As the world economies are beginning to emerge from the economic crisis, Islamic funds have proven adaptable and have been one of the survivors of the economic downturn. In 2009, the Islamic fund industry remained strong with almost US$50 billion in fund assets under management, according to Ernst & Young’s Islamic Funds and Investments Report 2009.

The Islamic fund industry has gained increased popularity and according to Lipper, the mutual fund division of Thomson Reuters, there are now 473 Islamic funds, more than half of which are equity funds. Islamic funds have been popular among investors seeking to limit the risk of their investment, especially in the Middle East and in Asia.

The defining feature of Islamic finance remains the ethical principles that underpin the industry. These principles comprise the ethical distribution of wealth, risk sharing, the prohibition of interest and linking deposits and investments to real underlying assets. These principles have assisted Islamic financial institutions in maintaining more consistent returns, even during the economic downturn.

In light of this growing interest in Islamic funds, it has become even more imperative that robust corporate governance policies and adherence to internationally recognized standards are maintained in order for Islamic funds to remain consistent and have a degree of permanence comparable to conventional funds.

**Standardization of industry best practice**

Investors increasingly expect funds to adhere to strict standards of corporate governance, which involves adopting structures and processes that incorporate the values of fairness, transparency and accountability. The objective of corporate governance is to put in place a system which will deliver a company’s business objectives whilst managing risk. Islamic entities share these same objectives, but are also subject to an additional layer of compliance with Shariah rules and principles.

**Shariah governance**

The Islamic finance industry has developed industry bodies to provide guidance on the application of the Shariah, in line with good corporate governance. The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) provides 41 Shariah standards for Islamic financial institutions to ensure that their products and services are Shariah compliant. The Shariah standards as well as accounting, auditing and governance standards are widely adhered to among Islamic finance practitioners.

Accounting and auditing standards are provided by AAOIFI in order to provide a standard measure for accounting principles to be applied across Islamic financial institutions.

The Islamic Financial Services Board (IFSB) issues global standards and guiding principles for the banking, insurance and capital markets sectors to promote the development of a prudent and transparent Islamic financial services industry. IFSB introduces new, or adapts existing, international standards consistent with Shariah principles and has so far issued 12 standards and guiding principles on the key areas of risk management, capital adequacy, corporate governance, transparency and market discipline, supervisory review process, governance for Takaful operations and a system of Shariah governance.

To comply with Shariah governance, an Islamic fund will appoint a Shariah board (usually consisting of three scholars as recommended by AAOIFI) which provides guidance on investment guidelines and undertakes a periodic review of the fund and its investments. The board also provides guidance on purification. Purification is the process of separating any income generated by an Islamic fund which is derived from any interest-based transactions or non-Shariah compliant trades. Such amount is either deducted prior to distribution of dividends or investors are informed of the amount that should be deducted and the Shariah board recommends that the income is purified by the investor donating such amount to a nominated charity.

**Conventional corporate governance**

A number of industry bodies provide guidance on corporate governance and best practice for the conventional financial industry. The key areas of corporate governance which these bodies address, to which Islamic funds should also seek to adhere, are structural governance and risk management, disclosure and transparency requirements and valuation and accounting policies.

The International Organization of Securities Commissions (IOSCO) promotes high standards of regulation and provides fund valuation and guidance. The Objectives and Principles of Securities Regulation are a set of 30 principles of securities regulation which are based upon the objectives of protecting investors, ensuring that markets are fair, efficient and transparent and reducing systemic risk. IOSCO members regulate more than 90% of the world’s securities markets and is today the world’s most important international cooperative forum for securities regulatory agencies.

The Institutional Limited Partners Association (ILPA) is a non-profit association committed to serving limited partner investors in the global private equity industry by facilitating value-added communication and promoting research and standards in that industry. ILPA member organizations collectively manage approximately US$1 trillion of private equity assets. ILPA has issued principles that address issues such as a general partner’s duty of care to the limited partners, recommendations to make valuation and financial information available on a quarterly basis and the need for access to information and greater transparency for investors in a private equity fund.

ILPA has also established model preferred terms for private equity investors to consider when entering into investment structures, including the appointment of an independent auditor and the establishment of a limited partner advisory committee to give prior approval in relation to any conflicts presented by the general partner.

