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Moral Behavior in Stock Markets:
Islamic Finance and Socially Responsible Investment

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Abstract

This paper addresses the puzzle of why the inclusion of non-financial social justice or religious criteria by professional fund managers has been so popular in Malaysia and yet has had to date relatively little influence in the United States stock market. Drawing from over 125 ethnographic interviews with financial workers in Malaysia, this paper argues that moral investment behavior in stock markets is shaped primarily by 'market structure' rather than by 'mandates.' In both countries mandates are a weak form of social control of fund manager's behavior. This is because mandates are not principal-agent contracts but are primarily marketing exercises and cultural tools. Social investing in the United States is weak because it relies solely on mandates to communicate clients' ethical desires to their fund managers. Islamic and Ethical finance in Malaysia is strong because Islamic social movements have reformed the Malaysian stock market's structure. Specifically, a uniform interpretation of Islamic investing was institutionalized with the creation of a nearly-unique quasi-governmental body. As a consequence, Islamic principles systematically influence the behavior of corporations listed in Malaysia, at present narrowly, but with the potential for wider influence in future. The paper closes with implications for social investment in the United States.

***Keywords*:**
Investor Behavior, Ethics, Malaysia, United States, Islamic Finance, Socially Responsible Investment

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A13: Relation of Economics to Social Values
A14: Sociology of Economics
G11: Portfolio Choice; Investment Decisions
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P52: Comparative Studies of Particular Economies
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Would you feel uncomfortable financially supporting and profiting from a corporation that used sweatshop labor, produced products that were harmful to consumers, paid excessive compensation to its executives, or had recently violated environmental regulations in order to make a profit? Many people would feel uncomfortable. In a U.S. poll of households with investments in the stock market, one-third would like to incorporate moral criteria in their investment decisions and an additional third would consider it (MMA 2003: 11).[1] The above social concerns were the top four of significance to United States investors in 2003 (MMA 2003).[2] We could consider these 'harmful business practices' since they include a corporation's behavior vis-a-vis its employees, consumers and our environment (see Dolan and Werner, this volume).

Money management subject to moral, ethical, religious or some other non-financial constraint is known as Socially Responsible Investing (SRI). Yet in contrast to the one-third of investors who wish to incorporate ethical concerns in their investment behavior, the size of funds invested in the United States in SRI account for only $7.00 in every $100.00 invested with professional money managers, approximately $171 billion (Social Investment Forum 2006). Even more interestingly, in contrast to the 'harmful business practices' of concern to American investors, the top four prohibited investments of actually invested SRI dollars were (in declining size of funds) tobacco, alcohol, gambling, and defense/weapons—sin stocks and war (Social Investment Forum 2006).[3] Thus we can observe a gap between individuals' beliefs on moral investment behavior and the menu of ethical investment vehicles presently available and purchased in the market.[4] Moreover with the weak exception of occasional shareholder resolutions, this sizable minority of SRI funds does not appear to have much of an influence over corporate behavior of U.S. listed corporations.[5]

In contrast to Socially Responsible Investing in the United States, in the Malaysian stock market there is a coherent and unified vision of ethical investment. As of December 2005, I estimate that the size of funds invested in 'Islamic' or 'ethical' investment accounts is approximately $15.00 in every $100.00 invested with professional money managers.[6] Even more importantly, this investment behavior systematically influences Malaysian corporations' behavior.

The organization of the article is as follows. I begin by briefly describing popular social movements in both the United States and Malaysia that partially shaped peoples' preferences to extend ethical or religious criteria to their investment behavior. I also distinguish "Islamic finance" from "conventional" finance and introduce a Malaysia-specific concept of "ethical finance." I then make two arguments to explain the more powerful influence of morality on investment behavior (and by extension, on corporate behavior) in Malaysia as compared to the United States. The first is a bottom-up argument that focuses on professional money managers' behavior. I argue that clients' preferences and their "mandates" (to use the native term) in both the United States and Malaysia are relatively weak external constraints on fund managers' behavior because they are socially constructed by the interaction between powerful money managers and their relatively less powerful clients. As a consequence, SRI in the United States has a weak influence because it relies on mandates. I then make a top-down argument that the Islamic capital market in Malaysia has been shaped by a powerful social movement with a coherent ideology and backed by powerful actors, namely the Malaysian government, that has altered the market's structure by institutionalizing Islamic finance. When this institutionalization is combined with bottom-up social pressure on asset management firms to invest in conformance to Islamic principles, the combined social forces create a potentially powerful influence over corporations in Malaysia, regardless of the religion (if any) of their leadership. This article draws on over 125 tape-recorded semi-structured ethnographic interviews with financial workers in Malaysia in 2001-2002 (Pitluck 2005) and in 2006, particularly a subset of 22 interviews with current and six interviews with former money managers (whom I also refer to as fund managers), three members of the Syariah[7] Advisory Council and three regulators at the Securities Commission.

