Law ("UCL"), is codified at CAL. BUS. & PROF. CODE §§ 17200–17210 (West 2008). *Kasky*, 45 P.3d at 249. The UCL recently was amended by Proposition 64 to eliminate the right of private plaintiffs to sue as "private attorneys general" without a showing of injury. *See* Schwartz & Silverman, *supra* note 150, at 34–37.

[153] *See Kasky*, 45 P.3d at 247–48.

[154] *Id.* at 248.

[155] *See* Nike, Inc. v. Kasky, 539 U.S. 654 (2003); *Kasky*, 45 P.3d at 262.

granted[156] and Nike settled the case.[157] The implications of this type of state action for the SCF industry will be addressed below. Another potential source of liability exists in at least three states that allow their respective consumer protection statutes to be used for securities fraud, which would bring the entire SCF industry under consumer fraud scrutiny.[158]

Additional laws implicated are the federal Lanham Act,[159] which regulates, *inter alia*, fraud in the description of goods, services, or commercial activities,[160] and laws governing consumer finance. Consumer finance in the U.S. falls within the ambit of the federal Truth-in-Lending Act (TILA)[161] and the myriad regulations promulgated thereunder referred to collectively as Regulation Z.[162] Banks and other lenders advertising "zero-interest loans" or "*riba*-free loans" might in fact run afoul of the TILA disclosure requirements and the restrictions on deceptive advertising. The Home Ownership and Equity Protection Act (HOEPA) and the state versions of HOEPA,[163] which are part of TILA, might also apply to what amounts to predatory lending to *Shari'ah*-adherent Muslims to the extent that the fees and costs are almost always higher than conventional loans.

5. Due Diligence and Compliance Statutes

The federal securities laws in several instances incorporate due diligence as defenses to the anti-fraud provisions and as such are an integral part of any legal analysis for civil or criminal exposure.[164] In addition, due diligence is incorporated

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[156] *See Nike, Inc.*, 539 U.S. at 655.

[157] Mark B. Baker, *Promises and Platitudes: Toward a New 21st Century Paradigm for Corporate Codes of Conduct?*, 23 CONN. J. INT'L L. 123, 146–47 (2007).

[158] The three states are Arizona, see State *ex rel.* Corbin v. Pickrell, 667 P.2d 1304, 1307 (Ariz. 1983) (stating that an amendment to the Arizona Consumer Fraud Act "provide[s] an additional avenue of relief" to those aggrieved by securities act violations); Illinois, see Onesti v. Thomson McKinnon Sec., Inc., 619 F. Supp. 1262, 1267 (N.D. Ill. 1985) (construing Illinois's Consumer Fraud and Deceptive Practices Act as covering securities); and Pennsylvania, see Denison v. Kelly, 759 F. Supp. 199, 202–05 (M.D. Pa. 1991) (construing Pennsylvania's Consumer Protection Act to apply to securities transactions).

[159] Pub. L. No. 79-489, 60 Stat. 427 (1946) (codified as amended at 15 U.S.C. §§ 1051–1141n (2006)).

[160] *See* 15 U.S.C § 1125 (2006).

[161] Pub. L. No. 90-321, 82 Stat. 146 (1968) (codified as amended at 15 U.S.C. §§ 1601–1693r (2006)).

[162] Truth in Lending Rule (Regulation Z), 12 C.F.R. § 226 (2007).

[163] Home Ownership and Equity Protection Act of 1994, Pub. L. No. 103-325, 108 Stat. 2160, 2190 (1994) (codified as amended in scattered sections of 15 U.S.C.).

[164] LOSS & SELIGMAN, *supra* note 5, at 1205 (discussing the defense of "reasonable care" under Section 12(a)(2) of the 1933 Act); LOSS & SELIGMAN, *supra* note 5, at 1227–39 (reviewing reasonable care and "expertizing" defenses under Section 11 of the 1933 Act).

into several compliance regimes such as the Bank Secrecy Act[165] and anti-money laundering statutes,[166] many of which were modified by the Patriot Act.[167] Insofar as SCF incorporates the *Shari'ah* obligation to tithe and also requires the "purification" of profits earned in violation of, *Shari'ah*, the question for the legal practitioner is who decides what happens to the monies gifted to charities and which charities are selected. Given the historical connection between some of the largest and well-known Muslim charities and the funding of terrorist groups,[168] these questions take on added focus in the context of material support of terrorism. Finally, the structure of the *Shari'ah* authority boards and their professional membership organizations raise antitrust issues.

C. A Suggested Analytical Taxonomy

The challenges described above for the SCF transactional lawyer and other professionals advising clients on the intricacies of legal compliance are not inconsequential. In agreements and in law, words are given context by the intent of the parties. The inherent problem of SCF is that the intent of the parties is to comply with *Shari'ah*, but the intent of *Shari'ah* generally and in any particular transaction is typically lost on the secular professionals who help structure SCF within the bounds of secular regulation.[169] These professionals, especially the lawyers, are very good at solving problems by re-structuring a transaction through wordsmithing, thereby arriving at the same result in different form. But their approach is to deal only with the trees hindering the client's path to the goal within the landscape of the transaction itself.

For the typical secular financial transaction, this is sufficient because there is no dark forest in which to get lost. An obstacle in the path can be safely circumvented because the problem is transparent and thus its ramifications for disclosure and compliance are understood. When the trees, however, grow out of the forest known as *Shari'ah*, it is not at all clear to these professionals why they are where they are, what dangers might lurk there, or where the forest might lead. This is because *Shari'ah* is not accessible to the secular professionals. As a

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[165] *See* 31 U.S.C.A. § 5318(i) (2006). The Bank Secrecy Act was enacted as Pub. L. No. 91-508, 84 Stat. 1114 (1970) (codified as amended at 31 U.S.C.A. §§ 5311–5332 (West 2003 & Supp. 2007)).

[166] *See infra* Part V.C.1.a.

[167] Pub. L. No. 107-56, 115 Stat. 272 (2001) (codified as amended at scattered titles of U.S.C.).

[168] *See infra* Part V.C.1.b.

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

consequence, the forest is packaged as a black box and ignored. It is no surprise then that the professional literature has paid little attention to the liability and criminal exposure issues unique to a financial investment or business transaction fitted to *Shari'ah*.[170] This article seeks to facilitate academic and professional scrutiny of SCF by suggesting an analytical taxonomy separating SCF-related legal exposure into two elements: those arising of out endogenous elements and those arising out of exogenous elements.[171]

1. Exposure Arising out of Endogenous Elements

To understand the risks and exposure for a financial institution contemplating SCF, a lawyer must first understand what *Shari'ah* itself says it is—that is, what the *Shari'ah* authorities understand it to be, without reference to how SCF attempts

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[170] A good example is to look at the published works of the legal practitioners who provide expert legal services to the SCF industry. The articles by McMillen cited herein generally are examples, but notably see McMillen, *supra* note 12, at 439–40 n.18 and accompanying text. McMillen considers the utilization of *Shari'ah* in Saudi Arabia and various other Muslim countries, yet does not raise even a word of caution regarding abuses under *Shari'ah* legal systems. This is not unique to legal academics and professionals studying SCF. *See generally* FELDMAN, *supra* note 37 (theorizing that *Shari'ah* in the hands of the classic Islamic Empire's *Shari'ah* authorities acted as a constitutional balance of power and brake on run-away executive authority; opining that this condition is the necessary ingredient to restore sensible political order to the Islamic world; but failing to address the *telos* of Shari'ah, the purpose of the *Shari'ah* political order per Shari'ah, or the methodology of subjugation and violent Jihad used to achieve that end).

[171] These terms are borrowed from 1 THE SAGE ENCYCLOPEDIA OF SOCIAL SCIENCE RESEARCH METHODS 308–09, 347 (Michael S. Lewis-Beck, Alan Bryman, & Tim Futing Liao eds., 2004), *available at* http://www-personal.umd.umich.edu/~delittle/Encyclopedia%20entries/endogeneous%20variable.pdf&wwwpersonal.umd.umich.edu/~delittle/Encyclopedia %20entries/exogenous%20variable.pdf. The endogenous/exogenous taxonomy for analyzing disclosure has an ancient pedigree. In standard common law fraud, commentators such as Judge Story distinguished between the heightened duty to disclose for intrinsic elements of a deal versus the extrinsic:

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

1 JOSEPH STORY, COMMENTARIES ON EQUITY JURISPRUDENCE 301–02 (W. H. Lyon, Jr. ed., 14th ed. 1918).

to navigate the demands of modern finance. This inquiry can be termed an analysis of the endogenous elements or aspects of *Shari'ah*, and it will be relevant to many fundamental issues of SCF. Moreover, to the extent that *Shari'ah* compliance is determined by *Shari'ah* authorities, presumably there is something in the institution of *Shari'ah* itself that will inform a lawyer who qualifies as an authority and how the qualification process operates. Finally, to the extent that *Shari'ah* is in fact what its proponents say it is—a way of life combining authoritative Islamic legal, moral, theological, and normative social constructs—an attorney has a responsibility to ensure that her client has conducted the necessary due diligence to be certain that these structures do not violate U.S. law. These endogenous elements are explored in Part IV below in further detail.

2. Exposure Arising out of Exogenous Elements

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

In this part of the analysis, a lawyer should address the exogenous features of SCF that might raise liability exposure issues that are not inherent in *Shari'ah* principles but are adaptations of *Shari'ah* principles to fit Western financial structures and institutions. An example of a transactional structure designed to deal with this collision between *Shari'ah* and a Western world built on the time-value of money is the sale-lease back agreement.[172] While sale-lease back agreements are not unique to SCF and are in fact a popular vehicle in contemporary finance, in the two contexts, they are not identical in structure and are worlds apart in their purposes.[173] An example of the legal-definitional parameters set out by *Shari'ah*

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[172] One such *Shari'ah*-based nominate lease contract is called *Ijara*. VOGEL & HAYES, *supra* note 17, at 143–45.

[173] Typically, a sale-lease back financing transaction is a way for a company to gain liquidity and to move a capital asset off the balance sheet to avoid the burdens to the company's debt ratios if standard capital asset financing is used. For a short discussion of the accounting aspects, see generally Ronald T. Max & Richard J. Strotman, *Sale/Leaseback: Financing Tool for the '90s*, CPA J., Apr. 2001, at 48, *available at* http://www.nysscpa.org/cpajournal/old/10691657.htm (explaining sale/leaseback financing). The motivation for a *Shari'ah* sale-lease back, however, is to avoid interest and to accommodate *Shari'ah* fixed rules relative to the actual transfer of ownership of the property, who is responsible for repairs (lessor), who can cancel the contract under changed

authorities to deal with the doctrinal conflicts between the two systems is the ruling that, while interest income is absolutely forbidden in *Shari'ah*, it is not forbidden to invest in a company that earns less than X%[174] from interest income that is not a core business of the company (i.e., interest earned on liquid assets or accounts receivables).[175] Further discussion of the exogenous elements of SCF is provided in Part V below.

IV. THE ENDOGENOUS ELEMENTS: DISCLOSURE OF *SHARI'AH* IN SCF

A. The Preliminary Analysis

The first order of business for an attorney providing advice in the context of disclosure laws to a U.S. financial institution interested in SCF should be answering the following question: how intimate is the connection between SCF and *Shari'ah* itself? In legal terms, how material is *Shari'ah* to SCF? If *Shari'ah* is a material part of SCF, the attorney must confront the likelihood that it is a material fact of SCF in the context of disclosure laws. While the answer to the question might appear self-evident—that is, *Shari'ah* has everything to do with SCF—extant literature by legal scholars and practitioners suggests that, even if *Shari'ah* is a material component of SCF, it is not material to any of the disclosure laws because *Shari'ah* is treated as a "black box" that merely turns out rules requiring specific kinds of contractual arrangements.[176]

But secular lawyers' treatment of *Shari'ah* as a "black box" that does not concern them—except in the specific rulings relative to a given investment or transaction—is simply a willful avoidance of material facts. Those facts are the endogenous elements of *Shari'ah* that result in the "rules and principles" of

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circumstances (lessee), and how the parties will treat future sale and option terms. In other words, the purposes of a secular sale-lease back are purely for accounting purposes or "form"; for the *Shari'ah* contract, however, the purpose is to effect the actual "substance" required by *Shari'ah* in an approved "form."

[174] *See, e.g.*,Yaquby, *supra* note 23, at 21–24 (addressing various "guidelines" of "permissibility," such as prohibiting investment in companies that earn more than 5–15% of total earnings from interest income). The DJIMI achieves this prohibitory goal by screening out companies with a debt to market capitalization ratio equal to or greater than 33%. For this and other ratios intended to screen for interest income, see M. H. KHATKHATAY & SHARIQ NISAR, INTERNATIONAL CONFERENCE ON ISLAMIC CAPITAL MARKETS, INVESTMENT IN STOCKS: A CRITICAL REVIEW OF DOW JONES *SHARI'AH* SCREENING NORMS 11–12 (2007), http://www.djindexes.com/mdsidx/downloads/Islamic/articles/DowJonesShariahScreeningNorms.pdf.

[175] Yaquby, *supra* note 23, at 21–24.

[176] *See, e.g.*, McMillen, *supra* note 12 (discussing contractual enforceability issues); McMillen, *supra* note 111 (discussing the structuring of financial arrangements).

SCF.[177] Indeed, according to the proponents and practitioners of SCF, *Shari'ah* is not just an approach to interest-free, ethical Islamic business practices or investing.[178] Invariably, SCF is described by its proponents, practitioners, and scholars as the contemporary Islamic legal, normative, and communal response to the demands of modern-day finance and commerce.[179] What makes the response "Islamic," or one pursued almost exclusively by Muslims,[180] is the fact that this legal, normative, and communal response to modern finance is framed and regulated by *Shari'ah* authorities ruling on what *Shari'ah* permits and prohibits.[181] Thus, whether called *Shari'ah*-compliant finance, Islamic economics and finance, or even "ethical" investing, the one unifying characteristic of SCF is the appearance of authoritative Muslim *Shari'ah* scholars who, individually and collectively through various manifestations of consensus,[182] define the "rules and principles" of SCF and set out how a *Shari'ah*-adherent Muslim may "lawfully" engage in commerce, investing, and finance.[183]

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[177] "*Shari'ah* rules and principles" is a term of art among *Shari'ah* authorities. Various standards publications are available to the public through the Islamic Financial Services Board ("IFSB"), one of the premier standards institutes of SCF. *See* Islamic Financial Services Board, Defining New Standards in Islamic Finance, http://www.ifsb.org/index.php?ch=4&pg=140 (last visited Aug. 3, 2008) [hereinafter IFSB Standards].

[178] *See generally* WARDE, *supra* note 11, at 1–4 (highlighting the challenge of reconciling Homo Islamicus and Homo Economicus); *see also* DeLorenzo & McMillen, *supra* note 47, at 132-197 (analyzing examples of "Islamic economy" from both *Shari'ah* and secular sources).

[179] *See* WARDE, *supra* note 11, at 74–75 (discussing the challenge of building a financial system that could feasibly "be at once consistent with religious precepts and viable in a modern economy").

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

[181] VOGEL & HAYES, *supra* note 17, at 9–10.

[182] *See* DeLorenzo & McMillen, *supra* note 47, at 139–51 (explaining how Islamic economics has evolved to a point where "modern Islamists have settled for majority-based decisions" so that "scholars have been engaging in . . . ijtihad [*Shari'ah*-based reasoning]"); WARDE, *supra* note 11, at 40–41. As the literature makes clear, consensus among *Shari'ah* authorities is an important part of the tradition and integrity of *Shari'ah*. *See infra* notes 201–202 and accompanying text. In some Muslim countries, however, there is actual government oversight and regulation. *See, e.g.*, POLITICS, *supra* note 11, at 155–285 ("offer[ing] case studies of Islamic banking experiences" in various countries). *See generally* ISLAMIC FIN. SERVS. BD., GUIDANCE ON KEY ELEMENTS OF THE SUPERVISORY REVIEW PROCESS OF INSTITUTIONS OFFERING ISLAMIC FINANCIAL SERVICES (EXCLUDING ISLAMIC INSURANCE (TAKĀFUL) INSTITUTIONS AND ISLAMIC MUTUAL FUNDS), Dec. 2007, http://www.ifsb.org/view.php?ch=4&pg=257&ac=36&fname=file&dbIndex=0&ex=12015 33270&md=%C1h%D5%BB%AA%B9zc%C3%9E%7CV%29%0A%BA%3C (giving "guidance on key elements in the supervisory review process for authorities supervising institutions offering only Islamic financial services") [hereinafter IFSB STANDARD].

[183] *See* IFSB STANDARD, *supra* note 182, at 11–12; *infra* note 411.

Further, the *Shari'ah* authorities are clear: SCF is not a discreet or segregable component of *Shari'ah*.[184] It is a fully integrated discipline within the *corpus juris* of *Shari'ah*, which in turn is a holistic, all-encompassing way of life.[185] *Shari'ah* is not divisible. For example, one cannot extract from *Shari'ah* the SCF "commercial legal code" from *Shari'ah* and end up with a body of laws articulating a secular code of business conduct. This is demonstrated by the prohibitions against businesses that trade in pork products (seemingly strictly an issue of dietary code) or the leasing of a building to a church (quite obviously a theological consideration informing a business law issue).[186] Even in Islamic legal rulings relating to whether a Muslim bank or individual may receive interest from deposit accounts, the decision turns in large part on whether the deposits reside in a jurisdiction called the "abode of war," where non-Muslims predominate, or the "abode of peace," where Muslims predominate.[187]

The inclusiveness, universality, and indivisibility of *Shari'ah* are not just evidenced by the published work of *Shari'ah* authorities on the one hand and secular academic scholars on the other. Especially important for a lawyer

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[184] *See infra* notes 186–187 and accompanying text; *see, e.g.*, VOGEL & HAYES, *supra* note 17, at 53–55 (attempting to describe SCF by examining the "religious wellsprings of the law and the moral logic of particular outcomes").