The British Private Equity and Venture Capital Association provides guidance on current best practice on the valuation of private equity and venture capital investments, through the International Private Equity and Venture Capital Valuation Guidelines. These guidelines can be applied to investments in early stage ventures, management buyouts, management buy-ins and similar transactions, and growth or development capital.

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The Association of Investment Companies (AIC) provides guidance to a broad range of closed-end investment companies, including investment trusts, offshore investment companies and venture capital trusts, which are traded on the London Stock Exchange, AIM (Alternative Investment Market) and Euronext, through the AIC Code of Governance (AIC Code). The AIC Code is built on understanding the needs of shareholders and promoting best practice for boards to adhere to.

The Hedge Fund Standards Board (HFSB) brings together major hedge fund investors promoting conformity to the best practice Hedge Fund Standards, drawn up in 2007 in response to concerns about the financial stability of the industry, and providing a guiding standard for hedge funds to limit systemic risk. In October 2009, HFSB participated in the CESR consultation on short selling and the UK Treasury Inquiry into macro and micro prudential financial regulation.

The standards address the development of risk management techniques and the monitoring of operational and portfolio risks, the adequate disclosure of investment policies, risks and commercial terms to investors and the separation of duties to adequately mitigate potential conflicts of interest and provide investors with sufficient information about the valuation process. These principles provide a basis for over 56 hedge fund managers who have signed up to the standards, accounting for over US$215 billion in assets under management.

**Islamic shipping fund**

Norton Rose recently advised Qinvest (a Qatar Financial Center Regulatory Authority authorized firm) and Fortis Bank Nederland (together the sponsors) on the launch of the Qinvest-Fortis Bank Nederland Shipping Fund. The fund was structured as a limited liability company incorporated in the Netherlands Antilles to provide Shariah compliant mezzanine finance to shipowners, being the first of its kind in the market. The structure of the fund was developed with good corporate governance in mind and with the aim of ensuring that the principles of disclosure, valuation, risk management, accounting and Shariah fund governance were adhered to.

**Shariah governance**

A Shariah supervisory board has been appointed by the fund’s investment manager to advise in relation to Shariah compliance and to approve the overall structure of the fund and each investment by the fund. In addition, the board periodically reviews the fund, its investments and the financing provided by it. The resolutions of the board are binding upon the fund and the investment manager. However, the board does not have responsibility for the management of the fund and does not have the power to make any investment decisions for the fund; such decisions have been delegated to the investment manager.

The board comprises Islamic scholars from different geographic backgrounds with a track record in the practical implementation of Shariah. This complies with the IFSB principle that, in order to ensure independence and impartiality in the decision making process, no individual member of a Shariah board should be “connected” with a fund or serve another function within a fund. Shariah investment guidelines have been developed to ensure each of the fund’s investments is in compliance with Shariah.

**Structural governance and risk management**

The fund board includes independent directors. The investment manager has been established as a joint venture between the sponsors. The board of the investment manager comprises an equal number of directors appointed by each of the sponsors, and it has appointed an independent consultant to provide advice.

A recommendation panel has been established to recommend transactions to the investment manager board. This panel is composed of three representatives from each of the sponsors, drawn from a range of business lines within the sponsors, including business and risk. The fund has adopted an investment process which separates the decision-making process into various stages, which include involving each of the investment manager board, the Shariah supervisory board and the recommendation panel at different stages of the process, to ensure that investments are made in a Shariah compliant manner and to minimize risk. To provide comfort to investors and to minimize risk, care has been taken in the selection of service providers to the fund to ensure that such service providers are independent and self-standing. The annual report and audited financial statements of the fund will be prepared in accordance with international financial standard reporting standards for each financial year.

**Outlook**

There is growing optimism that the Islamic finance industry will benefit from the consistent implementation of corporate governance policies and adherence to internationally recognized standards, which will strengthen the industry and provide a basis for investors to gain greater confidence to invest in the long term. AAOIFI secretary-general Dr Mohammad Nedal Alchaar has highlighted the need for “the enforcement of well-designed standards backed by close regulatory supervision” to safeguard the Islamic banking and finance system.

Aligning Islamic principles with corporate governance principles and standards will provide a stronger platform for Islamic funds, and indeed the wider Islamic finance industry, to flourish. Such promotion within Islamic finance structures of corporate governance policies which encourage greater alignment of interests between investors, and increased disclosure and transparency obligations will arguably be a step closer to the true ethos of Islamic finance.