Note that this argument need not assume or claim that Malaysia's stock market is unproblematic (see Gomez and Jomo 1999 for a sophisticated catalog of problems). Rather, this article seeks to explain the relatively greater prevalence of explicitly moral, non-financial investment behavior by professional money managers in the Malaysian stock exchange relative to that in the United States equities market.

U.S. and Malaysian Ethical Investment Social Movements

Drawing on two decades of data from the World Values Survey, Inglehart and Welzel (2005) describe a global, uneven, and potentially reversible temporal shift in cultural values towards post-material values in countries with pervasive existential security. This shift in cultural values provides an opportunity for social movements and market entrepreneurs to promote the incorporation of non-financial criteria in financial markets (see Dolan and Garsten and Hernes, this volume).

Before describing how social movements have created a market for Islamic finance and Socially Responsible Investing, it may be helpful to define three forms of finance: "Islamic," "conventional," and a Malaysia-specific "ethical" finance. Islamic finance, like other Islamic entrepreneurship, is largely (but not entirely) self-defined (Henry and Wilson 2004: 1-2) and differs from conventional financial institutions insofar as they base their objectives and operations on Islam (Warde 2000: 5). There are two important characteristics distinguishing Islamic finance from conventional finance. The first is that Islamic finance emphasizes a "risk-sharing philosophy" in which fixed, predetermined interest rates are inferior to a profit-and-loss sharing agreement. The second is "the promotion of economic and social development through specific business practices and through *zakat* (almsgiving)" (Warde 2000: 5). However, as a leading scholar of Islamic finance acknowledges, "no definition of Islamic finance is entirely satisfactory" (Warde 2000: 5; see also Maurer 2002).

With a few exceptions, every country in the world with an Islamic Capital Market has in parallel a 'conventional' capital market and therefore there are few 'Islamic' stock exchanges.[8] Instead, there is a subset of corporations on each country's stock exchange that could be considered ethical (*Shariah*-compliant) insofar as the corporations conform to Islamic principles. At present, whether a firm is considered ethical by Islamic criteria in global stock exchanges (including Malaysia and the United States) rests on four principles of corporate behavior (IOSCO 2004: 5-9; Iqbal and Molyneux 2005: 4-17; Securities Commission 2005; Usmani 2002; Warde 2000: 55-72):

1. Prohibition of *riba*. One may not profit from "fixed, predetermined aspects of interest-based lending" which is perceived as an unfair advantage lenders impose on borrowers (Warde 2004: 40).
2. Prohibition of *gharar*. Contracts should be transparent, minimize risk, and not seek to profit from uncertainty.
3. Prohibition of *maysir*. Related to *gharar*, one may not profit from gambling and games of chance, including pure speculation.
4. Corporations' activities must be productive and must not primarily engage in '*haram*' activities forbidden by the religion such as producing liquor and gambling. The precise list of such activities may vary, reflecting the global reach and adaptability of the religion (see also Warde 2000: 41-42).

Of course there is a great deal of potential interpretation of these principles in practice. Corporations are complex organizations frequently engaged in multiple activities. Like Domini (2001: 54) and other SRI advocates, Islamic finance seeks to set a "percentage limit of acceptable involvement in an unacceptable industry."

In Malaysia, in addition to "Islamic" or "Syariah-compliant" investing, a second type of social investing called "ethical" investing has been adopted by government bodies and agencies such as the Employee Provident Fund. This simpler investment philosophy only prohibits investment in companies that are involved in alcohol or gambling. Some entities additionally prohibit investments in tobacco.