[185] DeLorenzo & McMillen, *supra* note 47, at 136–37; *see also* WARDE, *supra* note 11, at 44–48 (suggesting the difference between Homo Islamicus and Homo Economicus "is the assumption of altruism . . . . Islam is preoccupied with the welfare of a community where every individual behaves altruistically and according to religious norms").

[186] *See* 2 A COMPENDIUM OF LEGAL OPINIONS ON THE OPERATIONS OF ISLAMIC BANKS 13–29 (Yusuf Talal DeLorenzo ed. & trans., 2000). A typical ruling reads: "If the lease of real estate is for purely prohibited purposes, like a bar, or a church, or a nightclub, then the lease contract is prohibited and legally void because the benefit, or subject of the contract, is prohibited." *Id.* at 16.

[187] *See, e.g.*, *id.* at 214–45. In a detailed legal ruling relating to interest earned in a bank in non-Muslim lands, a leading *Shari'ah* authority explains that the strictures of *Shari'ah* on certain business transactions such as deposits in a non-Muslim bank are relaxed when a Muslim enters the Abode of War (*dar al-harb*), which is the land of non-Muslims. The point of citing this ruling is to give a concrete example of how even the Law of *Jihad* in the context of the doctrines relative to the Abode of War versus the Abode of Islam is integral to the law of commerce. Thus, in the legal ruling, the *Shari'ah* authority began his analysis as follows:

> In the terminology of Islamic Law, "people of the abode of war" are not only those who are actually at war with Muslims, but all those who are not formally allied with Muslims by a covenant of protection, such that war could conceivably be declared between them and Muslims at any time.

Id. at 224 (emphasis added). For a ruling on whether a Muslim can lease a building in the Abode of Islam to a coeducational foreign school for foreign, non-Muslim students, see *id.* at 27–28.

attempting to determine what the "*Shari'ah*" of SCF is in the context of disclosure laws, and what if anything of this "*Shari'ah*" is material and subject to the duty to disclose, is what *Shari'ah* actually is in practice. An attorney in search of the actual presentation of *Shari'ah* as an extant and authoritative basis for law in modern times has the opportunity to examine several Muslim regimes which have implemented *Shari'ah* as the law of the land to a substantial degree. The best examples of such implementation are Iran, Saudi Arabia, and Sudan.[188] The Taliban of Afghanistan had also imposed a fully authoritative *Shari'ah*, and many other Muslim regimes have utilized aspects of *Shari'ah* to complement a non-*Shari'ah* secular code.[189] The more a country's laws are based upon *Shari'ah*, the better the evidence of what *Shari'ah* actually is in practice—devoid of all the academic theorizing and parsing.[190]

It is beyond this article's scope to determine what *Shari'ah* is in fact or what it means to the contemporary *Shari'ah* authorities sitting as the final arbiters of SCF. However, examining the literature of *Shari'ah* over the course of its history; determining what *Shari'ah* is in Muslim countries that apply traditional *Shari'ah* rules and principles; and, importantly, studying the published rulings by contemporary *Shari'ah* authorities on what *Shari'ah* is,[191] what its purposes are, and what *Shari'ah* considers the appropriate means to achieve those ends, are all part of any inquiry into the material endogenous elements of *Shari'ah* subject to disclosure.

B. The Hypothetical: Not so Hypothetical

Notwithstanding a reluctance based on practical considerations to engage in a full analysis of the material endogenous elements of *Shari'ah*, it is helpful to assume a few facts about *Shari'ah* in order to provide a factual predicate for the analysis of the disclosure (and other) laws that follow. The first assumption is that consensus exists among *Shari'ah* authorities on the fundamental purpose of *Shari'ah*: submission to the will of Allah as expressed in Allah's law. Second, the *Shari'ah* seeks to establish that Allah is the divine lawgiver and that no other law may supersede Allah's law. Third, *Shari'ah* seeks to achieve this goal through

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[188] *See, e.g.*, Stahnke & Blitt, *supra* note 115, at 954–62 (examining the connections between Islam and government in predominantly Muslim countries). Recently, northern Nigeria has been added to this list. *See* Lydia Polgreen, *Nigeria Turns from Harsher Side of Islamic Law*, N.Y. TIMES, Dec. 1, 2007, at A1, *available at* http://www.nytimes.com/2007/12/01/world/africa/01shariah.html?_r=1&oref=login.

[189] U.S. Dep't of State, Afghanistan: International Religious Freedom Report Released by the Bureau of Democracy, Human Rights, and Labor (Oct. 26, 2001), http://www.state.gov/g/drl/rls/irf/2001/5533.htm.

[190] Except perhaps as noted in *supra* note 182. For a country-by-country analysis by Freedom House, see Freedom Survey 2007, *supra* note 115.

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

persuasion and other non-violent means. Finally, when necessary and under certain prescribed circumstances, the use of force—and even full-scale war to achieve the dominance of *Shari'ah* worldwide—is not only permissible but obligatory.

While this article poses these conclusions as a hypothetical, they are not entirely conjectural. In fact, as set forth in an important study on the subject, they reflect the rulings of the classical *Shari'ah* authorities dating back almost a millennium and include the most contemporary of *Shari'ah* authorities issuing authoritative legal rulings today.[192] This study, conducted by Major Stephen Collins Coughlin, examines *Shari'ah* as a law defined and interpreted by *Shari'ah* authorities themselves.[193] Further, it surveys the binding rulings of *Shari'ah* authorities covering the classical periods dating back to the early days after Mohammed's death, the so-called Golden Era of Islamic enlightenment, and the chaotic period around the fall of the Ottoman Empire through to the present day.[194] The contemporary survey also includes reference to a best-selling 7th grade textbook used in Islamic day schools throughout the U.S. to validate the study's choice of authorities and to confirm that their legal rulings are used pedagogically as the foundation for understanding traditional, *Shari'ah*-centered Islam.[195] Further, Coughlin carefully authenticates the authorities so that one is not misled into accepting either a weak authority or an "extremist" view point.[196] The work is the best of any such scholarship because it treats doctrinal *Shari'ah* as *Shari'ah* expects to be treated and as evidenced by the published rulings of the *Shari'ah* authorities: as a sectarian legal-political-military normative social construct sourced in divine and immutable law.[197]

Coughlin's study demonstrates that *Shari'ah* and the doctrines of war articulated as the Law of *Jihad* are as valid today as they were one thousand years ago.[198] *Jihad,* in this context meaning violent struggle and war,[199] should be implemented as circumstances permit, and the contemporary authoritative *Shari'ah* scholars continue to teach, preach, and issue legal rulings to this effect.[200] Coughlin's investigation further explicates that once the *Shari'ah* authorities reach a consensus on a legal ruling based on the *Qur'an* and *Hadith*, the ruling is

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[192] *See generally* Coughlin, *supra* note 30 (studying *Shari'ah* and its foundational role as controlling doctrine for *Shari'ah*-adherent terrorists in their war against the infidel).

[193] *Id.* at 87–96.

[194] *Id.* at 43–70.

[195] *Id.* at 69, 86, 144, 284; *see also* YAHIYA EMERICK, WHAT ISLAM IS ALL ABOUT: STUDENT TEXTBOOK (3d. prtg. 2000).

[196] *See* Coughlin, *supra* note 30, at 43–70.

[197] The classic scholarly work on the subject is SCHACHT, ISLAMIC LAW, *supra* note 37; *c.f.* ISLAMIC LEGAL THEORIES, *supra* note 32, at 162–206 (exploring the theories of Abu Ishaq al-Shatibi as a theory that "provide[s] for flexibility and adaptability in positive law" but that has as its primary goal "restoring . . . the true law of Islam").

[198] *See* Coughlin, *supra* note 30, at 219–20.

[199] *See id.* at 134–68.

[200] *See infra* note 208 and accompanying text.

considered immutable and irrevocable.[201] This adds further concretization to the rulings on *Jihad* because the purpose of Islam and the methodologies to achieve those ends per *Shari'ah* are universally accepted by the *Shari'ah* authorities with relatively minor exceptions as to specifics.[202]

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

(1) The goal of *Jihad* to convert or conquer the entire world and the methodology to achieve this end by persuasion, by force and subjugation, or by murder is extant doctrine and valid law by virtue of a universal consensus among the authoritative *Shari'ah* scholars throughout Islamic history.[203]

(2) The doctrine of *Jihad* is foundational because it is based upon explicit verses in the *Qur'an* and the most authentic of canonical *Sunna*. It is considered a cornerstone of justice and until the infidels and polytheists are converted, subjugated, or murdered, their mischief and domination will continue to harm the Muslim nation.[204]

(3) *Jihad* is conducted primarily through kinetic warfare, but it includes other modalities such as propaganda and psychological warfare.[205]

Coughlin's thesis is supported by the rulings of several very prominent contemporary *Shari'ah* authorities. In a book of collected writings by one such authority, Mufti M. Taqi Usmani—a member of numerous *Shari'ah* advisory boards and one of the most respected *Shari'ah* authorities in the world[206]—advocates violent and aggressive *Jihad* even against peaceful non-Muslims residing in the West if they don't heed the call to Islam[207] or if they in any way obstruct *Shari'ah*'s mandate for Islam to dominate legally and socially all other

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[201] Coughlin, *supra* note 30, at 97–107, 134–68.

[202] One poignant example is Coughlin's use of Averroes (Abu al-Walid Muhammad ibn Ahmad ibn Rushd), one of the leading *Shari'ah* authorities of the so-called Golden Era in Islamic history often touted as an age of Muslim enlightenment, pluralism, and peace. Coughlin points out, based upon available English translations of Averroes' major work on *Jihad*, that even in their best light *Shari'ah* authorities consistently maintain that infidels and polytheists must be fought. *See, e.g.*, Coughlin, *supra* note 30, at 68, 108–09, 184–86. For the entire work on *Jihad* translated, see PETERS, *supra* note 8, at 27–42.

[203] *See* Coughlin, *supra* note 30, at 134–68.

[204] *Id.* at 134–68.

[205] *Id.* at 168–206, 220–21. *See also*, Brief for Center for Security Policy as Amicus Curiae Supporting Plaintiffs, Boim v. Holy Land Foundation for Relief and Development, Nos. 05-1815, 05-1816, 05-1821, 05-1822 (consol.) (7th Cir. Aug. 22, 2008) (en banc) (detailing the connection between violent Jihad and "other modalities" such as Da'wa or civil, political, and economic outreach).

[206] Shariah, Law, and 'Financial Jihad': How Should America Respond?: Analysis and Findings of a Workshop Co-sponsored by: The McCormack Foundation and The Center for Security Policy 25-32 (2008) (detailing Usmani's work on behalf of Dow Jones, HSBC, Guidance Financial Group, and many others).

[207] Coughlin, *supra* note 30, at 168–206, 220–21.

religions.[208] He bases his ruling explicitly on legal verses in the *Qur'an*, the actions of Mohammed and the successor Caliphates, and a consensus among *Shari'ah* authorities.[209] If Coughlin is correct, then Usmani is but one example of a *Shari'ah* authority who both embraces the Law of *Jihad* as an extant doctrine for action by *Shari'ah*-adherent Muslims and bases his rulings on the classical *Shari'ah* authorities who fully embraced the consensus on the Law of *Jihad*.

C. Applying the Endogenous Elements of Shari'ah to the Specific Duty to Disclose

As noted previously, the SCF industry in the U.S. includes a panoply of businesses regulated by the securities laws.[210] Examples include mutual funds tracking one of the Islamic indexes, publicly traded bond issuances and the trading of securitized bond issuances on a secondary market, and even U.S. public companies who conduct their business affairs in accordance with the principles of *Shari'ah*.[211] Do the facts of *Shari'ah*—representing the overriding purposes of *Shari'ah* and the methods authorized to achieve those purposes—require disclosure under the securities laws?

Failure to disclose a material fact (or the material misrepresentation of an asserted fact) is the basis for administrative, civil, and criminal actions under all of the securities laws requiring disclosure.[212] The breach of this duty might arise in a registration, prospectus or other required filing with the SEC, or "in connection with" a purchase or sale of securities.[213] For example, the 1933 Act imposes a number of requirements upon issuers, underwriters, and dealers to make full and fair disclosures in securities offerings.[214] Section 11 of the 1933 Act ("Section 11") provides that purchasers of securities may sue for material misrepresentations or omissions in registration statements as long as they did not know of the misrepresentation or omission at the time of purchase.[215] The dragnet under Section 11 for potential defendants is fairly wide and includes: (1) any person who signed the registration statement;[216] (2) any person who was a director or partner of the issuer at the time of the filing of the registration statement;[217] (3) any person

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[208] MUFTI MUHAMMAD TAQI USMANI, ISLAM AND MODERNISM 123–39 (1999) (representing a part of Usmani's writings and rulings over a 27-year period).

[209] *See id.*

[210] *See supra* notes 70–77 and accompanying text.

[211] *See supra* notes 70–77 and accompanying text.

[212] *See supra* notes 136–141 and accompanying text.

[213] Rule 10b-5 uses the language "in connection with." *See* discussion *infra* notes 223–227 and accompanying text.

[214] *See, e.g.*, 15 U.S.C. § 77g (2006) (requiring disclosures in registration statements); *id.* § 77j (requiring disclosures in prospectuses); *id.* § 77aa (requiring schedules of information in registration statements).

[215] *Id.* § 77k.

[216] *Id.* § 77k(a)(1); *see also id.* § 77(f).

[217] *Id.* § 77k(a)(2).

listed in the registration statement as a soon-to-be director or partner;[218] (4) every accountant, engineer, appraiser, or other expert named in the statement after having consented, but only as to any liability arising from the portion of the statement attributed to the specific expert;[219] or (5) any underwriter of the securities.[220] In addition, Section 12 of the 1933 Act ("Section 12") authorizes a purchaser of securities to sue the offeror or seller for any material misrepresentation or omission in a prospectus and adds "oral communication[s]" to the landscape.[221] The depth of the exposure from both of these provisions is demonstrated by the fact that a private plaintiff generally need not allege or show actual reliance on the misrepresentation or show that the absence of the material omission was in fact a contributing element.[222]

The preeminent statutory authority regarding disclosure in securities transactions is Section 10(b) of the 1934 Act[223] and its regulatory offspring, Rule 10b-5.[224] It has been the source for much litigation due to its breadth and the fact that it includes an implied private right of action, thereby adding private plaintiff and class action claims to the enforcement suits by the SEC and Department of Justice criminal prosecutions.[225] The essential elements of a Rule 10b-5 action are: (1) a misstatement or omission; (2) of material fact; (3) with scienter; (4) in connection with the purchase or the sale of a security; (5) upon which the plaintiff reasonably relied; and (6) that the plaintiff's reliance was the proximate cause of his or her injury.[226]

Once these elements of the Rule 10b-5 cause of action are established, a criminal penalty can be imposed under Section 32(a) if the government satisfactorily proves a willful violation of the 1934 Act.[227]

This article examines two elements unique to most fraud claims based upon allegations that the defendant omitted material information about *Shari'ah* in public filings and representations: materiality and scienter. Because the discussion regarding materiality in a federal securities fraud action also applies to fraud claims under the common law, state blue sky laws, or other anti-fraud federal and state statutes, the discussion of materiality will not treat these other claims separately. These two elements of the fraud action are carved out for special attention because a failure to consider them properly will contribute to the

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[218] *Id.* § 77k(3).
[219] *Id.* § 77k(4).
[220] *Id.* § 77k(a)(5).
[221] *Id.* § 771.
[222] *See* LOSS & SELIGMAN, *supra* note 5, at 1200–01, 1227–29.
[223] 15 U.S.C. § 78j(b).
[224] 17 C.F.R. § 240.10b-5 (2007).
[225] *Supra* notes 142–145 and accompanying text.
[226] *See* 17 C.F.R. § 240.10b-5; LOSS & SELIGMAN, *supra* note 5, at 1273–1301; *see also* Heuer, Reese & Sale, *supra* note 145 (reviewing the legal bases of securities fraud).
[227] 15 U.S.C. § 78ff(a); *see also* Heuer, Reese & Sale, *supra* note 145, at 965–66 nn.53–54, 1014–19.

conclusion that the *Shari'ah* "black box" poses no great risk to U.S. companies involved in SCF. This conclusion, if reached without due consideration of the matters raised herein, would be faulty and very costly.

1. Materiality

(a) The Supreme Court's Standards

Materiality is a fundamental element for an action alleging a failure to disclose under the securities laws. For instance, a hypothetical complaint might allege the following:

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

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

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

(4) It was subsequently discovered and made public that the *Shari'ah* advisory board members all treated the rulings and pronouncements of Ibn Taymiyyah, a fourteenth-century Hanbali *Shari'ah* authority and scholar "with strikingly modern-sounding views" on commerce and finance,[228] as authoritative. It was also discovered and made public that Ibn Taymiyyah was a key *Shari'ah* authority for most of the terrorists associated with al Qaeda.[229] He was also a leading advocate of a *Shari'ah*-centered political organization for Muslims that would declare war against infidels and Muslims who rejected *Shari'ah*.[230] In fact, all sorts of "Islamists" who have declared war on the U.S. and seek the establishment of a worldwide Caliphate are students and followers of the *Shari'ah* "rules and principles" espoused by Ibn Taymiyyah insofar as he advocates Muslims to war against infidels.[231]

(5) There is a consensus among *Shari'ah* authorities from all schools of *Shari'ah* jurisprudence that forced subjugation or *Jihad* against non-Muslims is obligatory when efforts to peacefully convert the non-Muslims fail, and war is a viable option.[232]

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[228] VOGEL & HAYES, *supra* note 17, at 38.

[229] *See* MARY R. HABECK, KNOWING THE ENEMY: JIHADIST IDEOLOGY AND THE WAR ON TERROR 19 (2006).

[230] *Id.* at 19–22.

[231] *See* Coughlin, *supra* note 30, at 47, 147–50.

[232] *See* USMANI, *supra* note 208, at 123–39 (exploring the difference between defensive and offensive jihad, and concluding that "Aggressive Jehad [sic] . . . . is obligatory against non-hostile, non-Muslim states if Muslims have enough power to carry it out); Coughlin, *supra* note 30, (reviewing the doctrinal basis of *Jihad*); *see also* PETERS,

In addition to these allegations, which would support an SEC enforcement action or a private right of action for rescission, a plaintiff might opt to pursue damages. In such a case, one might anticipate the following hypothetical consequences: Were the information alleged above to become public knowledge, the fund might suffer irreparable reputational damage, and many of the U.S. investors would sell their shares in the mutual fund, causing the value of the traded shares to plummet. The complaint might also allege that the plaintiff purchased shares in the mutual fund without knowing anything about *Shari'ah* other than what the defendants represented to the public. Since the defendants promoted their *Shari'ah* authority board members as highly respected scholars and authorities in their field, and since these authorities ruled that *Shari'ah* forbade interest and excessive speculation in investments, and also prohibited investing in various "vice" industries, the plaintiff reasonably relied on these representations in the belief that *Shari'ah* was a "socially responsible" business practice and worth utilizing as an investment "screen."[233] The plaintiff would also have to show that had she known the facts about *Shari'ah* as they had now come to light, the plaintiff would never have invested in a *Shari'ah*-compliant mutual fund. In addition to damages, the plaintiff would likely apply to certify a class of similarly situated investors.[234]

The first issue confronting the plaintiffs under Rule 10b-5 would be whether the omissions of fact relating to *Shari'ah* doctrine and its treatment of apostates (both non-Muslims and Muslims) were material. The leading decision in this area is *TSC Industries, Inc. v. Northway, Inc.*,[235] where the Supreme Court addressed whether a failure to disclose in the context of a proxy solicitation was material.[236] The Court began by rejecting what it considered to be too low a threshold for materiality as adopted by the lower court.[237] The Court considered the lower court's standard of "all facts which a reasonable shareholder *might* consider important"[238] to be "too suggestive of mere possibility, however unlikely."[239]

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supra note 8, at 1–8 (noting that "Classical Muslim Koran interpretation . . . did not go [in the] direction" of interpreting *Jihad* "only as a defense against aggression").

[233] In what might be termed a typical 10b-5 private action for damages, the plaintiff would have to show reliance although when there is a duty to disclose and a public representation, reliance may be presumed (albeit a rebuttable presumption). *See* LOSS & SELIGMAN, *supra* note 5, at 1273–84. *But see* Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc., 128 S. Ct. 761, 774 (2008) (refusing to extend 10b-5 liability to aiders and abettors involved in the deceptive acts of another company).

[234] *See generally* LOSS & SELIGMAN, *supra* note 5, at 1376–92 ("Claims under the federal securities laws are particularly susceptible to class action treatment." (quoting Hudson v. Capital Mgmt. Int'l, Inc., 565 F.Supp. 615, 628 (N.D. Cal. 1983)).

[235] 426 U.S. 438 (1976).

[236] *Id.* at 440.

[237] *Id.* at 445–47.

[238] *Id.* at 445.

The Court went on to explain in detail the objective standard it chose for materiality:

> An omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote. . . . Put another way, there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the "total mix" of information made available.[240]

Arguably, the question whether the *Shari'ah* in SCF is a material fact that ought to be disclosed will rest on one of two analytical approaches, or possibly both. The first approach seeks to determine the materiality of *Shari'ah* in principle. It asks: Would a reasonable post-9/11 investor consider the connection between *Shari'ah* and SCF important to his or her decision to invest? In other words, would a reasonable investor, looking to invest in something promoted as "*Shari'ah*-compliant," want to know what *Shari'ah* and its "rules and principles" say about constitutional government, treatment of infidels, the Law of *Jihad*, the use of suicide-homicide bombers, and other acts of terrorism? Would the reasonable investor want to know about the published statements by international terrorist leaders citing *Shari'ah* authorities as justification for their war against the U.S. and other Western nations? These and similarly phrased questions all attempt to get at the associational link between *Shari'ah* in principle as an authoritative set of rules and principles advocating violence and SCF. If in fact such an association exists, would it be material information to a reasonable investor?[241]

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[239] *Id.* at 449 (quoting Gerstle v. Gamble-Skogmo, Inc., 478 F. 2d 1281, 1302 (2d Cir. 1973)).

[240] *Id.* at 49 (citation omitted).

[241] A related question would be who decides and how does one decide what *Shari'ah* is? This is not specific to the query of materiality. As noted previously, if a financial institution relies upon specific *Shari'ah* authorities, the question might be as simple as determining what these specific *Shari'ah* authorities consider to be authentic and authoritative *Shari'ah* rulings on *Jihad*, terrorism, and violence against non-Muslims and non-*Shari'ah*-compliant Muslims. *See supra* notes 228–231 and accompanying text. Aside from a careful examination of the rulings on these subjects issued by the relevant *Shari'ah* authorities, a problem arises if they have not published rulings in these areas, so one would be well-advised to look to the classical *Shari'ah* authorities upon which contemporary *Shari'ah* authorities rely as authoritative in their SCF rulings. Such reliance might not be dispositive (i.e., a *Shari'ah* authority might rely on Ibn Taymiyyah for purposes of determining what kind of nominate contract *Shari'ah* allows for any given transaction, but in fact reject Ibn Taymiyyah's rulings on *Jihad* and war against the infidels). At the very least, it raises an important question of fact for the reasonable investor that might very well rise to the level of materiality: do the *Shari'ah* authorities of the particular financial institution consider Ibn Taymiyyah's *Shari'ah*-based rulings on war against non-Muslims and non-*Shari'ah* compliant Muslims authoritative? If not Ibn Taymiyyah's, whose?

The second analysis relevant to materiality goes beyond the association in principle of SCF with *Shari'ah* and its call to violence and asks whether there is enough evidence of association in fact. This analysis asks: Is the nexus between *Shari'ah* and violence so contingent or speculative that it would render any theoretical association between *Shari'ah* and violence immaterial? This is another way of analyzing the argument often made against any association between *Shari'ah* or Islam and violence. The argument is made that *Shari'ah* can be interpreted in peaceful or violent ways; the argument is supported by claiming that those authorities who interpret *Shari'ah* violently and in ways that would shock the conscience of a reasonable U.S. investor are extremists and represent such a small percentage of the recognized *Shari'ah* authorities that it would render any theoretical link between *Shari'ah* and violence against non-Muslims and *Shari'ah*-non-compliant Muslims so tenuous as to be immaterial to a reasonable investor. In short, this is an argument that accepts that violence might in fact be associated in principle with *Shari'ah*,[242] but argues that the association is less than material because it is not representative of *Shari'ah* as espoused by the vast majority of contemporary *Shari'ah* authorities.

While Coughlin's investigation and documentation may demonstrate this argument to be lacking in credibility,[243] the analysis in a courtroom would instead turn on an examination of the facts and the law. As the Court opined in *TSC Industries*, "[t]he issue of materiality may be characterized as a mixed question of law and fact, involving as it does the application of a legal standard to a particular set of facts."[244] Such a question of fact might be addressed by a simple factual showing that Islamic terrorists base their *raison d'être* for violence on the dictates of *Shari'ah* as expressed by the classical *Shari'ah* authorities and some contemporary ones, or by introducing evidence establishing what the contemporary *Shari'ah* authorities consider to be the purposes and authorized methods of *Shari'ah*. This question might be presented to a jury by introducing evidence (1) of the rulings of the contemporary *Shari'ah* authorities,[245] (2) of the rulings of classical *Shari'ah* authorities upon which the contemporary authorities have relied, and (3) of *Shari'ah in actu*, which would include a brief on Muslim-dominated regimes generally recognized as following *Shari'ah*. The latter would include their *Shari'ah*-based criminal codes and punishments and their track record for violations of the basic norms of the Law of Nations and human decency.[246]

The legal question presented by this second analysis will not be different in kind from the first analytical approach, which examines the association in principle

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

[243] See the discussion of Coughlin's work *supra* notes 198–205.

[244] 426 U.S. at 450.

[245] *See, e.g.*, *supra* note 208.

[246] *See, e.g.*, *supra* note 115; *infra* notes 408–409 and accompanying text.

between *Shari'ah*, its call to violence, and SCF. In both, one must determine if the law requires disclosure of qualitatively material facts as opposed to quantitatively material facts.[247] Quantitative materiality requires companies only to disclose hard, empirical facts such as financial data and any criminal convictions of management personnel.[248] Qualitative materiality requires a fuller disclosure of behavior that might be considered unethical or even illegal but which has not yet resulted in an actual conviction.[249]

While qualitative materiality is frowned upon by the courts and commentators because it renders the duty to disclose open to wholesale uncertainty about what must be disclosed in the first instance,[250] the problem of disclosure for the *Shari'ah*-compliant financial institution is not circumscribed by this concern. Disclosure remains a significant legal issue for the company looking to promote its SCF business (or simply to disclose publicly the involvement in SCF) because of the difference between whether a duty to disclose exists in the first instance and what must be disclosed to make a partial disclosure not misleading to the reasonable investor.[251] Thus, to the extent an SCF business actively promotes its business or includes SCF within the risk factors in its SEC filings, this disclosure opens the door to a full and accurate disclosure of all facts that a reasonable investor would find material. It hardly seems in doubt that a post-9/11 investor, when contemplating an investment in something represented as *Shari'ah*-compliant, would consider material any factual link between *Shari'ah* and the call for violence against non-Muslims and *Shari'ah*-non-compliant Muslims, or more specifically against the U.S. or U.S. interests abroad. Indeed, it would be improbable that a post-9/11 investor would not want to know what *Shari'ah* says about the Law of *Jihad* and the use of *Shari'ah* by Islamic terrorists, even if the reporting company made no disclosure or representation about being *Shari'ah*-compliant. *Shari'ah* compliance itself would likely be a sufficiently material fact for the duty of disclosure to exist independently of any partial representation.[252]

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[247] LOSS & SELIGMAN, *supra* note 5, at 171–74.

[248] *Id.*

[249] *Id.* For a thorough discussion of the quantitative-qualitative distinction in disclosure, see John M. Fedders, *Qualitative Materiality: The Birth, Struggles, and Demise of an Unworkable Standard,* 48 CATH. U. L. REV. 41, 44–47 (1998).

[250] Fedders, *supra* note 249, at 42, 87–88.

[251] Common law fraud did not originally impose a duty to disclose; rather, once a statement represented something as fact, it had to be truthful. Materiality gets at "truthfulness" in that "half-truths" can be as misleading as false statements. The development of the law on the disclosure of omitted facts has always lagged behind the duty to disclose the whole of a truth partially told. For a discussion of this development relative to securities fraud cases, see LOSS & SELIGMAN, *supra* note 5, at 910–18.

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

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

(b) Global Security Risk: A Material Fact?

The close nexus in the hypothetical factual predicate for this discussion between *Shari'ah* and global terrorism is, as explained above, more than just theoretical. Efforts by corporate legal counsel to dismiss these concerns will invariably run up against the wall of common understanding linking in material ways the violent and oppressive world of *Shari'ah* one hears about in the public media,[253] terrorism committed in the name of *Shari'ah*,[254] *Shari'ah* itself,[255] and something calling itself SCF. This common understanding has already begun to articulate itself in the debate over materiality in the context of what is a material or relevant disclosure with respect to shareholder proxy statements.

In at least two instances, the New York City Comptroller, as the custodian and trustee of several major New York City employee pension funds, which had acquired substantial stock in Halliburton Company and General Electric, demanded that these two U.S. multi-national corporations doing business in Iran approve a shareholder proposal at their respective annual meetings to examine the "potential financial and reputational risks" associated with doing business in terror-

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[253] Recent media stories about the *Shari'ah* criminal law include a Muslim convert to Christianity sentenced to death and a rape victim sentenced to lashes. *See, e.g.*, Josh Gerstein, *Widespread Outrage at Afghan Facing Death for Abandoning Islam*, N.Y. SUN, Mar. 21, 2006, http://www2.nysun.com/article/29500; Dave Goldiner, *Saudi Juliet Told She Can't Stay Wed to Romeo*, N.Y. DAILY NEWS, Jan. 21, 2008, at 12. For a scholarly look at the *Shari'ah* criminal law from the time of the Ottoman Empire until today, see generally RUDOLPH PETERS, CRIME AND PUNISHMENT IN ISLAMIC LAW: THEORY AND PRACTICE FROM THE SIXTEENTH TO THE TWENTY-FIRST CENTURY (2005).

[254] *See* HABECK, *supra* note 229, at 101–33.

[255] For *Shari'ah* as expressed by *Shari'ah* authorities over the past millennium, see DAVID COOK, UNDERSTANDING JIHAD, 5–162 (2005) (defining *Jihad* and the role of Islam in contemporary times); PETERS, *supra* note 8 (outlining a broad survey of *Jihad*); see also Coughlin, *supra* note 30, at 83–106 (reviewing scholarly consensus); ANDREW G. BOSTOM, THE LEGACY OF JIHAD 141–250 (Andrew G. Bostom, M.D., ed., 2005) (compiling a collection of writings from influential Muslim theologians and jurists).

sponsoring countries.[256] The first effort was directed against Halliburton and began in late 2002, culminating in a final negative response to Halliburton's request for an SEC no-action letter in March 2003.[257] The denial of a no-action letter was perhaps influenced by the Comptroller's statement that "[t]he link between Iran and Halliburton is of special interest to the public, including institutional, professional and non-professional investors, who are paying a great deal more attention to the relationship between their investments and terrorism."[258]

Almost two years later, the SEC took the same hands-off policy when GE came knocking at the door also seeking a no-action letter to support its contention that it need not include a proxy proposal by the Comptroller at its annual shareholders' meeting.[259] In its correspondence in opposition to GE's request, the Comptroller quoted at length from the Congressional Conference Report on the 2004 Budget, which requested that the SEC establish an Office of Global Security Risk to evaluate the risks caused by the conduct of business operations in terrorist states.[260] The SEC denied GE's no-action letter and ultimately established an Office of Global Security Risk, the purpose of which is to "monitor whether the documents public companies file with the SEC include disclosure of material information regarding global security risk-related issues."[261]

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[256] Halliburton Co., SEC No-Action Letter, 2003 SEC No-Act LEXIS 433, at *18–19 (Jan. 16, 2003) [hereinafter Halliburton No-Action File]. For General Electric, see General Electric Co., SEC No-Action Letter 2005 SEC No-Act LEXIS 137, at *1 (Jan. 12, 2005) [hereinafter GE No-Action File]. For a broader article discussing these cases in some detail in the context of compliance by foreign subsidiaries of U.S. corporations, see Terence J. Lau, *Triggering Parent Company Liability Under United States Sanctions Regimes: The Troubling Implications of Prohibiting Approval and Facilitation*, 41 AM. BUS. L.J. 413, 414–20, 445–46 (2004).

[257] *See* Halliburton No-Action File, *supra* note 256, at *1–2, *26–28.

[258] Letter from Janice Silberstein, Assoc. Gen. Counsel, City of N.Y., Office of the Comptroller, to SEC, Div. of Corporate Fin., Office of the Chief Counsel (Feb. 7, 2003), *in* Halliburton No-Action File, *supra* note 256.

[259] *See* GE No-Action File, *supra* note 256.

[260] Letter from Richard S. Simon, Deputy Gen. Counsel, City of N.Y., Office of the Comptroller, to SEC, Div. of Corporate Fin., Office of the Chief Counsel (Dec. 10, 2004), *in* GE No-Action File, *supra* note 256.

[261] U.S. Securities and Exchange Commission, Office of Global Security Risk, http://www.sec.gov/divisions/corpfin/globalsecrisk.htm (last visited Aug. 4, 2008). In this context, the SEC proposed the following:

> II. Disclosure of Business Activities in or With Countries Designated as State Sponsors of Terrorism
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> The federal securities laws do not impose a specific disclosure requirement that addresses business activities in or with a country based upon its designation as a State Sponsor of Terrorism. However, the federal securities laws do require disclosure of business activities in or with a State Sponsor of Terrorism if this constitutes material information that is necessary to make a company's

It is clear that U.S. companies can no longer consider their associations with countries or entities tainted by terror a private, non-material, or irrelevant matter. While the courts have not yet entered the fray, the executive and legislative branches have laid down some markers. This trend suggests that the closer a company gets to a "state sponsor of terror," the more it has to disclose. Prudent counsel suggests that the closer a company gets to *any* association with terror, the more it has to disclose. The obvious question raised by the two proxy examples above would be: If a shareholder submits a proxy proposal to a publicly reporting financial institution involved in SCF, requiring a full study of the risks associated

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> statements, in the light of the circumstances under which they are made, not misleading.[6] [Note 6 citation appears here in the text. See below.] The term "material" is not defined in the federal securities laws. Rather, the Supreme Court has determined information to be material if there is a substantial likelihood that a reasonable investor would consider the information important in making an investment decision or if the information would significantly alter the total mix of available information.[7] [Note 7 citation appears here in the text. See below.]
>
> The materiality standard applicable to a company's activities in or with State Sponsors of Terrorism is the same materiality standard applicable to all other corporate activities. Any such material information not covered by a specific rule or regulation must be disclosed if necessary to make the required statements, in the light of the circumstances under which they are made, not misleading. The materiality standard's extensive regulatory and judicial history helps companies and their counsel to interpret and apply it consistently, and we remain committed to employing this standard to company disclosure regarding business activities in or with State Sponsors of Terrorism.
>
> Although the Commission is well positioned to review disclosure relating to business activities regardless of the country in which they are conducted, we do not have the expertise or information necessary to identify the particular countries whose governments have funded, sponsored, provided a safe haven for, or otherwise supported terrorism. Nor is it the Commission's role to determine the degree to which a public company's business activities may support terrorism or may be inconsistent with U.S. foreign policy or U.S. national interests.
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> . . . .
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> [6] Rule 408 of Regulation C, [17 CFR 230.408] and Rule 12b-20 under the Securities Exchange Act of 1934 [17 CFR 240.12b-20].
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> [7] *TSC Industries v. Northway, Inc.*, 426 U.S. 438 (1976). It has also held that materiality of contingent or speculative events or information depends on balancing the probability that the event will occur and the expected magnitude of the event. *Basic v. Levinson*, 485 U.S. 224, 238 (1988).