The operationalization of Islamic finance in Malaysia is a product of global and national social movements. Advocacy of contemporary Islamic Finance originated in the mid-1970s when there was firstly, a shift in political economic power from the global North to the Organization of Petroleum Exporting Countries (OPEC) and secondly, the rise of pan-Islamism (Kahf 2004; Warde 2004, 2000: 73-112). Non-governmental Islamic banks were founded throughout the world in the 1970s as a consequence of social movement activism by Saudi Arabian leaders (principally King Faisal, Prince Mohammad Al-Faisal and Sheikh Saleh Kamel), social networks (the Dar al-Maal al-Islami Group and the Dallah al-Baraka Group), and Organization of the Islamic Conference (OIC) governments (IOSCO 2004: 19-20; Warde 2004, 2000: 73-112; Kahf 2004).

In Malaysia, the Islamic revival movement (popularly known as *dakwah*, literally "to summon or call"), dates from the same years of Middle Eastern pan-Islamism and increased piety but originates with older, local concerns of Malay nationalism, religious-ethnic identities and post-Independence ethnic politics (see Chandra Muzaffar 1987; Shamsul 1997; Zainah Anwar 1987). As documented by Shamsul (1997), the *dakwah* movement flourished first in the domestic universities, radicalized in overseas universities, and in the 1980s entered into government with the retrospective milestone of ex-Deputy Prime Minister Anwar Ibrahim joining the government in 1982. As a continuation of the above domestic concerns, as well as a frequently pan-Islamic foreign policy dating from the 1970s, the Malaysian government promoted Islamic finance as well as numerous other Muslim institutions associated with economic development and cultural modernization (see Bank Negara 1999: 243-260; Securities Commission 2002: 7).

An additional motivation for promoting Islamic finance is that the Malaysian government estimates that $800 billion is owned by Muslims world-wide and that this may be potentially invested in global Islamic capital markets, including Malaysia (Securities Commission 2001: 181-182).[9] A symbol of the Malaysian government's commitment to becoming a global "Islamic capital market centre" is that it was one of six "strategic initiatives" enshrined in the government's touchstone, *Malaysian Capital Market Masterplan* (Securities Commission 2001: 173-197). This goal was reiterated in the economy-wide *Ninth Malaysia Plan, 2006-2010* (Economic Planning Unit 2006: 184).

The market for Socially Responsible Investing in the United States has also arisen from social movements. Beginning in the 1960s, anti-Apartheid, civil rights, and consumer social movements targeted corporations and their investors to promote social justice and to improve consumer and environmental protection. In 1969, the Council on Economic Priorities began rating corporations on their social and environmental performance. In the 1970s the Investor Responsibility Research Center and Interfaith Center on Corporate Responsibility was founded. In the 1980s, U.S. anti-Apartheid social movements focused their energies on persuading universities, churches, and charitable endowments to disinvest from South Africa. As a product of these diverse social movements, in the early 1980s, entrepreneurs and activists created several religious-based and politically-based Socially Responsible Investment (SRI) funds (Domini 2001). This financial services industry niche market has grown such that in 2006 the SRI sector

comprised approximately $171 billion, with over 7 per cent of funds invested with professional money managers (Social Investment Forum 2006).

The Social Construction of Mandates

To begin a bottom-up argument that examines how money managers incorporate moral decision-making in their investment and disinvestment decisions, and particularly how these choices are structured by social forces, including their clients, we must first address the generic question of how money managers make their speculative decisions. In this section I will argue that the social construction of "mandates" as practiced in both the United States and in Malaysia offers one explanation why Socially Responsible Investing in the United States—including religious-based criteria—is so infrequently conducted and so poorly mapped to investors' stated preferences.

Money managers are like positivistic social scientists; they systematically gather information, create simplified descriptions of a dynamic and complex reality and then seek to make predictions based on this representation. These predictions are then operationalized into investment and disinvestment decisions (see also Brügger 2000).

[INSERT Figure 1 HERE; found at end of manuscript]

Figure 1 illustrates four social forces influencing money managers' cognition and behavior. In the illustration, pictured on the left is the influence of the money managers' clients and the client preferences in the form of a *mandate*. On the right is *market structure*, that is the formal and informal regulations – as well as the degree of enforcement – of the stock exchange. Below is the very important structuring influence of the *asset management firm* that employs the money manager (e.g., Clark and Thrift 2005). And finally, above is the money manager's *social cognitive network* – his or her community of co-thinkers and co-doers in the industry, composed of market analysts, brokers, and other fund managers. With the context of the discussion in this chapter, the most relevant social forces are those on the left and right; the independent effects of the money managers' asset management firm and social networks, I have documented elsewhere (Pitluck 2005). The second section of this article focuses on market structure.