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

with *Shari'ah*, will the company have legitimate grounds to argue that the risks of *Shari'ah* and its connection to terror are not relevant? Outside of the proxy arena, if a company engages in SCF and represents to the public that *Shari'ah* is a standard set by *Shari'ah* authorities relied upon by the company, has the company disclosed enough about *Shari'ah* to tell the whole story? Given the hypothetical this analysis has been working with, the answer appears to be "no."

2. Scienter

Unlike materiality, which is an element in any type of fraud action, scienter, or intent, is a critical element of the common law and of most statutory provisions imposing liability on a wrongdoer.[262] As understood by the common law, a plaintiff's claim for deceit could only survive a motion to dismiss if the pleadings alleged that the defendant knew the falsity of the representation and that the false representation was made in an effort to induce reliance by the plaintiff.[263] Over time, this standard has been relaxed to include not merely false representations but also half-truths.[264] This change means that having opened the door to a representation, the putative defendant must be certain to have told the whole truth or at least the whole material truth.[265]

But the question remains: Having omitted some important part of the story, and assuming that the omitted part was material, did the defendant withhold the omitted part (1) knowingly and (2) with intent to deceive? Successful civil and criminal fraud litigation is as much about properly alleging scienter as it is proving it.[266] Judges will decide the former; jurors are most likely to decide the latter.[267]

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[262] *See generally* LOSS & SELIGMAN, *supra* note 5, at 910–11, 1018–31 (surveying varying conceptions of the scienter requirement, and the application of scienter to securities claims).

[263] *See* LOUIS LOSS, JOEL SELIGMAN & TROY PAREDES, FUNDAMENTALS OF SECURITIES REGULATION 910 (5th ed. Supp. 2008).

[264] *Id.*

[265] *See supra* note 251.

[266] This is especially true after the passage of the Private Securities Litigation Reform Act of 1995 ("PSLRA"), which ratcheted up the scienter pleadings requirements and froze discovery during a defendant's motion to dismiss to eliminate frivolous suits and to eliminate the "leverage" plaintiffs use by propounding reams of discovery requests early on to tie-up company management and extort a settlement. For a good discussion of the pleadings requirements post-PSLRA, see Ray J. Grzebielski & Brian O. O'Mara, *Whether Alleging "Motive and Opportunity" Can Satisfy the Heightened Pleading Standards of the Private Securities Litigation Reform Act of 1995:Much Ado About Nothing*, 1 DEPAUL BUS. & COM. L.J. 313, 317–27 (2003).

[267] Certainly this division is true in the Second Circuit Court of Appeals, given the ruling in Press v. Chem. Inv. Servs. Corp., 166 F.3d 529, 538 (2d Cir. 1999) ("Whether or not a given intent existed is, of course, a question of fact." (quoting SEC v. First Jersey Sec., Inc., 101 F.3d 1450, 1467 (2d Cir. 1996))); *see also id.* ("Whether a given intent existed is generally a question of fact." (quoting *In re* Time Warner, 9 F.3d 259, 270–71

Today, fraud claims alleging a failure to disclose might be based upon violations of federal securities laws, state blue sky laws, state consumer protection laws, or other federal and state anti-fraud statutes. While the common law has generally moved away from requiring a specific intent to defraud and toward a standard of recklessness—and in those jurisdictions that have adopted Section 552 of the Restatement (Second) of Torts,[268] the move has included even negligent misrepresentation—specific claims under federal or state anti-fraud statutes will vary depending upon the statute, the specific jurisdiction, and whether the action is administrative, civil, or criminal.

For example, under federal securities laws, there are statutes and rules permitting SEC administrative and civil enforcement actions and private causes of action that do not impose a requirement to plead or prove scienter. Under the 1933 Act, which arguably has become far more important for those seeking to pursue class action claims,[269] Sections 17(a)(2) and (a)(3) are free of any scienter requirement for SEC civil actions and, to the extent that a private right of action exists, the no-scienter rule is likely to extend to private plaintiffs.[270] Also, Section 11, which relates to misrepresentations in a registration statement, imposes absolute liability on the issuer without any reference to scienter, but does provide for reasonable-care defenses as a kind of substitute for scienter for other defendants.[271] Section 12(2) imposes liability without reference to scienter in public offerings[272] but provides an out for a defendant who can "sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission."[273]

Another serious avenue for enforcement that avoids the scienter issue arises under the Investment Advisors Act of 1940 (Investment Advisors Act). Fund

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(2d Cir. 1993))). For an argument in favor of the Second Circuit's approach to scienter, see Daniela Nanau, *Analyzing Post-Market Boom Jurisprudence in the Second and Ninth Circuits: Has the Pendulum Really Swung Too Far in Favor of Plaintiffs?*, 3 CARDOZO PUB. L. POL'Y & ETHICS J. 943, 958–60 (2006).

[268] RESTATEMENT (SECOND) OF TORTS § 552(1) (1977).

[269] *See supra* notes 266–267; *see also* Cook, *supra* note 146 (providing an overall examination of the jurisdictional issues raised by the recent federal legislation affecting class actions alleging securities fraud).

[270] *See generally* LOSS & SELIGMAN, *supra* note 5, at 1019, 1029 (discussing scienter and its pleading).

[271] LOSS & SELIGMAN, *supra* note 5, at 1230–33. *But see* LOSS & SELIGMAN, *supra* note 5, at 1232–33 (discussing the limited effectiveness of "expertizing" part of a statement as a defense to misrepresentations).

[272] Per its terms, section 12(2) creates civil liability for misrepresentations when someone "offers or sells a security" and does so "by means of a prospectus or oral communication." 15 U.S.C. § 77l(a)(2) (2006); *see also* Gustafson v. Alloyd Co., 513 U.S. 561, 569 (1995) (stating that a "prospectus" is a specific kind of document under the 1933 act and misrepresentations of the written kind must be in the prospectus to be the basis for an action under Section 12(2)).

[273] 15 U.S.C. § 77l(a)(2).

managers who embrace SCF while ignoring *Shari'ah* as a material part of the disclosure will likely face serious scrutiny as the SEC and large institutional investors come to understand the intimacy between the terms "*Shari'ah*-compliant," "Islamic finance," "socially responsible Islamic investing," and the *Shari'ah* witnessed in Iran, Saudi Arabia, and Sudan. Indeed, an SCF investment or business which attempts to disguise the "*Shari'ah*" and utilize a less emotionally charged term has added to its exposure, since that would be circumstantial evidence that the putative defendants knew of the dangers of *Shari'ah* and sought to minimize them by using a more acceptable, public relations-sensitive nomenclature.

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

> a. It shall constitute a fraudulent, deceptive, or manipulative act, practice, or course of business within the meaning of section 206(4) of the Act . . . for any investment adviser registered or required to be registered under section 203 of the Act . . ., directly or indirectly, to publish, circulate, or distribute any advertisement:
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> . . . .
>
> 5. Which contains any untrue statement of a material fact, or which is otherwise false or misleading.[274]

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

> (a) *Prohibition*. It shall constitute a fraudulent, deceptive, or manipulative act, practice, or course of business within the meaning of section 206(4) of the Act . . . for any investment adviser to a pooled investment vehicle to:
>
> (1) Make any untrue statement of a material fact or to omit to state a material fact necessary to make the statements made, in the light of the circumstances under which they were made, not misleading, to any investor or prospective investor in the pooled investment vehicle; or
>
> (2) Otherwise engage in any act, practice, or course of business that is fraudulent, deceptive, or manipulative with respect to any investor or prospective investor in the pooled investment vehicle.[275]

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[274] 17 C.F.R. § 275.206(4)-1 (2007) (citations omitted).

[275] For the SEC Final Rule, see Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles, 72 Fed. Reg. 44,756, 44,761 (Aug. 9, 2007) (codified at 17 C.F.R. pt. 275).

As the Supreme Court made clear in *SEC v. Capital Gains Research Bureau*,[276] the Investment Advisors Act was meant to safeguard the fiduciary relationship between the advisor and the investor.[277] The nature of the SEC proceeding, the heightened duty of such fiduciaries, and the purposes of the act eliminate the need to show intent to injure as in common law fraud.[278] The exposure of investment advisors to the claim that they have a duty to disclose all of the material facts about *Shari'ah* prior to any investment in an SCF fund, securitization, or company seems quite substantial, which is further highlighted by the complete lack of attention given the duty and its breach by the SCF industry.

While scienter's common law and statutory roles appear greatly diminished in the contexts discussed above, the same cannot be said for implied rights of action under Rule 10b-5. Congress and the Supreme Court have gone a long way to gut both the 1934 Act and the blue sky laws of their private class action fear factor—in part by requiring strict pleading of all necessary elements, including scienter.[279] The attorney representing the financial institution must keep in mind, however, that the SEC and institutional plaintiffs with significant investments at stake will continue to employ Rule 10b-5 and state securities anti-fraud provisions. As an economic matter, institutional investors with large investment portfolios are very likely less inclined to turn to class actions when they can bring far more manageable private civil claims that carry enough investment clout to make a difference to the defendant.

Moreover, even after the Supreme Court's decision in the oft-cited *Ernst & Ernst v. Hochfelder* case,[280] while a Rule 10b-5 allegation requires more than negligence, a reckless disregard for the truth likely suffices.[281] This is as much about artful pleading as it is about nailing down the legal standard, especially after a financial institution opens the door to a partial but misleading truth—experience

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[276] 375 U.S. 180 (1963).

[277] *Id.* at 195.

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

[279] *See supra* note 266; *see also* Jeffrey W. Stempel, *Class Actions and Limited Vision: Opportunities for Improvement Through a More Functional Approach to Class Treatment of Disputes*, 83 WASH. U. L. Q. 1127, 1189–93 (2005) (discussing the Class Action Fairness Act of 2005 (CAFA)).

[280] 425 U.S. 185, 201 (1976) (holding that negligent actions cannot give rise to Rule 10b-5 liability).

[281] *See* Sundstrand Corp. v. Sun Chem. Corp., 553 F.2d 1033, 1045 (7th Cir. 1977) (stating the "recklessness" standard as follows: "[H]ighly unreasonable [conduct], involving not merely simple, or even inexcusable negligence, but an extreme departure from the standards of ordinary care, and which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it") (quoting Franke v. Midwestern Oklahoma Dev. Auth., 428 F.Supp. 719, 726 (W.D. Okla. 1976)).

dictates that the rule announced in *Rubin* on half-truths being viewed, "in the light of the circumstances under which they were made," is an invitation for good plaintiffs' counsel to plead well the circumstances so as to avoid a motion to dismiss.[282] Thus, a financial institution that recognizes the threshold duty to disclose something about *Shari'ah* and the *Shari'ah* authorities who set the standards for the particular SCF investment or business must be extremely careful to capture all of the material facts about *Shari'ah*, its purposes, and its methods. Failure to recognize an extant connection between *Shari'ah* and violence after representing *Shari'ah* as divine Islamic law based on the *Qur'an*, the *Sunna*, and legal rulings of the competent *Shari'ah* authorities will likely suffice to satisfy the scienter requirement—at least at the pleadings stage.

Recklessness, especially in a case where a representation was made but without all the requisite material facts, is a notoriously fact-based standard that allows a showing of proof through circumstantial evidence.[283] The case law suggests a "totality of the circumstances" test where a variety of factors come into play to establish recklessness.[284] The specific factors typically cited include how material the omission was; how available the omitted facts were to the defendant; whether there was an extant standard of care in the industry giving rise to a duty to disclose

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[282] *See supra* note 251; *see also* City of Monroe Employees Ret. Sys. v. Bridgestone Corp., 399 F.3d 651, 686–89 (6th Cir. 2005) (discussing recklessness as to the truth of corporate representations). In the *Bridgestone* case, the court quoted Rubin v. Schottenstein, 143 F.3d 263, 267 (6th Cir. 1998) (en banc), as follows:

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

Bridgestone, 399 F.3d at 670 (alterations in original).

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

[284] *See Id.* at 683 (quoting PR Diamonds, Inc. v. Chandler, 364 F.3d 671, 683 (6th Cir. 2004)).

the omitted facts; how egregious the breach was; and what the likely consequences were of not disclosing the material facts.[285]

Rule 10b-5 is important because it operates as a "catch-all" anti-fraud statute with an implied private right of action. But beyond Rule 10b-5, there are many state securities laws which require no scienter and are broader in their reach than Rule 10b-5. Arizona's blue sky anti-fraud provisions have been given an expansive reach to get at all kinds of securities fraud without the burden of scienter[286] and also permit punitive damages.[287] In addition, at least three states provide for a securities fraud claim under their respective consumer anti-fraud statutes,[288] of which, two have a private right of action allowing for punitive damages.[289] Even a

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[285] While the Supreme Court has not ruled definitively on the question of recklessness, the lower courts have taken the general approach of examining a whole host of factors that might imply scienter:

> (1) insider trading at a suspicious time or in an unusual amount;
> (2) divergence between internal reports and external statements on the same subject;
> (3) closeness in time of an allegedly fraudulent statement or omission and the later disclosure of inconsistent information;
> (4) evidence of bribery by a top company official;
> (5) existence of an ancillary lawsuit charging fraud by a company and the company's quick settlement of that suit;
> (6) disregard of the most current factual information before making statements;
> (7) disclosure of accounting information in such a way that its negative implications could only be understood by someone with a high degree of sophistication;
> (8) the personal interest of certain directors in not informing disinterested directors of an impending sale of stock; and
> (9) the self-interested motivation of defendants in the form of saving their salaries or jobs.

Helwig, 251 F.3d at 552 (citing Greebel v. FTP Software, Inc., 194 F.3d 185, 196 (1st Cir. 1999)).

[286] *See* ARIZ. REV. STAT. ANN. § 44-1991 (2003); *see also* Richard G. Himelrick, *Arizona Securities Fraud Liability: Charting a Non-Federal Path*, 32 ARIZ. ST. L.J. 203, 216–18 (2000) (reviewing Arizona's law and the differences between it and Federal law).

[287] *See* Himelrick, *supra* note 286, at 230 & n.186.

[288] *See supr*a note 158.

[289] For case law regarding Illinois' private right of action, see *In re* CLDC Management Corp., 18 B.R. 797, 799–800 (Bankr. N.D. Ill. 1982) (allowing an implied private right of action); Martin v. Heinold Commodities, 634 N.E.2d 734, 756–57 (Ill. 1994) (allowing punitive damages). For case law regarding Arizona's private right of action, see Holeman v. Neils, 803 F. Supp. 237, 242–43 (D. Ariz. 1992) (allowing an implied private right of action); Dunlap v. Jimmy GMC of Tucson, Inc., 666 P.2d 83, 87–88 (Ariz. Ct. App. 1983) (allowing punitive damages).

state like California, which does not recognize securities fraud as a cause of action under its consumer fraud statute, will allow a consumer fraud claim relating to a holder of securities where the allegation is of fraud, but not in connection with the sale or purchase of a security.[290] These state consumer fraud actions are potentially effective weapons in the hands of sophisticated plaintiffs against financial institutions treading down the seemingly golden path of SCF.

D. Sedition: Shari'ah as the Advocacy of the Violent Overthrow of the U.S. Government

The Smith Act of 1940 makes it criminal to "knowingly or willfully advocate[e], abet[], advis[e], or teach[] the duty, necessity, desirability, or propriety of overthrowing or destroying the government of the United States."[291] The Supreme Court has taken four occasions to review cases prosecuted under the Smith Act. In the first case, *Dennis v. United States*, the Court heard appeals from Communist Party leaders who had been convicted of violating the Smith Act and whose conviction had been affirmed by the lower court.[292] The Court examined the First Amendment and other constitutional challenges, upheld the statute as constitutional, and affirmed the convictions.[293]

The Court again examined the Smith Act six years later in the case of *Yates v. United States*.[294] By this time, however, the Court was now under the spell of Chief Justice Earl Warren and the other liberal Justices of the time. They had already tested their mettle in *Brown v. Board of Education*[295] some three years earlier, and one could reasonably have wondered whether the Court would sustain a First Amendment challenge and effectively overrule *Dennis*.

Because the charges in *Yates* were brought under the "advocat[ing]" and "teach[ing]" prohibitions of the Smith Act, the defendants argued that the Act was an unconstitutional restriction on their freedom of speech.[296] Rather than overturning the Smith Act, the Court carefully sidestepped the issue by narrowly construing the words "advocates" and "teaches" to bring them within the Court-created boundaries for permissible speech restrictions.[297] Specifically, the Court limited the Smith Act to cases where the advocacy for the overthrow of the

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[290] Strigliabotti v. Franklin Res., Inc., No. C 04-00883 SI, 2005 U.S. Dist. LEXIS 9625, at *30 (N.D. Cal. March 7, 2005).

[291] 18 U.S.C. § 2385 (2006).

[292] *See* Dennis v. United States, 341 U.S. 494, 495 (1951).

[293] *See id.* at 516–17.

[294] 354 U.S. 298 (1957).

[295] Brown v. Bd. of Educ., 347 U.S. 483 (1954).

[296] *Yates*, 354 U.S. 298, 312–18.

[297] *Id.* at 319 ("We need not, however, decide the issue before us in terms of constitutional compulsion, for our first duty is to construe this statute. In doing so, we should not assume that Congress chose to disregard a constitutional danger zone so clearly marked . . . .").

government was more than merely theoretical.[298] The Court limited the Act by holding that criminal advocacy under the Smith Act requires a nexus between the advocacy itself and some action that was being urged to achieve the treasonous goal.[299]

In *Scales v. United States*, the Court again examined the Smith Act.[300] In this case, the defendant sought to have his conviction for being a member of the Communist Party set aside on "statutory, constitutional, and evidentiary grounds."[301] While the procedural aspects are not relevant to this discussion, the statutory and constitutional parts of the case are. The first argument raised by the defendant-petitioner was based on the claim that another federal statute had been enacted providing that mere membership in the Communist Party would not constitute a *per se* violation of any federal statute.[302] From this, the petitioner formulated the argument that the Smith Act's membership clause had been repealed *pro tanto*.[303] The Court rejected this argument on several grounds, but most importantly because the Court found that the petitioner's Smith Act conviction was for being a member of an organization which called for the violent overthrow of the U.S.[304] There was nothing unique about the Communist Party except its doctrine for violent overthrow; the Smith Act applied to any organization, not just to the Communist Party.[305]

The petitioner also challenged his Smith Act conviction on *per se* constitutional grounds.[306] The petitioner argued that the membership clause of the Smith Act violated his First and Fifth Amendment rights.[307] The Fifth Amendment claim essentially boiled down to this: although the trial court instructed the jury that the defendant had to be an "active member" of the criminal group, in accord with the earlier decision in *Yates*, which required a nexus between advocacy and action, the trial court did not require that the defendant actually participate in the criminal activity.[308] It was enough that the defendant knew of the criminal designs

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[298] *Id.*

[299] *See id.* at 324–25.

[300] *See* Scales v. United States, 367 U.S. 203, 205 (1961).

[301] *Id.* at 206.

[302] *Id.* at 206–07. The intervening statute purportedly overruling the Smith Act membership clause, the Internal Security Act of 1950, 64 Stat. 987 (codified at 50 U.S.C. § 781), was repealed by The FRIENDSHIP Act, Pub. L. No. 103-199, § 803(1), 107 Stat. 2317, 2329 (1993) (codified at 50 U.S.C. § 783).

[303] *Scales*, 367 U.S. at 206–07.

[304] *Id.* at 207–08.

[305] *Id.* ("[T]he membership clause of the Smith Act . . . only [proscribes membership] in organizations engaging in advocacy of violent overthrow . . . .").

[306] *See id.* at 219–20. The petitioner also raised "as applied" claims but these boiled down to an evidentiary analysis. *See id.* at 220. ("The balance of [the 'as applied' claims,] essentially concerns the sufficiency of the evidence . . . .").

[307] *See id.* at 224, 228.

[308] *See id.* at 220.

of the group at large and that the defendant was an active member, even if such activity was wholly legal.[309] As such, the petitioner argued that the absence of this nexus violated his Fifth Amendment rights to due process because it convicts a person for mere association and not overt criminal activity.[310] The First Amendment claim was similarly an argument that the defendant's right to freedom of association was unconstitutionally infringed by virtue of the threat of criminal prosecution for mere non-criminal membership.[311]

The Court rejected the argument, asserting that:

> Any thought that due process puts beyond the reach of the criminal law all individual associational relationships, unless accompanied by the commission of specific acts of criminality, is dispelled by familiar concepts of the law of conspiracy and complicity. . . . In this instance it is an organization which engages in criminal activity, and we can perceive no reason why one who actively and knowingly works in the ranks of that organization, intending to contribute to the success of those specifically illegal activities, should be any more immune from prosecution than he to whom the organization has assigned the task of carrying out the substantive criminal act.[312]

Thus, the Court concluded that a Smith Act membership conviction will stand when (1) the defendant knows (2) that the group to which the membership attaches intends criminal purposes and (3) that the defendant's membership evidences a specific intent to promote the criminal goals of the organization (4) even if the defendant's membership and involvement is not itself criminal activity.[313]

In *Noto v. United States*, the fourth of the Smith Act cases to come before the Court and a companion case to *Scales*, the Court overturned the conviction because it found the nexus between the theory of violence and the actual call to violence too remote.[314] Quoting from its opinion in *Yates*, the Court explained that the advocacy must be "not of . . . mere abstract doctrine of forcible overthrow, but of action to that end, by the use of language reasonably and ordinarily calculated to incite persons to . . . action" immediately or in the future.[315]

Given this judicial treatment of the Smith Act, a lawyer representing a U.S. company which retains *Shari'ah* authorities must be critically aware of several threatening circumstances. One, if the *Shari'ah* authorities advocate the Law of *Jihad* against the U.S., this advocacy probably falls within the Smith Act as refined

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[309] *See id.* at 220–21.
[310] *Id.* at 220.
[311] *Id.*
[312] *Id.* at 225–27.
[313] *See id.* at 226–28.
[314] Noto v. United States, 367 U.S. 290, 297–98 (1961).
[315] *Id.* at 297 (quoting Yates v. U.S., 354 U.S. 298, 316 (1957)) (alterations in original).

by the Supreme Court. The argument here rests on two prongs. First, the *Shari'ah* authorities are not mere advocates of theory or theology but authorized religious leaders who have been retained by the company precisely because their legal rulings and pronouncements are authoritative. Moreover, the call to violence at some point in the future when *Shari'ah*-adherent Muslims have the logistical opportunity to conduct *Jihad* is captured by the Smith Act as the Court explained when it stated that advocacy is an actual call to violence whether it advocates violence "immediately or in the future."[316]

Second, the *Shari'ah* authorities are not speaking as advocates to an empty auditorium, but as jurists who issue normative and instructional commands to the members of their group—*Shari'ah*-adherent Muslims. Further, these *Shari'ah* authorities are chosen because the *Shari'ah* faithful listen and act upon their legal rulings. Thus, the call to violence is likely to result in violence. Evidence of this direct nexus can be observed in numerous terrorist and violent events that occur immediately after *Shari'ah* authorities issue legal rulings calling for violence. One relatively recent event was the violence over the publication of cartoons in a Danish paper which satirized Mohammed. The cartoons had been public for several months and it was not until certain leading *Shari'ah* authorities called for a "day of anger" and "for Muslims worldwide to protest" that protests, violence, and murder erupted en masse.[317]

Additionally, to the extent that *Shari'ah* authorities are employed by a U.S. corporation to issue legal rulings on *Shari'ah* and, while serving in that capacity, issue rulings which include a call to *Jihad* against the United States, the

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[316] *Id.* In Brandenburg v. Ohio, 395 U.S. 444, 447 (1969) (per curiam), the Court held, in striking down a state law criminalizing speech advocating criminal acts including violence and terrorism—this genre of law often referred to as a criminal syndicalism statute—that such speech is constitutionally protected unless it is intended and likely to cause imminent illegal conduct. While the *Brandenburg* Court understood its decision as concordant with the Smith Act cases cited, many First Amendment commentators have understood the "imminence" requirement as, in effect, overruling *Dennis* and its progeny. *See id.*; GEOFFREY R. STONE, PERILOUS TIMES: FREE SPEECH IN WARTIME 522–23 (2004). For an analysis of the "imminence" requirement and what it might mean or should mean, see Marc Rohr, *Grand Illusion? The* Brandenburg *Test and Speech That Encourages or Facilitates Criminal Acts*, 38 WILLAMETTE L. REV. 1 (2002); see also, Eugene Volokh, *Crime-Facilitating Speech*, 57 STAN. L. REV. 1095 (2005) for an interesting if not overly pedantic analysis of First Amendment issues, including Brandenburg's imminence test, in the context of crime incitement versus crime facilitating speech. While the Supreme Court has not applied "imminence" to a real sedition case, the point to be made here is that sedition is more like crime-facilitation or conspiracy than it is to incitement where imminence has some temporal context. The application of "imminence" will no doubt plague future cases and remain a fact-based inquiry and will likely involve not simply the timing of the threat of violence, but also its seriousness and its likelihood.

[317] Olivier Guitta, *The Cartoon Jihad: The Muslim Brotherhood's Project for Dominating the West*, WKLY STANDARD, Feb. 20, 2006, at 10, *available at* http://www.weeklystandard.com/Content/Public/Articles/000/000/006/704xewyj.asp.

corporations should not ignore the threat of criminal exposure. The important case on this point is the Supreme Court's decision in *New York Central & Hudson River Railroad v. United States*.[318] In *New York Central*, prosecutors indicted a railroad company based on the conduct of an assistant traffic manager, who paid illegal rebates.[319] While corporations could be liable for breach of civil law duties, "earlier writers on the common law held the law to be that a corporation could not commit a crime" in part because, as artifices of the law, they could not have the requisite mens rea.[320] The Court, however, took this opportunity to transport the concept of *respondeat superior* from tort law and import it into the criminal law:

> Applying the principle governing civil liability, we go only a step farther in holding that the act of the agent, while exercising the authority delegated to him to make rates for transportation, may be controlled, in the interest of public policy, by imputing his act to his employer and imposing penalties upon the corporation for which he is acting in the premises.
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> . . . [W]e see no good reason why corporations may not be held responsible for and charged with the knowledge and purposes of their agents, acting within the authority conferred upon them. If it were not so, many offenses might go unpunished and acts be committed in violation of law where, as in the present case, the statute requires all persons, corporate or private, to refrain from certain practices, forbidden in the interest of public policy.[321]

In the matter under discussion, legal counsel will be somewhat misguided to argue in defense of their corporate clients that the *Shari'ah* authorities were employed strictly to issue legal rulings on financial matters and all other rulings fall outside the scope of their employment. Typically, *respondeat superior* would apply for intentional transgressions in the criminal context where the agent (1) committed a crime; (2) within the scope of employment; and (3) with intent to benefit the company.[322] Arguably, a crime was committed by advocating violent *Jihad* against the U.S. The problem with legal counsel's defense on the "scope of

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[318] 212 U.S. 481 (1909).

[319] *Id.* at 489. According to the Court, the Elkins Act made it illegal to "give or receive a rebate whereby goods are transported in interstate commerce at less than the published rate." *Id.* at 498; *see* Preet Bharara, *Corporations Cry Uncle and Their Employees Cry Foul: Rethinking Prosecutorial Pressure on Corporate Defendants*, 44 AM. CRIM. L. REV. 53, 61 n.42 (2007).

[320] *New York Cent.*, 212 U.S. at 492.

[321] *Id.* at 494–95 (citations omitted).

[322] *See* W. PAGE KEETON ET AL., PROSSER AND KEETON ON THE LAW OF TORTS 499–508 (5th ed. 1984). For a general discussion on corporate liability, see Note, *Corporate Crime: Regulating Corporate Behavior Through Criminal Sanctions*, 92 HARV. L. REV. 1227, 1247–51 (1979).

employment" element is the fact that *Shari'ah* authorities have stated time and again that there is no separation between a ruling on commercial matters and one on *Jihad*. As illustrated by the very software "filters" employed in SCF, the legal rulings on prohibited vice industries are part and parcel of the undivided whole of *Shari'ah*. This explains the SCF legal ruling by many *Shari'ah* authorities that Muslims, including U.S. Muslims, should not invest in U.S. defense industries. Yet, these same *Shari'ah* authorities praise and obligate Muslim investment in weapons for Muslim nations as part of preparation for *Jihad*.[323] In other words, the ruling on weapons in the context of SCF is part and parcel of the Law of *Jihad*.[324] Finally, by definition, every legal ruling by a *Shari'ah* authority is for the achievement of Allah's divine law and for the attainment of truth, and therefore, of benefits to all Muslims, including the companies in which they invest.

While it is not necessarily the case that an aberrant ruling by an "extremist" *Shari'ah* authority will always be imputed to his employer, it is not a stretch to conclude that a company employs a *Shari'ah* authority precisely because his legal rulings are authoritative and because *Shari'ah* is a holistic and integrated legal and normative unit.[325] Thus, a ruling on *Jihad* by a *Shari'ah* authority is no less a part of his role as an internationally renowned *Shari'ah* authority—and his employment as such—than his other rulings on SCF.[326]

V. THE EXOGENOUS ELEMENTS OF SCF: DISCLOSURE, DUE DILIGENCE, AND OTHER COMPLIANCE ISSUES

Beyond the duty of disclosure of endogenous elements of *Shari'ah*—facts that would be material to a reasonable investor who has been told of an investment or business transaction represented to be *Shari'ah*-compliant—several other legal issues arise in the context of how SCF is actually structured. In addition to the question of what must be disclosed about *Shari'ah* itself, the "rules and principles" of *Shari'ah* have been fitted to modern finance and business to achieve a product

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[323] *See* USMANI, *supra* note 208, at 36–38.

[324] In his essay on the proper role of a *Shari'ah* authority for a mutual fund, DeLorenzo argues that beyond the "quantitative" rules, there are "socially responsible" screens that must be applied over the purely objective ones. DeLorenzo, *supra* note 26, at 6.

[325] *See infra* notes 397–409 and accompanying text.

[326] This point can be illustrated by the connection among Usmani, *Jihad*, Dow Jones and HSBC. *See supra* notes 207–208. By retaining *Shari'ah* authorities who call for *Jihad* against the West, U.S. financial institutions raise the profile and importance of the *Shari'ah* legal rulings of these authorities, thereby contributing to the likelihood that their call for *Jihad* will be heeded. At what point does Dow Jones' or HSBC's failure to conduct even minimal due diligence arise to the level of willful blindness or recklessness, which begins to touch upon criminal scienter? *See generally* Robin Charlow, *Wilful Ignorance and Criminal Culpability*, 70 TEX. L. REV. 1351 (1992) (providing an overview of the criminal law related to willful ignorance).

that is represented as *Shari'ah*-compliant. These contemporary structures are exogenous to *Shari'ah* but very much a part of how *Shari'ah* has been manipulated to accommodate modern finance and commerce. These exogenous elements reflect on how *Shari'ah* has been transformed, modeled, and presented in various SCF contexts.

It is important to keep in mind a fundamental principle of SCF: *Shari'ah* compliance must be judged by one or more *Shari'ah* authorities.[327] It is clear from the literature that a non-Muslim cannot determine what is *Shari'ah*-compliant and further that a Muslim who is not recognized by his peers as a *Shari'ah* authority cannot assume the role of one.[328] The corollary of this principle is that the *Shari'ah* authorities are themselves bound by the community of *Shari'ah* authorities within which they operate.[329] The exact nature of this community or "consensus," both in terms of its theoretical elasticity and its geographic boundaries, is only vaguely articulated in the SCF literature, but the implications of its contours both when adhered to and when breached are significant.[330]

A. Disclosure

Our analysis begins with an examination of several questions about what it means to represent to the public that a financial institution or business has embraced SCF. Is there a duty to represent to the public what a *Shari'ah* authority is and how any given authority has obtained that status? Is it material to the investment? Is the failure to articulate the risks associated with conflicting SCF rulings from a more authoritative *Shari'ah* authority a disregard of minimal standards of disclosure?[331]

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

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[327] *See* DeLorenzo, *supra* note 24, at 1–3.

[328] *See* Ian D. Edge, *Shari'a and Commerce in Contemporary Egypt*, *in* ISLAMIC LAW AND FINANCE, *supra* note 21, at 33.

[329] *See* VOGEL & HAYES, *supra* note 17, at 9–10.

[330] *See Id.* at 9–10.

[331] It seems *Shari'ah* authorities themselves understand the reputational and even financial risks of not imposing some broad standards for entry into the elite group of *Shari'ah* authorities and for not standardizing what is *Shari'ah*-compliant and what is not. *See, e.g.*, IFSB Standards, *supra* note 177 (providing a wide range of standards covering areas such as disclosure, corporate governance, and exposure).

by Muslims in Muslim military industries for weapons to be sold to Muslim regimes?

In this context, the *Nike* case takes on a new dimension. Recall that Nike, an Oregon corporation, was sued in California under its Unfair Competition Law on the grounds that Nike's public statements in defense of its labor practices abroad were actionable.[332] The California Supreme Court was not inclined to restrict the statute's reach and rejected Nike's argument that non-commercial speech rights were violated, remanding for reconsideration.[333] Nike argued that the extension of such business fraud statutes to generic discussions by companies that have more to do with social commentary on issues of public importance than promoting the sale of specific goods and services effectively denies First Amendment protections to U.S. businesses.[334] In effect, after being attacked in the media and having chosen to speak in its own defense, Nike had invited the lawsuit under California's Draconian consumer fraud statute.[335] The company could have continued to litigate the case for years, attempting to prove that it had spoken truthfully about its offshore labor practices, but it understood that every new twist and turn in the litigation would amount to millions of dollars in bad publicity for a company that spent millions trying to build and maintain its brand.[336]

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

Another exogenous factor has been addressed by the academic and professional SCF literature. A significant focus of SCF publications is the dearth of competent *Shari'ah* authorities worldwide.[337] This is because while *Shari'ah* authorities are available in sufficient numbers to answer the needs of the *Shari'ah*-adherent communities worldwide,[338] there is a severe shortage of these authorities who are sufficiently versed in English and modern finance to handle the international documentation invariably drafted with an eye towards institutions

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[332] Nike, Inc. v. Kasky, 539 U.S. 654, 656 (2003) (per curiam) (Stevens, J., concurring); *see supra* notes 152–156 and accompanying text.