Typically the preeminent criteria by which a client gauges a money manager's performance is how much money he or she makes for every dollar invested. When clients have

additional constraints that they wish to place on the fund managers, the native term for this in the international asset management industry is a "mandate." The typical mandate describes the riskiness of the fund's investments and/or the investment strategy that the money manager should pursue. As a product of the shifting cultural values and of campaigning by the ethical investment social movements described earlier, an increasingly popular mandate is a 'social' or 'religious' mandate that prohibits investments in specific lines of business. In the case of these ethical funds, the mandate specifies non-financial criteria that the client imposes on the money manager. Mandates are created and defined in each asset management firm and may be customized for particular clients.

Drawing on my interviews in Malaysia, as well as on the international financial press, I have identified three perspectives with which we can understand mandates, both financial and social: the economics, marketing, and cultural tool perspectives. The first is the *economics perspective*, which is closest to the dictionary definition of 'mandate:' a mandate is an "authoritative command," "a formal order from a superior to an inferior," and "an authorization to act" given to an agent (American Heritage Dictionary 2004). In principal-agent theory (Jensen and Meckling 1976) and in the rational choice literature, a mandate could be viewed as a social contract between a principal (the client investor) and the agent (money manager) he or she hires. According to this perspective, since client investors have diverse goals for investment, investment philosophies and tolerances for risk, these 'mandate' terms are intended to match appropriate fund types with particular types of investors. For example, risk-loving younger or wealthy individuals may prefer a fund with a risky aggressive investment strategy. Alternatively, a hospital's pension fund may take an ethical stance by not investing in corporations that profit from alcohol or tobacco. In sum, in the economics perspective, a mandate is a constraining social contract binding the behavior of the money manager to the preference structure of the hiring principal. A client agrees to a mandate as an imposition of will on the behavior of the hired money manager. In interviews with financial workers, this is the most frequently voiced interpretation of mandates by fund managers:

> When you sell is up to you, although some funds have guidelines. [For example] one fund has a maximum of 20 per cent gain. If the fund mandates that you sell, you sell.

If a mandate is a social contract, as the economics perspective suggests, it is in practice a weak social contract. The mandates that U.S. clients are aware of – namely the names of the funds and their descriptions – have little correlation with the types of stocks that the funds in practice purchase. Consider the observations of a director of fund analysis and two financial journalists who observed mutual fund companies changing their fund's names to reflect a "value" orientation following the end of the U.S. technology bubble in 2000:

> The portfolios remain much the same, but the names are changing at a rapid rate. Hundreds of U.S. mutual funds have altered their names this year to reflect the sober mood of the markets—"New Economy" and "Growth" are out, and "Value" is definitely in. "Investment companies are ripping names from the headlines and slapping them on funds that haven't changed a bit," said Russ Kinnel, director of fund analysis at Morningstar, which tracks the performance of mutual funds. (cited in Cooper et al. 2003: 2)

The U.S. Securities and Exchange Commission (SEC) requires that merely 80 per cent of a fund's assets need to be invested "in the type of investment suggested by its name," (O'Brian 2001; Securities and Exchange Commission 2004). Such a standard is rather weak; consider the effect on a risk-averse fund if up to 20 per cent of its assets are invested in extremely risky investments. For example, in July 2001, Alliance Capital North American Government Income Trust, whose nominal mandate was investing in nearly risk-free U.S. debt, held 17.4 per cent of its portfolio in extremely risky Argentine government debt (O'Brian 2001). In December, such risk was tragically transformed into certainty when Argentina's economy collapsed and the government announced it would not pay its foreign creditors. A further illustrative example can be seen in the prospectus of the American Century Heritage Fund (2006) which claims to constrain itself "to invest the fund's assets primarily in U.S. stocks." At the beginning of 2005, it held 93 per cent of its funds in U.S. stocks. During 2005, the American Century Heritage Fund began investing overseas and by early 2006 it held only 76 per cent of its funds in American stocks. This shift to a strategy contrary to their mandate was not mentioned in shareholder reports. These are not atypical cases. According to Morningstar, Inc., an independent market research corporation, over 100 mutual funds that were classified by Morningstar as "U.S. stock funds" held over 20 per cent of their portfolios in non-U.S. securities in February 2006

(Lauricella 2006). Given the discrepancy between mandates and the actual investments U.S. money managers make, it appears that mandates act as only a weak constraint on shaping fund managers' behavior. While I do not have similar statistical evidence from Malaysia, anecdotal comments by Malaysian interviewees suggest that mandates can be a similarly weak constraint on Malaysian money managers' behavior. Two interviewees with mandates for investing in small and medium-size corporations explained that in practice they do not invest substantially in such corporations. Similarly, a large and diverse number of interviewees participated in or witnessed out-of-mandate investments during the "Super Bull Run" prior to the Asian Financial Crisis of 1997-98.

In both the United States and Malaysia, mandates are only strong constraints on professional fund managers' behavior if they are carefully defined by the stock market's regulatory authority or are strictly defined and monitored by the asset management firm itself. In both countries, few mandate terms are defined by the national regulator. In the U.S., the SEC has no official definition of most mandate terms, including such self-evident adjectives relating to a corporation's size such as "small cap," "mid-cap" and "large cap." More ambiguous terms like "ethical," "green," "Christian," "value" and "growth" – terms that reflect broad and contested ethical values or investment strategies – are similarly not defined by the SEC regulation (Cooper et al. 2003; O'Brian 2001). As long as an asset management firm does not define these terms in its prospectus, a "value" fund can legally invest entirely in "growth" corporations.

An alternative perspective of mandates is the *marketing perspective*; mandates are a brand, or marketing exercise, or story. Asset management firms design mandates in order to attract investors who associate with the brand. Likewise, clients choose money managers not only for their expertise, but also based on a social relationship of trust. This trust is facilitated when mandates mirror the clients' identity, affinities, or tells a story that the client can literally buy into by placing money in the fund. In the same way that laundry soap brands seek to market themselves as unique, despite selling nearly identical products, asset management firms may advertise themselves as an "Islamic fund," "ethical fund," "technology fund," "small-company growth fund," or another niche identity. Such clustering of small numbers of firms into partially monopolized niche markets based on identity is pervasive in economic markets (White 2002), and in the asset management market, where 'quality' is so elusive and uncertainty so high

(O'Barr and Conley 1992a; Podolny 1993), niche market names may be particularly useful symbolic signals of quality and identity (Lounsbury and Rao 2004). Ethnographies (O'Barr and Conley 1992a, 1992b), interviews and analyses of university endowment funds and public pension funds' trading behavior (Lakonishok et al. 1992; Shefrin 2000: 213-224), as well as one of my interviews with a director on a Malaysian investment committee, all suggest that a niche identity can contribute to attracting and retaining investors' money. These studies suggest that clients are attracted to asset management funds that market themselves as active traders with a distinctive niche mandate. Asset management firms can gain clients and therefore revenue by marketing multiple mandate niches independent of their actual investment behavior. In sum, according to the marketing perspective, a mandate is like a 'brand' such as Coca-Cola; the ingredients of Coca-Cola no longer contain coca leaf or perhaps even kola nut (Pendergrast 1993) but the inaccurate brand name remains and continues to serve as a useful marketing tool.

Client Management and the Social Construction of Mandates and Benchmarks

In my perspective, a mandate is a more complex and flexible tool than either the economic or marketing perspectives suggest. A mandate is a ***cultural tool*** that assists a fund manager with interpreting her or his speculations of the future and arriving at a decision. Mandates also provide meaning to fund managers, since they can assist these players in justifying their behavior to their boss or their client by referring to their mandate. The mandate is therefore also a means of communication between the fund manager and those with whom she or he needs to communicate, including clients and co-workers. As a result, a mandate is like a code or a blueprint that provides fund managers with a template for how to invest (Griswold 1987).

Even financially sophisticated clients have a single, preeminent, implicit mandate that is to receive high rates of return for their investment; they want to make money. More specifically, they want their fund's performance to outperform benchmarks associated with that fund's mandate. Money managers prefer a narrower mandate and therefore shape their clients' preferences. I argue that money managers' clients' preferences are endogenous and are predominantly constructed in their social interactions with money managers. This includes the operationalization of clients' ethical preferences into guidelines for ethical investment. In these interactions, money managers are in a more powerful position *vis-a-vis* their clients and shape their clients' preferences and perceptions to their advantage. As a consequence, money managers

and asset management firms shape mandates to fit their professional and organizational needs, except insofar as the mandate is a credible marketing exercise.