[333] *Nike*, 539 U.S. at 657 (Stevens, J., concurring).

[334] *See id.* at 656–57.

[335] *See id.* at 656.

[336] See *id.* at 668 (Breyer, J., dissenting).

[337] *See generally* Islamic Banking and Finance, Issue #3 Summary, http://islamicbankingandfinance.com/summary3.html (last visited Aug. 4, 2008) (summarizing an issue of the London-based journal *Islamic Banking and Finance*, which discusses this "bottleneck").

[338] This is assisted by the burgeoning use of Internet sites, which provide legal rulings (*fatawa*) to the *Shari'ah* faithful anywhere in the world. *See, e.g.*, IslamOnLine.net, http://www.islamonline.net/english/index.shtml (last visited Aug. 3, 2008) (providing a "Fatwa Bank" with questions and answers on *Shari'ah*).

working out of London or New York.[339] There are only approximately 20–25 sufficiently trained *Shari'ah* authorities, and each of these exclusive club members sits on dozens of *Shari'ah* supervisory boards around the world.[340] The result is a small clique that advises the lion's share of competing financial institutions on how to develop new SCF products and transaction structures.[341]

The legal advisor must evaluate the disclosure issues, a complicated task given the fact that a *Shari'ah* authority's rulings and artful craftsmanship in finding new transactional structures to avoid *Shari'ah* prohibitions might very well differ from one institutional client to another. For instance, are there issues that ought to be disclosed to a reasonable investor relating to confidentiality and the systems put in place to protect confidentiality? What duty of care do the *Shari'ah* authorities owe the financial institutions? Are they considered experts for purposes of the 1933 Act?[342] Do they participate in writing the portions of the registration statement or prospectus that deal with *Shari'ah*?

In all of these areas, the materiality and scienter issues will play into the calculus for the legal advisor as the examination of these and other exogenous elements unfold.[343] An additional facet of the disclosure complex, especially as it relates to the scienter standard of recklessness, is the implication for the financial institutions and their professional advisors of a duty to conduct due diligence to make certain that what they have said about SCF is the whole of the material truth.[344]

B. Due Diligence

The articulation of a breach of duty to disclose is closely related to the duty to exercise reasonable due diligence as either an element of scienter or a defense where scienter is not at issue. For example, under the 1933 Act, Sections 11 and 12(a)(2) provide for a due diligence defense for certain defendants who have failed to disclose all relevant material facts.[345] The case law and literature on these defenses is extensive, and legal counsel for any financial institution will have to seriously consider the implications of ignoring the exogenous structures set up for a *Shari'ah*-compliant investment or business.[346] At the very least, each of the

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[339] *See id.*

[340] *See* Michelle Wallin, *Among Islamic Banks, A Shortage of Scholars*, N.Y. TIMES, Feb. 8, 2005, at C8, *available at* http://www.nytimes.com/2005/02/08/business/world business/08bahrain .html?_r=1&pagewanted=print&position=&oref=slogin.

[341] Alexiev, *supra* note 21, at 16 n.43. There are probably more *Shari'ah* authorities if Pakistan, Malaysia and the GCC states are counted. *See* VOGEL & HAYES, *supra* note 17, at 10–12.

[342] *See supra* note 219 and accompanying text.

[343] *See* discussion *supra* Parts IV.C.1, IV.C.2.

[344] *See supra* notes 283–285 and accompanying text.

[345] *See supra* notes 271–273 and accompanying text.

[346] *See* LOSS & SELIGMAN, *supra* note 5, at 1230–32.

exogenous disclosure issues should be the subject of a carefully prepared legal opinion. Failure to rely on an expert legal opinion will likely expose the financial institution and its management to greater liability insofar as failure to do so rises to the level of reckless breach of the duty of care. The duty to rely on a formal legal opinion intimates the lawyer's exposure to liability for failure to conduct a reasonably competent investigation.

C. Other Compliance Issues

1. Global Security Risks Revisited

The due diligence requirements implied in the scienter element of many fraud actions and provided expressly as defenses under securities laws are only one component of the due diligence analysis pertinent to SCF. In the main, the effort to combat the global security risks associated with Islamic terror networks and the regimes that support those networks has incorporated many strategies, only some of which are appropriately suited to the task at hand. One approach is through trade sanctions and embargoes. These foreign policy initiatives are authorized by such laws as the Trading with the Enemy Act (TWEA)[347] and the International Emergency Economic Powers Act (IEEPA),[348] which authorize the Office of Foreign Assets Control (OFAC) of the Treasury Department to establish sanction regimes on states identified by the President as falling within the jurisdictional reach of either of the two laws.[349]

The Halliburton affair described above began as a seemingly innocuous inquiry by the New York City Comptroller on behalf of some shareholders into disclosure requirements of an annual proxy statement but soon spiraled out of control.[350] After Halliburton was forced to report to its shareholders on the financial and reputational risks of doing business in a terror-sponsoring state, the Comptroller was still unsatisfied and considered the company's disclosures inadequate.[351] Soon thereafter, OFAC got involved and referred the matter to the Department of Justice, which initiated a grand jury investigation.[352] Other

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[347] 50 U.S.C. app. § 1 (2006).

[348] 50 U.S.C.A. §§ 1701–1706 (West 2003 & Supp. 2008).

[349] *See, e.g.*, Continuation of the National Emergency with Respect to Iran, 72 Fed. Reg. 10,883 (Mar. 12, 2007) (renewing the national emergency, with respect to Iran, pursuant to 50 U.S.C. §§ 1701–1706).

[350] *See supra* note 256 and accompanying text.

[351] *See supra* notes 257–258 and accompanying text.

[352] *See* Halliburton, Annual Report (Form 10-K), at 58 (Dec. 31, 2006), *available at* http://www.sec.gov/Archives/edgar/data/45012/000004501207000072/ed10k2006_final.htm. The report provides a relatively concise summary of the complicated events:

companies doing business in terror-sponsoring states have also run into trouble.[353] While the implications for financial institutions relying on *Shari'ah* authorities associated with or sympathetic to terrorists do not touch upon TWEA or IEEPA compliance per se, the duty of disclosure of material facts under the compliance regimes remains.[354]

(a) Reverse Money Laundering Revisited

Another approach to the global security risk of Islamic terrorism has been the strengthening of anti-money laundering laws and regulations. The "heavy lifting" of this effort of late has been accomplished by the Patriot Act and its amendments

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Operations in Iran

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

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

Id.

[353] *See* Lau, *supra* note 256, at 418–19.

[354] *See id.* at 420 (noting that the Office of Global Security Risk identifies "companies whose activities raise concern about global security risks that are material to investors," with the SEC then looking "at whether a company has operations in a country where 'political, economic or other risks exist that are material'").

to the Bank Secrecy Act (BSA)[355] and the anti-money laundering statutes.[356] But with all of the fanfare and political disputation surrounding this legislation by civil libertarians, civil rights activists, and various Muslim organizations,[357] the legislation still fails to grapple effectively with the problem of money laundering in support of terrorism.[358] Almost all of the BSA, and the regulations promulgated thereunder, and the anti-money laundering statutes approach the problem of terrorist financing in the traditional way, notwithstanding a dangerous new *modus operandi*.[359] The BSA and anti-money laundering statutes are intensely focused on spotting and reporting suspicious money transfers, especially cash transfers that have criminal sources.[360]

This approach to battling the funding of terrorism fits the traditional approach to anti-money laundering efforts, which looks for money from illegal activities such as drugs and gambling, typically in the form of cash, and its laundering into clean money invested in legitimate businesses.[361] As long as the effort is "following the money" in the form of cash from its entry into the regulated and reporting financial system (what the professionals call "placement"),[362] and winds its way to its ultimate destination, the system works at least moderately well—though, most experts will admit that it both misses large sums and suffers from over-reporting of perfectly legitimate cash transactions.[363] A larger difficulty is "reverse money laundering," where clean money is used to support criminal ends.[364]

Reverse money laundering stands the classic model on its head—perfectly legitimate funds, some of which may come from charities, are wired or transferred

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[355] 31 U.S.C.A. §§ 5318, 5318A, 5319, 5321(a), 5322, 5324, 5326, 5328 5330(d)(1)(A), 5332, 5341(b) (West 2003 & Supp. 2007).

[356] *See generally* Eric J. Gouvin, *Bringing out the Big Guns: The USA Patriot Act, Money Laundering, and the War on Terrorism*, 55 BAYLOR L. REV. 955 (2003) (reviewing money laundering legislation and discussing some of the USA Patriot Act's inadequacies in this area).

[357] *See, e.g.*, Council on American-Islamic Relations-Chi. Office, Action Alert: CAIR Launches Patriot Act Blog (Dec. 1, 2005), http://www.cairchicago.org/actionalerts.php?file =aa_blog12012005 (announcing a special Internet "blog" pushing for the incorporation of additional civil liberties protections in a renewed Patriot Act, published by the Council on American-Islamic Relations (CAIR)).

[358] *See* Gouvin, *supra* note 356, at 973–81.

[359] *Id.* at 962.

[360] *Id.*

[361] *Id.*

[362] FED. FIN. INSTS. EXAMINATION COUNCIL, BANK SECRECY ACT/ANTI-MONEY LAUNDERING EXAMINATION MANUAL 8 (2006), *available at* http://www.ffiec.gov/pdf/ bsa_aml _examination_manual2006.pdf.

[363] *See* Gouvin, *supra* note 356, at 967–69.

[364] *See* Stefan D. Cassella, *Reverse Money Laundering*, 7 J. MONEY LAUNDERING CONTROL 92, 92 (2003).

to terrorists.[365] These transactions are difficult to spot unless government regulators already have the specific charities and organizations in question under surveillance.[366] Such proactive or prophylactic surveillance runs into privacy and constitutional thickets.[367] Assuming the federal government does not have sufficient evidence for probable cause or a Foreign Intelligence Surveillance Act warrant,[368] targeting Muslim charities would be roundly protested as racial profiling irrespective of the actual legal or constitutional infirmities of the practice.[369] As a result, while administrative "blocking orders" promulgated under the authority of the IEEPA have been an effective tool in disrupting and shutting down some of the largest and most dangerous Muslim charities funding terrorism,[370] prosecutions of terror-financing through charities have had mixed results.[371]

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[365] *Id.*

[366] Gouvin, *supra* note 356, at 976–77.

[367] *See generally* Richard Henry Seamon & William Dylan Gardner, *The Patriot Act and the Wall Between Foreign Intelligence and Law Enforcement*, 28 HARV. J.L. & PUB. POL'Y 319 (2005) (discussing Fourth Amendment "criminal" warrant standards and detailing FISA's reduced requirements for a warrant directed at foreign threats, even if they are on domestic soil).

[368] "FISA" is the Foreign Intelligence Surveillance Act of 1978, Pub. L. No. 95-511, 92 Stat. 1783 (1978) (codified as amended at 50 U.S.C. §§ 1801–1871), which was amended materially by the Patriot Act. *See* USA PATRIOT ACT, Pub. L. No. 107-56 § 218, 115 Stat. 272, 291 (2001) (amending 50 U.S.C. §§ 1804(a)(7)(B), 1823(a)(7)(B)).

[369] *See* David Hardin, Note, *The Fuss over Two Small Words: The Unconstitutionality of the USA PATRIOT Act Amendments to FISA Under the Fourth Amendment*, 71 GEO. WASH. L. REV. 291, 342 & n.395 (2003).

[370] *See* Montgomery E. Engel, Note, *Donating "Blood Money": Fundraising for International Terrorism by United States Charities and the Government's Efforts to Constrict the Flow*, 12 CARDOZO J. INT'L & COMP. L. 251, 282–85 (2004). Specifically, Engel writes that:

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

This problem raises its ugly head with SCF in two ways. One way, although it does not yet appear to be the norm in the U.S., is through a charitable contribution made by an SCF financial institution or business. This contribution would occur because faithful Muslims must gift a certain percentage of their income to charity.[372] Some SCF companies, banks, and investment funds actually calculate the amount that individual Muslim investors owe from profits and distribute those funds automatically to *Shari'ah*-approved Islamic charities, and only then distribute the net, after-*Shari'ah*-charitable-tax profits to the individual investor.[373] Most SCF institutions, however, leave such tithing to the individual investor to calculate and distribute.[374]

Several questions arise for those SCF businesses and investments which net the returns to the investor after this charitable payment: Which charities are *Shari'ah*-compliant? Who makes this determination? Do the businesses or financial institutions direct these contributions, or are these decisions made by the

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Id. at 258–59 (citations omitted). The role of Muslim charities in financing terror has been discussed in Congressional testimony as well. *See Role of Charities and NGOs in the Financing of Terrorist Activities: Hearing Before the Subcomm. on International Trade and Finance of the S. Comm. on Banking, Housing, and Urban Affairs*, 107th Cong. (2002) (statement of Matthew Levitt, Senior Fellow, Washington Institute for Near East Policy), *available at* http://banking.senate.gov/02_08hrg/080102/levitt.htm. Military strategists have also looked at this modality for furthering the terrorist war aims. *See* MAJ. WESLEY J. L. ANDERSON, DISRUPTING THREAT FINANCES: UTILIZATION OF FINANCIAL INFORMATION TO DISRUPT TERRORIST ORGANIZATIONS IN THE TWENTY-FIRST CENTURY 8–11 (Nov. 4, 2007), *available at* http://stinet.dtic.mil/cgi-bin/GetTRDoc?AD=A470454&Location=U2&doc=GetTRDoc.pdf.

[371] *See* Danielle Stampley, Comment, *Blocking Access to Assets*, 57 AM. U. L. REV. 683, 709 & n.152 (2008) (highlighting the fact that prosecutions for the "material support of terrorism" are difficult cases to try before a jury because they often require specific evidence against the defendants, like financial data evidence, as opposed to hearsay evidence and circumstantial evidence of associational links, which will lead the defendant to raise the defense that they had no specific knowledge that the money they contributed was going to support illegal activities). For an Internet site dedicated to tracking the results of terrorism-related prosecutions, *see* TRAC Reports: Criminal Terrorism Enforcement in the United States During the Five Years Since the 9/11/01 Attacks, maintained by the Transactional Records Access Clearinghouse (TRAC) associated with Syracuse University, http://trac.syr.edu/tracreports/terrorism/169/ (last visited Sept. 2, 2008).

[372] *See* Munir Morad, *Current Thought on Islamic Taxation: A Critical Synthesis*, *in* ISLAMIC LAW AND FINANCE, *supra* note 21, at 122–23.

[373] *See* DeLorenzo, *supra* note 24, at 11.

[374] *Id.* at 11. One of the leading *Shari'ah* authorities recommends that *Shari'ah*-compliant mutual funds leave the donation to the individual investor; though, it may be best for *Shari'ah* Supervisory Boards to prepare guidelines for the calculation of the religious tax called *zakat* "on profits earned through investments in funds." DeLorenzo, *supra* note 24, at 11. The assumption for this article has been that if a reporting mutual fund does not disclose that it has the authority to gift *zakat* contributions on behalf of the individual investors, then the mutual fund has left that for the individual investors.

Shari'ah authorities? Is there any vetting of the recipients of these charities to determine what they do with these funds? Why is this process not transparent?

A second form of this problem arises when some of the gross income of a business is from *Shari'ah*-prohibited sources. This typically occurs in two ways. The first is via the exceptional event when a *Shari'ah* "filter" misses a tainted source of income altogether. This might happen when a *Shari'ah*-compliant company in a *Shari'ah*-compliant mutual fund acquires a forbidden company, the main business of which is in a forbidden industry such as finance or hog farming.[375] Assuming the acquired company's forbidden assets are not *de minimis*, the acquisition renders the parent company in the mutual fund's portfolio *Shari'ah*-prohibited and the equity position in that company must be sold.[376] Where the proceeds of that sale will include a certain amount of profits attributed to the forbidden assets, that amount must be calculated and "purified."[377]

The second occasion for purification is more typical. For example, a mutual fund is permitted to invest routinely in companies which earn up to a fixed percentage of their income from interest on the forbidden business activities.[378] Notwithstanding this leniency, any profits to the mutual fund attributed to this forbidden income must be "purified" at some point.[379]

Because the calculation of this purification can be complex, most *Shari'ah* authorities either insist or prefer that the purification take place by the SCF institution so the *Shari'ah* authorities will have the opportunity to assess the amount needed to be purified and supervise the logistics.[380] As in the charitable contribution discussion, the purification process typically is not fully disclosed in public filings of U.S. SCF financial institutions.[381] The questions raised above about disclosure for the general charitable tax apply here *mutatis mutandis*. However, since most *Shari'ah* authorities have ruled that it is more appropriate to

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[375] *See* Yaquby, *supra* note 23, at 21 (detailing the total prohibition on investment in "unlawful activities, such as conventional banks, insurance companies, alcoholic beverages companies and gambling, pork, brothels, pornography-related companies and other similar companies").

[376] *See* LEWIS & ALGAOUD, *supra* note 21, at 222–23.

[377] *See* DeLorenzo, *supra* note 24, at 4–5; *see also* ISLAMIC FIN. SERVS. BD., EXPOSURE DRAFT: GUIDING PRINCIPLES ON GOVERNANCE FOR ISLAMIC COLLECTIVE INVESTMENT SCHEMES 14–17 (Dec. 2007), *available at* http://www.ifsb.org/docs/ed_islamic_collective_investment.pdf (outlining standards for governance); s*ee generally* Yaquby, *supra* note 23 (discussing different views on impurity and appropriate responses).