I had previously described that mandate terms' precise definitions vary between the asset management firms within which money managers work. In addition to this firm-level variance, however, there is also considerable leeway for the interpretation of the mandate and it is part of the money managers' job to perform this task. For example, in the interview below, Puan Aysha,[10] a Malaysian fund manager of Islamic and ethical funds, explains that "[m]andates are broad, but you make them specific." In the following excerpt, Puan Aysha provides a stylized example of an interaction she would have with a client while opening a new account.

Aysha: Mandates are kind of broad, but you make it specific. Usually [the client gives] you a broad mandate, like, okay, 'We are a government agency retirement fund. Maybe we want stable income or something like that.' So when you draft up the agreement, you try to be specific. Because you don't want [the mandate] to be very broad because it will be difficult for you to manage. So you put in some kind of suggestion. 'Do you want it to be ethical or something like that?' And they say, 'Okay, yeah, fine.' So you just take that one. 'Will you allow us to invest overseas?' . . . So you have to put in those guidelines and ask them. 'Do you allow us to buy Second Board stocks?' 'Do you allow us to buy non-trustee stocks?'

Pitluck: (...) When you say 'non-trustee' ones, what do you mean by that?

Aysha: We classify trustee... [*Voice trailing*.] I think that is a grey area, also, how you define trustee status. There's no such proper definition for that. But the most commonly used is that the stock must declare dividends for five years after listing. Of course there are exceptions to that. But that's the most widely used one. So if you have clients with very long-term objectives, I'm sure they would want companies that can declare dividends for them. So most—I'm not saying all—but most of the clients with long-term objectives require you to have either 100%, or a certain percentage in trustee stocks. They would give you maybe 70 per cent or 50 per cent or 100 per cent.

In this narrative, note that the fund manager sought to narrow a broad investment objective – "stable income" – with specific categories of stocks allowable on the buy list (e.g., "Do you allow us to buy non-trustee stocks?") in her ideal-typical conversation with her client. And yet

the terminology – for example “trustee stocks”– is not specific enough to actually constrain a fund manager’s strategies (with exceptions detailed in the next section). A 70 per cent threshold may be specific, and may in practice be a strict bright-line regulation for the asset management firm’s employees. But this ‘hard’ constraint is ‘soft’ if the definition of whether the corporation is a ‘trustee stock’ is malleable and is partly a function of changing contextual factors such as its behavior relative to other corporations.

In Malaysian (Securities Commission 2005) and U.S. securities legislation (Langevoort 1996) such a conversation between Puan Aysha and her clients is legally necessary and the fund manager is legally bound to know the financial circumstances and objectives of the client. Because such client preferences are simultaneously created and shaped by the fund manager’s conversation with the client, I refer to these preferences as “endogenous,” that is, they are shaped by the process that reveals them.

The need for interpreting investment objectives for clients is particularly important when the broad mandate is not specified when the account is first opened. Another fund manager of Islamic funds, Hassan, described how this was rarely done for public sector client investors in the recent past:

> If you look at the fund management agreements, only now do you see objectives being stated, time horizons, benchmarks, etc. Previously there was no agreement. They just give you the money, and they expect you to make more money for them. . . . So when I took over [the account two years ago], the first thing I had to do was to actually try and figure out who are these people. Who are these institutions. What should be their required returns. Their risk tolerances. So that was the first thing. The second thing, then, would be, to restructure their portfolios to meet these objectives.

This was particularly true for the recent past when Malaysian federal and state government ministries were first beginning to invest their funds in the stock market. As Hassan described it, “It was like the blind leading the blind,” since the early fund managers were typically accountants teaching themselves how to be fund managers.

Even a client's interpretation of the monthly, quarterly and annual reports of their fund's performance (and that of their fund manager) is shaped by interactions with their fund manager.[11] This is because, firstly, even professional clients require money managers to interpret performance relative to a benchmark given the shifting macroeconomic context in which these investments are made (O'Barr and Conley 1992a: 172; Sheffrin 2000: 217). In addition, a fund's observable performance can be reinterpreted by referring to the unobservable risk absorbed or avoided (see also Beck 1992).[12] Secondly, fund performance is interpreted relative to a benchmark and money managers typically have a great deal of power in suggesting these benchmarks and in interpreting them, thereby allowing "obfuscation games" to the fund manager's true performance (Sheffrin 2000: 159-174). Thirdly, there are high transaction costs involved in firing and replacing an external money manager (O'Barr and Conley 1992a) and often insufficient incentives to do so in mutual fund industries due to conflicts of interest (Bogle 2005: 139-214). Finally, the problems of interpreting a money manager's performance and the choice of a performance benchmark is exacerbated when funds have non-financial goals and/or constraints, as is the case in Islamic Finance and SRI.

When performance is below expectations, the conversation continues in operationalizing the client's wishes into an investment strategy. As Hassan explained, "They [his clients] don't really understand, they don't really know what they themselves want. So basically it is up to me to impose it on them." Half an hour later in the interview, he stresses that without such cognitive management of his clients, they have "unrealistic expectations" of what is financially possible, and what risks are involved. Thus, not only are clients' preferences endogenous, but their ongoing expectations and interpretations of the funds' performance are as well.

Multiple studies in the United States have made similar observations regarding the asymmetrical relationship between money managers and bureaucratic clients, including civil servants, corporate treasury departments, and even financial corporations' Investment Committees (Sheffrin 2000: 213-224; see also Langevoort 1996; Lakonishok et al. 1992; O'Barr and Conley 1992a, 1992b). In sum, money managers have considerable power to shape even sophisticated and powerful client investors' endogenous preferences.

What becomes evident in this section is that the social construction of mandates as practiced in both the United States and Malaysia offers one explanation for why Socially

Responsible Investing (SRI) in the United States is so infrequently conducted and so poorly mapped to investors' stated preferences. I argue that mandates are a particularly weak constraint on money managers' behavior relative to the other social forces listed in Figure 1 and therefore clients' preferences are not translated into their money managers' behavior. Mandates are socially constructed as a credible marketing exercise and by an unequal interaction between money managers and their clients. As a consequence, money managers and asset management firms use mandates as communication tools to lightly coordinate their investment strategies with the (malleable) endogenous preferences of clients.

In Malaysia, as in the United States, financial mandates appear to be a weak constraint on money managers' behavior. However ethical investing in Malaysia, particularly Islamic finance, is treated as a strong constraint on money managers' actions. In the following section, I argue that the success of Islamic Finance as a powerful influence on money managers' and corporations' behavior is not because of the proliferation of Islamic mandates, but rather because the Islamic finance social movement altered the nation's market structure.

The Political Economy of Market Structure in the Islamic Capital Market

In Malaysia, Islamic Finance's morality has been operationalized in a constellation of social forces I categorize as 'market structure,' a far stronger influence on money managers' behavior than firm-level and interaction-level mandates (recall Figure 1). Market structure includes self-enforcing regulations within the stock exchange, national financial regulation by national political bodies on all exchanges within their jurisdictions (e.g. the Securities Commission, the Central Bank, and the Ministry of Finance) and finally the degree of enforcement of such written regulations. Market structure also includes informal regulations and local market cultures (Abolafia 1996; Pitluck 2005). I argue here that the uniform interpretation and enforcement of Islamic investing in Malaysia is created by a transformation of the market's structure, specifically the institutionalized role of the Syariah Advisory Council as a quasi-governmental body in concert with the Securities Commission. This has resulted in an unambiguous bifurcation of listed corporations as either "Syariah-compliant" or "non-compliant," accompanied by unambiguous rules to determine the investment universe for money managers with Islamic mandates. As a consequence, Islamic principles influence the behavior of

listed corporations in Malaysia, at present narrowly, with the potential for wider influence in future.

Like the Socially Responsible Investment movement in the United States, in Islamic finance there is no universal ethical thresholds or uniform operationalization of Shariah principles. Fragmentation of Shariah interpretation exists not only at the level of differing traditions in Islamic jurisprudence (Warde 2000: 15-17, 32-37) and competing applied and academic standard-setting organizations,[13] but also at the level of individual financial firms with each having its own board of Shariah advisors (see also IOSCO 2004:64-65). This has produced fragmentation of interpretation and operationalization of Shariah principles and periodic public distrust of Shariah advisors' independence from their paymasters as well as accusations of leniency of interpretation in favor of their paymasters (Iqbal and Molyneux 2005: 105-106, 109; Kahf 2004; Warde 2000: 226-230).