[378] *See* Yaquby, *supra* note 23, at 23–24.

[379] *See* DeLorenzo, *supra* note 24, at 4–5.

[380] *Id.* at 4–5.

[381] *See* Dow Jones Islamic Market Index Portfolio, Registration Statement (Form N-1A) (Sept. 1, 1999), *available at* http://www.sec.gov/Archives/edgar/data/1088654/0000935489-99-000014.txt.

have the purification process carried out by the SCF company rather than by the individual investor, one might reasonably assume that this is the general rule.[382]

In both instances, the legal advisor to the SCF financial institution or business must be careful about how these charitable contributions are made and who the beneficiaries of these funds are. Given the prosecutions of Islamic charities for funneling contributions to terrorist organizations directly and indirectly through other charitable organizations in a laundering process,[383] the anti-money laundering laws must be analyzed carefully by the attorney to be certain that the financial institution is not facilitating a criminal violation and that there is strict compliance with all reporting requirements.

The principal anti-money laundering statutes are 18 U.S.C. §§ 1956–1957. The focus of these statutes is on criminalizing the movement of funds from unlawful activity.[384] As such, they have a limited application to the issue of charitable contributions directed by *Shari'ah* authorities related to a given SCF financial institution. The legal advisor, however, must take the following into consideration before proffering advice because Section 1956(a)(2) criminalizes the following:

> (2) Whoever transports, transmits, or transfers, or attempts to transport, transmit, or transfer a monetary instrument or funds from a place in the United States to or through a place outside the United States or to a place in the United States from or through a place outside the United States—(A) with the intent to promote the carrying on of specified unlawful activity; . . . .[385]

Two issues stand out. First, a purely domestic transfer of legal funds with the requisite criminal intent is not a per se violation under this provision. Arguably, if a domestic transfer took place but with the understanding that the funds would find their way overseas as part of the criminal intent, such a transfer would be prohibited. Thus, a U.S. financial institution might run afoul of this provision when it "purifies" its forbidden assets by transferring funds to a terrorist-supporting charity overseas or possibly even to a domestic charity as a conduit to problematic overseas groups.

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[382] While it does not appear that the DJIMI calculates the "purification" requirement for its index of funds with a concomitant reduction in the stated values and returns for its universe of stocks, one index actually promotes this feature: "Incorporates Dividend Purification. In addition, the application of a dividend adjustment factor in the creation of the MSCI Islamic Index Series results in more relevant benchmarks, as they reflect the total return to an Islamic portfolio net of dividend purification." MSCI Barra, MSCI Global Islamic Indices, http://www.mscibarra.com/products/indices/islamic/ (last visited Sept. 3, 2008).

[383] *See supra* note 370 and accompanying text.

[384] *See supra* notes 362–363 and accompanying text.

[385] 18 U.S.C. § 1956(a)(2)(A) (2006).

The second issue is intent. The statute requires that the defendant have the intent to move the funds to promote one of the illegal activities enumerated.[386] Terrorism is one of those criminal activities set out in Section 1956(c)(7).[387] A lawyer representing a financial institution contemplating "purification" must consider the possibility that the charitable gift might be going to a charity with intimate connections to terrorists.[388] In this context, prudent legal counsel must determine who directs the funds to the charitable contribution, whether the charities or universe of acceptable charities are chosen by the *Shari'ah* authorities, and whether this decision is binding on the financial institution. The issue here is obvious. If the financial institution places this decision-making authority into the hands of the *Shari'ah* authorities it has retained, it is possible that any criminal "intent" or "purposes" connecting the *Shari'ah* authorities to these charities will be attributed to the financial institution. The criminal culpability in this case is similar to that described above in the discussion of the Smith Act.[389]

While many financial institutions involved in SCF attempt to distance themselves from the *Shari'ah* authorities, a lawyer analyzing these issues must determine who made the decision about which charities would be considered *Shari'ah*-complaint and thus recipients for the "purification" of funds. Moreover, if it turns out that these charities have ties to terrorists or are implicated in the material support of terrorism, the lawyer must determine whether this fact was known to any agent of the company.[390]

Obviously, the criminal exposure arising from the "purification" process might lead responsible legal counsel to ask the following questions about any list

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[386] *Id.*

[387] *Id.* § 1956(c)(7)(D) (referring to other sections relating to various types of terrorist acts).

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

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

Engel, *supra* note 370, at 251 (citations omitted).

[389] *See supra* Part VI.D.

[390] Or, as set out *supra* at note 280, was this fact willfully or recklessly avoided?

of potential charities: Are these well-known non-Muslim charities? If they are Muslim charities, have they been vetted and by whom? The three largest Muslim charities in the U.S. have all been implicated in financing terror and were subject to administrative blocking orders wherein their assets were frozen and they were effectively shut down.[391]

The practice of Muslim charities funneling money to terrorists is so widespread and the problem so insidious that the federal government keeps an updated list on dozens of such organizations worldwide.[392] But it will not suffice for the legal advisor to simply determine that the charities are "well-known" Muslim charities and not currently listed as designated supporters of terrorism. At a minimum, the following queries would need to be undertaken: Who are the ultimate beneficiaries of the contributions?[393] Do these charities have overseas branches? Is the financial institution wiring the funds domestically or internationally? Who or what organization founded the organizations and who controls them today? Once these questions are answered, the legal advisor will need to be careful that, whatever policies are put in place to avoid criminal exposure under Sections 1956 and 1957, the client continues to monitor these "charitable contributions" carefully.[394]

(b) Material Support of Terrorism and Related Civil Exposure

Material support of terrorism is a federal crime under 18 U.S.C. §§ 2339A–2339B. The Intelligence Reform and Terrorism Prevention Act of 2004[395] amended the definition of "material support" to read as follows:

> (1) the term "material support or resources" means any property, tangible or intangible, or service, including currency or monetary instruments or financial securities, financial services, lodging, training, expert advice or assistance, safehouses, false documentation or identification, communications equipment, facilities, weapons, lethal substances, explosives, personnel (1 or more individuals who may be or include oneself), and transportation, except medicine or religious materials.[396]

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[391] *See supra* note 388.

[392] *See* U.S. Department of the Treasury, Terrorism and Financial Intelligence, Key Issues: Protecting Charitable Organizations, http://www.ustreas.gov/offices/enforcement/key-issues /protecting/charities_execorder_13224-a.shtml (last visited Aug. 3, 2008).

[393] In other words, who or what is the ultimate recipient of the charities' "good deeds"?

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

[395] Pub. L. No. 108-458, 118 Stat. 3638 (2004).

[396] 18 U.S.C.A. § 2339A(b)(1) (West Supp. 2008).

A *Shari'ah* authority issuing, promoting, or advocating a legal ruling for *Jihad* to anyone for the purpose of conducting terrorism would clearly fall within the definition of "'expert advice or assistance' . . . derived from . . . specialized knowledge."[397] In addition, a New York federal district court found that an attorney who passed along a legal ruling calling for *Jihad* had provided "material support" in the form of "personnel" as part of a terror-laden conspiracy.[398] In *U.S. v. Satter*, the court upheld attorney Lynne Stewart's conviction for violating Section 2339A.[399] There, Stewart merely passed along a *fatwa* or legal ruling regarding *Jihad* issued by her client, Sheikh Omar Abdel Rahman, indirectly to terrorists in Egypt, some of whom apparently respected his authority in matters of *Shari'ah*.[400] The court concluded that passing along a legal ruling could be equivalent to providing "personnel" to the co-conspirators and amounted to material support.[401]

A U.S. company that promotes the legal rulings of a *Shari'ah* authority who is known for issuing such rulings on the Law of *Jihad* could risk extraordinary criminal exposure. While it is not likely that the company would promote the actual rulings relative to *Jihad* or do so with the intent to cause violence, this will not be the standard. Instead, the question will be what role does the *Shari'ah* authority occupy within the company or what relationship does he have to the company if he is an "outside advisor?" To the extent that criminal *respondeat superior* implicates the corporate entity in the *Shari'ah* authority's scienter, a defense built upon lack of knowledge by the board of directors will not be effective. Also, the fact that such legal rulings are published in broad daylight and available from English open sources will render the corporation's plea of lack of intent all the more unavailing to the extent it rises to the level of "willful blindness" or "recklessness."[402]

Additional areas of criminal and civil liability exposure relate to the anti-money laundering statutes. To the extent that any "purification" funds move from the financial institution to a charity and are found to support terrorist activities, there would likely be additional criminal exposure under Sections 2339A and 2339B because both of these statutes forbid the provision of material support for terrorism.[403] The distinction between the two statutes is important. Section 2339A requires a showing that the defendant provided support knowing its intended purposes.[404] Under Section 2339B, the defendant need only know of the status of the target organization as a designated terrorist organization and need not know or

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[397] *See id.* § 2339A(b)(3).
[398] United States v. Sattar, 395 F. Supp. 2d 79, 93, 95, 99, 103 (S.D.N.Y. 2005).
[399] *Id.* at 82, 103.
[400] *See id.* at 87–88.
[401] *Id.* at 99.
[402] *See, e.g.*, USMANI *supra* note 208, at 123–39 (discussing the topic of *Jihad*).
[403] 18 U.S.C.A. §§ 2339A, 2339B (West 2000 & Supp. 2008).
[404] *Id.* § 2339A(a) (West Supp. 2008).

intend that the material support is going to support terrorism.[405] This also applies to the discussion regarding corporate criminal exposure for the intent of the company's agents and must be considered by legal counsel.

In addition to criminal exposure, to the extent that a U.S. financial institution can be criminally linked to terrorist organizations as a result of the "purification" funds or via other "material support" relationships between the *Shari'ah* authorities and the terrorists, additional statutes provide civil remedies to victims of such violence, even if the violence occurs outside the jurisdiction of the U.S. The most important of these statutes is 18 U.S.C. § 2333, which provides for civil remedies and treble damages for any U.S. national injured by terrorists.[406] Several federal circuits have allowed private rights of action under this statute against defendants who have "aided and abetted" the offending terrorists by violating Sections 2339A and 2339B.[407]

Beyond the civil exposure in Section 2333, the Alien Tort Statute (ATS)[408] probably exposes companies linked criminally to terrorism to enormous civil liability. It is severe enough to be sued by U.S. nationals for damages caused by terrorism, but the potential for mass litigation by foreigners for such damages is greater still. Once the criminal connection is made through the anti-money laundering or the material support of terrorism statutes, the plaintiffs' bar will likely then allege that terrorism is a violation of some norm of the law of nations that is "specific, universal, and obligatory" and that there is a proximate cause between the "material support of terrorism" alleged and the injuries suffered.[409]

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[405] *See id.* § 2339B(a)(1); United States v. Sattar, 314 F. Supp. 2d 279, 301–02 (S.D.N.Y. 2004) (discussing this point in an earlier appeal arising out of the same trial).

[406] 18 U.S.C. § 2333(a) (2006).

[407] *See, e.g.*, Boim v. Quranic Literacy Inst., 291 F.3d 1000, 1023–24 (7th Cir. 2002) (allowing suit under section 2333 for U.S. "citizen murdered in Israel by Hamas terrorists").

[408] 28 U.S.C. § 1350.

[409] *See id.*; *see, e.g.*, Sosa v. Alvarez-Machain, 542 U.S. 692, 738 (2004) (demonstrating the utility of ATS as a jurisdictional statute). In particular, ATS gives an alien plaintiff access to federal courts if there is an allegation that the alien suffered some harm that is in "violation of the law of nations or a treaty of the United States." 28 U.S.C. § 1350. In the Court's opinion, it was "persuaded that federal courts should not recognize private claims under federal common law for violations of any international law norm with less definite content and acceptance among civilized nations than the historical paradigms familiar when § 1350 was enacted," and the Court implicitly endorsed the "specific, universal, and obligatory" standard. *Sosa*, 542 U.S. at 732 (citing *In re* Estate of Ferdinand Marcos, 25 F.3d 1467, 1475 (9th Cir. 1994)). To the extent that U.S. laws against torture encompass terrorism and the "material support of terrorism," they are in accord with the Law of Nations and, at the very least, would likely satisfy the "specific, universal, and obligatory" standard. *See* Torture Victim Protection Act of 1991, Pub. L. No. 102-256, § 2(b), 106 Stat 73, 73 (1992) (codified at 28 U.S.C. § 1350 notes); Filartiga v. Pena-Irala, 630 F.2d 876, 885 (2d Cir. 1980) (stating that torture is a violation of the Law of Nations).

2. Antitrust

Another area of civil liability exposure related to the exogenous structure imposed by the need for *Shari'ah* authority boards arises under antitrust law. As noted above, at present there are a limited number of *Shari'ah* authorities filling the positions available on the *Shari'ah* authority boards of the major *Shari'ah*-compliant financial institutions worldwide.[410] There has been a concerted effort among these *Shari'ah* authorities to impose universal standards to prevent materially divergent opinions. Such efforts have been launched by the Accounting and Auditing Organization for Islamic Financial Institutions ("AAOIFI") and the Islamic Financial Services Board ("IFSB"). The AAOIFI seeks to establish accounting standards for the various transactional structures, whereas the IFSB sets the standards by which *Shari'ah* authorities self-regulate and interact with the financial institutions that employ them.[411]

According to the IFSB and the independent writings of many *Shari'ah* authorities, there are designs to establish industry-wide minimal credentials that a newcomer would be required to obtain to enter this apparently lucrative market.[412] The initial antitrust issue raised by such efforts is the problem of "group boycotts" or the implications of "self-regulation" for a small, discreet, and insular group of authorities who have almost total market share deciding how one gains entry into the market.[413] Applying the standard "rule of reason," courts will look to the motivations and anti-competitive effects of such "industry standards."[414]

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[410] *See supra* note 337 and accompanying text.

[411] *See supra* note 18 and accompanying text; *see also* Accounting and Auditing Organization for Islamic Financial Institutions, http://www.aaoifi.com/index.shtml (last visited Aug. 5, 2008) (describing itself as "responsible for developing accounting, auditing, ethics, governance, and Shari'a standards for the international Islamic banking and finance industry"); Islamic Financial Services Board, http://www.ifsb.org/index.php (last visited Aug. 5, 2008) (explaining that the organization "is an international standard-setting organisation [sic] that promotes and enhances the soundness and stability of the Islamic financial services industry by issuing global prudential standards and guiding principles for the industry, broadly defined to include banking, capital markets and insurance sectors").

[412] *See* ISLAMIC FIN. SERVS. INDUS. DEV., TEN-YEAR FRAMEWORK AND STRATEGIES 10, 23, 47, 50, 52, 58, 61 (2007) (joint initiative of the Islamic Research & Training Institute Islamic Development Bank, Islamic Financial Services Board, and the Islamic Research and Training Institute), *available at* www.ifsb.org/docs/10_yr_framework.pdf (describing the industry and laying out goals for the next ten years).

[413] *See* Nw. Wholesale Stationers, Inc. v. Pac. Stationery & Printing Co., 472 U.S. 284, 290, 293–95 (1985).

[414] *See* Robert Pitofsky, Chairman, Fed. Trade Comm'n, Self Regulation and Antitrust (Feb. 18, 1998), http://www.ftc.gov/speeches/pitofsky/self4.shtm; Debra A. Valentine, Gen. Counsel, Fed. Trade Comm'n, Industry Self-Regulation and Antitrust Enforcement: An Evolving Relationship (May 24, 1998), http://www.ftc.gov/speeches/other/dvisrael speech.shtm.

This is especially problematic in SCF should a non-recognized *Shari'ah* authority attempt to market his services to the financial institutions seeking *Shari'ah* guidance. In such cases, *Shari'ah* authorities would not be satisfied with the newcomer's credentials and would likely render the market closed to that newcomer. This issue exists because financial institutions that market SCF products to the *Shari'ah*-adherent consumer are extraordinarily sensitive to the problem that public disputes among the *Shari'ah* authorities over what is permitted or prohibited could devastate both the demand for SCF products generally and render any given SCF product suspect.[415]

The problem of "self-regulation" would become an issue for the financial institutions if they play a material part in this effort to control entry into the market by newcomers in a *de jure* or *de facto* collusion with the dominant group.[416] Another potential problem is "rules collusion."[417] Here, the effort of the financial institutions and their agents—the *Shari'ah* authorities—to agree upon what transaction structures and investments should be considered "*Shari'ah*-compliant" will limit the development of new competitive products by market players. This collusion, in turn, will make it more difficult for the consumer to distinguish between SCF products, while raising the cost of searching for newer, innovative SCF products—thereby shaping and softening competition among cartel members in order to increase the profits of the parties to the agreement.[418] The fact that such

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[415] *See* McMillen, *supra* note 12, at 431–33; *Booming Islamic Bond Market Embroiled in Debate over Religious Compliance*, INT'L HERALD TRIB., Jan. 11, 2008, http://www.iht.com/articles/ap/2008/01/11/news/Mideast-Islamic-Bonds.php. *See generally* McMillen, *supra* note 12, at 458–67 (attempting to cure the lack of transparency, certainty, consistency, and predictability of SCF by arguing for the IFSB to propose Model Acts like the Model Acts propounded by the National Conference of Commissioners on Uniform State Laws).

[416] *See* Am. Soc'y of Mech. Eng'rs v. Hydrolevel Corp., 456 U.S. 556, 570, 576–78 (1982). In fact, the SCF financial institutions participate at various levels in setting the standards for the industry. *See* Accounting and Auditing Organization for Islamic Financial Institutions, Members, http://www.aaoifi.com/members.html (last visited Sept. 5, 2008). *But see* Islamic Financial Services Board, Members, http://www.ifsb.org/index.php?ch =3&pg=7&ac=10 (last visited Aug. 5, 2008) (showing that private banks do not appear to play as significant a role in setting standards for the IFSB).

[417] For an interesting discussion of "rules collusion" as "Type III," see Robert H. Lande & Howard P. Marvel, *The Three Types of Collusion: Fixing Prices, Rivals, and Rules*, 2000 WIS. L. REV. 941, 949–84 (2000).

[418] *Id.* at 942–43. The anti-competitive effects of the rule-making monopoly currently enjoyed by the *Shari'ah* authorities go in some measure to the endogenous aspects of what *Shari'ah* itself says about who is qualified to be part of the *Ulema* or scholarly elite with any real authority. *See supra* Part IV.A. Historically and institutionally, because the *Shari'ah* authorities have used "consensus" and the limitation of new interpretations via the doctrine of the "closing of the gate of *ijtihad*" as a self-regulator, they have been extraordinarily successful in keeping the group over time true to the early doctrines

a financial market is predicated upon a consensus of the market's private rules advisors suggests that SCF within the financial industry presents substantial exposure to antitrust liability.

3. Racketeering

As described above, the leading two dozen *Shari'ah* authorities effectively establish all of SCF's rules and regulations. If these men have as their ultimate and collective goal the implementation of a *Shari'ah*-based Caliphate in the U.S. and their methodologies include the Law of *Jihad*—meaning violence when necessary or possible and otherwise fraud and misrepresentations about the true purpose of *Shari'ah*—a prima facie case for a lawsuit under RICO is almost unavoidable.[419] This is especially true now that the Patriot Act has added the federal terror-related crimes to the RICO predicate offenses and beefed up the predicate offenses relating to money laundering.[420]

A cursory examination of the elements of a viable RICO prosecution reveals the enormous exposure. RICO is violated when a defendant, or in this case a cadre of defendants acting as *Shari'ah* authorities, engage in a "pattern of racketeering activity" and through these activities or the proceeds, have invested in an enterprise, acquired an enterprise, conducted or participated in an enterprise, or conspired to do any of the preceding.[421] The "pattern of racketeering activity" simply means two or more of the predicate offenses within a ten-year period.[422] Predicate offenses include mail and wire fraud, bank fraud, material support of terrorism, and money laundering.[423] The "enterprise," which is an entity, person, or group of entities or persons associated in some *de jure* way (e.g., partnership) or as a *de facto* association, exists separately from the defendants.[424] In this scheme, the enterprise is the financial institution involved in SCF. As discussed above, to the

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developed after the formal schools had articulated them. *See* Bassiouni & Badr, *supra* note 39, at 135, 137–38, 146–47, 153–55, 163–64 (2002).

[419] *See* PETERS, *supra* note 8, at 2–5 (pointing to some verses in the *Qur'an* which "order Muslims to fight the unbelievers unconditionally").

[420] CHARLES DOYLE, CRIMINAL MONEY LAUNDERING LEGISLATION IN THE 109TH CONGRESS 2–3 (2006), *available at* http://www.house.gov/gallegly/issues/crime/crime docs/RS22400.pdf.

[421] 18 U.S.C. § 1962(a)–(d) (2006).

[422] *Id.* § 1961(5) (2006); *cf.* H.J. Inc. v. Nw. Bell Tel. Co., 492 U.S. 229, 238–39 (1989) (stating that it must be shown that the predicate acts are related to one another and that they "amount to, or . . . constitute a threat of, *continuing* racketeering activity").

[423] 18 U.S.C.A. § 1961(1)(B), (G) (West Supp. 2008) (adding material support of terrorism via section 1961(1)(G) by reference to section 2332b(g)(5)(B)). Insofar as the material support of terrorism is a predicate offense under the anti-money laundering statutes, violation of the latter might occur by virtue of a *Shari'ah* authority issuing a fatwa in support of *Jihad*. *See supra* notes 395–401 and accompanying text.

[424] 18 U.S.C. § 1961(4) (2006).

extent that a U.S. financial institution has criminal culpability for the predicate offenses, that particular institution would join the list of defendants and operate as part of the enterprise.[425] The evidence of the RICO crime then would include the fraud and ulterior motives of the *Shari'ah* authorities and how they have manipulated the enterprise to achieve their criminal ends. If such an indictment were handed down, it could lead to a pretrial asset freeze[426] and a post-conviction forfeiture of the criminal enterprise's assets.[427]

4. Banks and Consumer Loans

Regulated commercial banks and private lenders have recognized the SCF market and have made significant inroads establishing this new industry. At least one U.S. commercial bank has attempted to design a *Shari'ah*-compliant depository account.[428] The unique feature of this kind of account is that it must be "at risk" as an equity investment and not viewed as a guaranteed deposit with interest income.[429] A U.K. bank has developed a regulatory work-around,[430] but although U.S. regulators do not appear to have officially permitted such accounts yet, one community bank advertises a *Shari'ah*-compliant profit-sharing deposit account, which purportedly does not earn interest but rather a share of the bank's profits.[431] This bank apparently received an exemption from a *Shari'ah* authority because the bank guarantees the principal of the deposit, as required by U.S. banking laws, and such "no risk" guarantees are typically considered forbidden under *Shari'ah*.[432]

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[425] *See* Schofield v. First Commodity Corp., 793 F.2d 28, 30, 32 (1st Cir. 1986) (discussing criminal *respondeat superior* under RICO and noting that although a corporation cannot be both the enterprise and a person at the same time, "a corporation may be a 'person' under [18 U.S.C. § 1961(4)]" and section 1962(a) "must be read to allow corporations to serve both as the RICO person and the RICO enterprise").

[426] 18 U.S.C. § 1963(d) (2006); *see also* 18 U.S.C.A. § 1956(b)(3)–(4) (West Supp. 2008) (providing pre-trial asset freezes for money laundering).

[427] 18 U.S.C. § 1963(a)–(c).

[428] *See* William L. Rutledge, Executive Vice President, Fed. Reserve Bank of N.Y., Regulation and Supervision of Islamic Banking in the United States, Address at the 2005 Arab Bankers Ass'n of N. Am. Conference on Islamic Fin.: Players, Products & Innovations in New York City (Apr. 19, 2005), http://www.nubank.com/islamic/regulation.pdf.

[429] *See* El-Gamal, *supra* note 98, at 32–34.

[430] *See* Rutledge, *supra* note 428; *see also* Callum McCarthy, Chairman, Fin. Servs. Auth., Speech at Muslim Council of Britain Islamic Fin. and Trade Conference (June 13, 2006), http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2006/0613_cm.shtml.

[431] *See* Shaheen Pasha, *Niche Banks Find Growth in Muslim Market*, CNNMONEY.COM, Jan. 17, 2006, http://money.cnn.com/2006/01/17/news/companies/banks_muslims/index.htm.

[432] *See* El-Gamal, *supra* note 98, at 32–34; Rutledge, *supra* note 428.

Another impediment for commercial banks entering this market appears to have been overcome. In a typical SCF home mortgage transaction, the lender purchases the property and either resells it immediately to the borrower at a stepped-up price to be paid out over time (i.e., a cost-plus sale) or leases it back to the borrower through a sale-lease back arrangement.[433] The problem for commercial banks in these transactions is that U.S. law does not allow banks to own real estate except in limited circumstances, such as the bank's own offices or property acquired through foreclosures on bad loans.[434] Two banks have received approval from the Office of the Comptroller of Currency (OCC) for such SCF transactions.[435] The rationale for the approvals was a substance-over-form analysis. Since these mortgage products were in fact disguised loans with interest and the real estate was only owned for a limited purpose, the Comptroller did not see these *Shari'ah*-compliant mortgages as a violation of the prohibition against owning real estate.[436] The OCC also granted one of the banks approval to use the cost-plus sale transaction structure to accommodate construction loans and other consumer loans.[437]

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

Commercial banks and other lenders must comply with TILA[438] and its complex Regulation Z.[439] TILA prohibits specific types of misrepresentations or misleading omissions in advertising.[440] It requires "lenders to make standardized disclosures whenever other price terms are advertised."[441] For example, any advertisement that states an interest rate must state the annual percentage rate (APR).[442] An oral response to consumer inquiries about closed-end loans, however,

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[433] *See* EL-GAMAL, *supra* note 15, at 15–17.

[434] 12 U.S.C. § 29 (2006). For a senior officer at the Federal Reserve Bank of New York remarking favorably on Islamic banking in the United States, see Michael Silva, *Islamic Banking Remarks*, 12 AM. LAW & BUS. REV. 201, 203–05 & n.4 (2006).

[435] *See supra* note 78 and accompanying text.

[436] *See* Office of the Comptroller of the Currency, Interpretive Letter No. 806, *supra* note 78, at 8.

[437] *See* Office of the Comptroller of the Currency, Interpretive Letter No. 867, *supra* note 78, at 4–8.

[438] *Supra* note 161.

[439] *Supra* note 162.

[440] *See generally* Patricia A. McCoy, *The Middle-Class Crunch: Rethinking Disclosure in a World of Risk-Based Pricing*, 44 HARV. J. ON LEGIS. 123 (2007) (discussing the strengths and weaknesses of TILA in regulating misleading advertising).

[441] *Id.* at 128.

[442] 15 U.S.C. § 1664(c) (2006); Truth in Lending (Regulation Z), 12 C.F.R. § 226.24(b) (2005).

may only state the APR.[443] Advertisements quoting a down payment by percentage or amount, the amount of any monthly loan payment or finance charge, the number of payments, or the period of repayment must also state the APR, the terms of repayment, and the amount or percentage of any down payment.[444]

The problem lenders have is that they are marketing the SCF products as interest-free and therefore *Shari'ah*-compliant.[445] In fact, and as scrutinized by the OCC and likely by the IRS and state tax authorities,[446] these various interest-free transactions are merely disguised loans. The banks are treating these products and representing them to the government authorities as conventional loans with interest

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[443] 15 U.S.C. § 1665a.

[444] *Id.* § 1664(d); Supp. I to Part 226–Official Staff Interpretations, 12 C.F.R. pt. 226 at 476–77 (construing section 226.24(c)).

[445] *See, e.g.*, University Islamic Financial Corp., Home Finance, http://www.universityislamicfinancial.com/homefinance.html (last visited Aug. 5, 2008) (declaring Islamic Financial Corporation's loans "free of interest"). In University Bank's "Frequently Asked Questions," the bank attempts to explain that:

> An accountant may argue that rent in the latter two and profit in the former is interest, but in none of these cases is it *riba*. Some accountants argue that anything that may be perceived as generating a benefit from the passage of time has interest in it. The *Sharia'a* scholars have not defined *riba* in this way, rather *riba* necessarily relates to loans of money or exchanges of money like commodities when they are used as money.

University Islamic Financial Corp., FAQs, http://www.universityislamicfinancial.com/faq.html (last visited on Sept. 5, 2008).

Interestingly, in contrast to what one might expect of an argument aimed at the IRS or OCC—which would downplay the "form" and argue that the "substance" of the transaction is a loan—University Bank represents to its customers that its *Shari'ah*-compliant transactions are in fact substantively not loans and that their form is their substance:

> Query: Isn't the Islamic system of purchasing houses the same thing, the same mechanics, as the traditional mortgage system only with different labeling?
>
> SHAPE™: This too is inaccurate. The process of qualifying a consumer and disclosing costs and risks to a consumer is the same as the mortgage system. This process is regulated by federal and state statutes in the United States. Hence, the paperwork is the same or very similar prior to and after making the acquisition, but not the acquisition itself.
>
> The acquisition mechanics are fundamentally different without creating all of the same rights and obligations as in a traditional mortgage. Hence, it is not a question of labeling, but of actual structure.

Id. (latter emphasis added).

[446] *See supra* note 78.

income while marketing them to the public as interest-free *Shari'ah*-compliant non-loan transactions.[447]

Full disclosure requires these banks to indicate that the loans are not interest-free and to fully disclose in all of their advertising the true APR. This would require an explanation that, while a loan might be considered "*riba*-free" for *Shari'ah* purposes, it is considered a standard loan with interest for all secular legal purposes. Unfortunately, even this might not be true. For example, it is unclear how a bankruptcy court would treat the transaction. Much would depend on whether the debtor or the lender was in bankruptcy. How the lender's attorney navigates these issues in print advertisements and on the Internet will likely come to a regulator's or court's attention.[448]

An additional concern for *Shari'ah*-compliant consumer loans is that they are typically more costly than conventional loans. This is true because of the machinations inherent in the transactional documents and because much of the documentation must be duplicated—one set to track *Shari'ah* compliance and one set to track government regulations. In addition, *Shari'ah* supervision adds a cost in most cases, as do some extra taxes attributed to the transfer of title as required by *Shari'ah*.[449] Because these consumer loans are marketed to a specific minority community with a unique cultural affinity to *Shari'ah*, and because the added costs of these loans have no economic value per se, it is possible that the marketing of these products will fall within the scope of the anti-predatory loan laws, such as the

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[447] *See supra* note 445.

[448] Bankruptcy and loan defaults open up an entire Pandora's box of issues that this article will not and cannot address. Legal commentators have discussed this in passing, however, only in the most cursory of terms. *See, e.g.*, McMillen, *supra* note 12, at 453–54 (discussing some of the issues surrounding *Shari'ah* and separateness covenants in the context of bankruptcy).

[449] *See, e.g.*, Devon Bank, Frequently Asked Questions, http://www.devonbank.com /Islamic/faq.html (last visited Aug. 5, 2008). Specifically, the bank explains:

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

Id.

Home Ownership and Equity Protection Act of 1994 (HOEPA)[450] or the state versions of HOEPA, which are typically more aggressive and have lower thresholds for offending predatory high-cost loans.[451]

VI. CONCLUSION

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

In pursuing SCF, U.S. businesses face civil liability in the realms of tort law, securities law, and antitrust. Furthermore, these businesses face criminal exposure in securities, antitrust, anti-sedition, racketeering, and money-laundering statutes. The failure by corporate management and their legal advisors to confront these issues in serious fashion is not surprising given the wholesale failure of the participants and facilitators in this industry to undertake a serious analysis of the risks. The extant academic and professional literature reads more like promotional material and not serious legal analysis conducted by those trained to protect clients from their own blind enthusiasm. The legal industry has gone down this road too many times in the past. This time, the risk is not simply financial; it is existential. Lawyers, academics, and regulators alike must acknowledge the potentially dire consequences of *Shari'ah*-compliant financing and take steps to address its legal and ethical issues.

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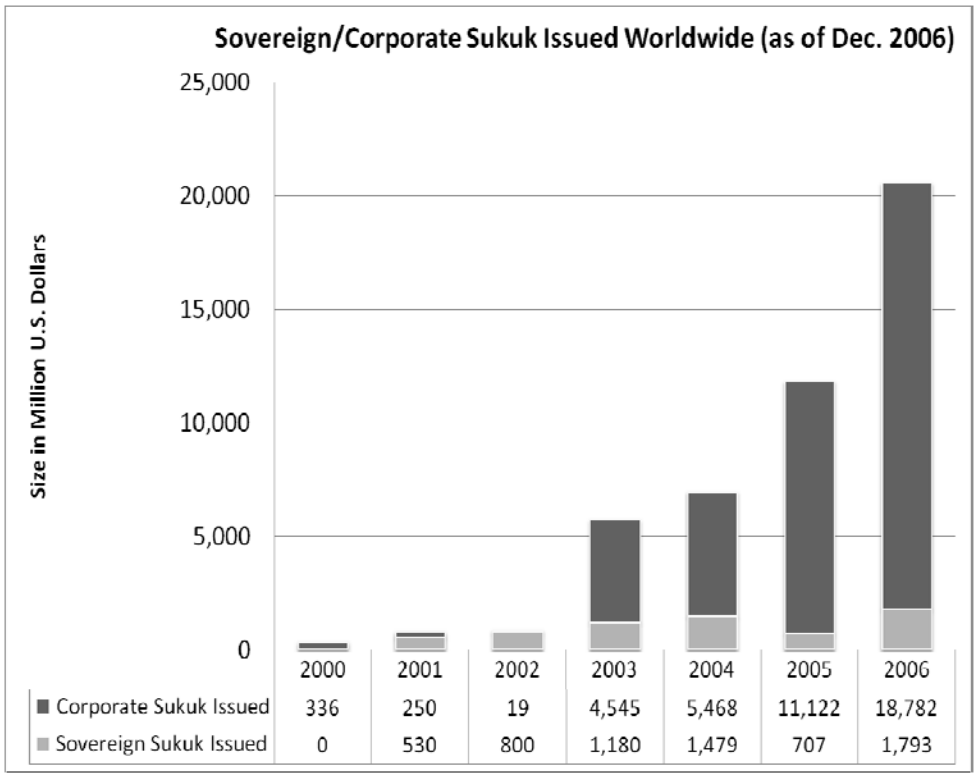
[450] Home Ownership and Equity Protection Act of 1994, Pub. L. No. 103-325, 108 Stat. 2160, 2190 (1994) (codified as amended in scattered sections of 15 U.S.C. §§ 1601–1667f).

[451] *See generally* C. Lincoln Combs, Comment, *Banking Law and Regulation: Predatory Lending in Arizona*, 38 ARIZ. ST. L.J. 617 (2006) (discussing conditions in Arizona, reviewing federal and state regulations, and encouraging Arizona to regulate predatory lending).

APPENDIX A: DOLLAR-GROWTH OF *SHARI'AH*-COMPLIANT BONDS ISSUANCES



Source: Ijlal A. Alvi, *Increasing the Secondary Markets for Sukuks: Overview and Considerations*, at 3, http://www.iifm.net/download/Presentations/Increasing%20the%20secondary%20market%20for%20Sukuk.pdf (last visited Sept. 5, 2008).