In contrast to SRI and non-financial mandates, all of which are primarily defined, operationalized and audited by individual asset management firms, the Malaysian government has created a national Syariah Advisory Council (SAC) to advise the Central Bank (*Bank Negara*) and the regulatory authority of the stock exchange (the Securities Commission, *Suruhanjaya Sekuriti*). Twice per year the SAC produces a list of Syariah-compliant securities in the Malaysian capital market, highlighting corporations added or removed from the previous list. As an institution, the SAC is unique amongst large Islamic capital markets (IOSCO 2004: 64-65) and enjoys support by its national government and legitimacy from the public.[14] This is a significant difference in market structure between Malaysia and other centers of Islamic Finance in that, 1. the potential universe of ethical corporations is centrally determined and listed by a national body, and 2. this body is aligned with the national regulatory authority and is therefore able to require corporations to provide uniform documentation of whether they meet ethical criteria.

As a consequence, in contrast to financial mandates in Malaysia or to financial and SRI mandates in the United States, the definition of which corporations are Syariah-compliant is uniform across Malaysian asset management firms and is operationalized within the firms as a bright-line constraint, as a true mandate in the economic perspective and as a social contract that strictly constrains the behavior of money managers. For example, in Malaysia, to be Syariah-

compliant, the SAC requires that a corporation have a positive public image and engage in core activities that are beneficial to both the Muslim community and to the country (Securities Commission 2005). Like SRI, percentage limits of acceptable involvement are set in unacceptable industries. For example, such corporations may also generate up to 5 per cent of their turnover and profit in clearly prohibited activities such as earning interest, gambling, liquor or pork. There are also 10 per cent thresholds for prohibited activities that Malaysian society finds difficult to avoid such as tobacco. Finally, there is a 25 percent threshold for lines of business that involve activities that are deemed non-permissible. For example, hotel and resort operations often involve non-permissive activities, such as mixed-sex massage or swimming pools, such that a Syariah-compliant corporation can only generate up to a quarter of its profit or turnover by owning or operating a hotel or resort (Securities Commission 2005).

Thus in Malaysia, in contrast to mandate terms like "growth" or "income," and in contrast to Shariah-compliance in most other countries in the world, including in the United States, money managers in Malaysia work with a uniform definition of "Syariah-compliance" and a uniform list of corporations in their universe of strategic decision-making. In 2006, Syariah-compliant corporations constituted approximately 63 per cent of total market capitalization. As of May 2006 this universe of 871 securities constituted 85 per cent of listings on the Malaysian stock market (Securities Commission 2006b: 18). The pragmatic standards of Syariah-compliance are therefore, in practice, not too distant from current corporate economic practices in Malaysia. Nevertheless, due to Malaysia's historic legacy of Chinese capitalists and its current multiethnic and multireligious form, a large percentage of these Syariah-compliant corporations are run by non-Muslims and without any religious corporate identity or mission.

The potential power of the Islamic Capital Market on corporate behavior in Malaysia can be understood by examining the SAC's recommendations for firms that lose their Syariah-compliance status. The SAC (Securities Commission 2006a: 10), like any investment manager, uses boilerplate language such as: "[t]his document does not constitute a recommendation to buy or sell the listed Syariah-compliant securities by the Securities Commission's Syariah Advisory Council." Nevertheless in the same document five pages later, they unequivocally state that in the case of the 14 Syariah-compliant corporations that were recategorized as "Syariah-non compliant securities," "[t]he SAC advises investors who invest based on Syariah principles to

dispose of any Syariah-non compliant securities which they presently hold, within a month of knowing the status of the securities" (Securities Commission 2006a: 15). Every fund managers I interviewed with an Islamic portfolio is required by his or her firm to completely disinvest in any corporation that loses its Syariah-compliant status.

What influence, if any, does this coherent and uniform vision of Islamic investing have on corporate behavior in Malaysia? Islamic principles influence the behavior of corporations listed in Malaysia, at present narrowly, but with the potential for wider influence in future.

In 2006, regulators and Islamic fund managers did not believe that there is an 'Islamic premium' for corporations that behave according to Islamic principles nor that there is a 'penalty' for non-Syariah compliant corporations. This is because, at present, the size of funds invested in the Malaysian stock market under an Islamic mandate is small relative to the size of the entire market. When a corporation loses its Syariah-compliant status, Islamic funds are required to wholly sell their corporate shares, but there are sufficient investors to purchase it so that share prices are not affected in the medium-term.

One important influence on corporate behavior, however, was noted by regulators in the Securities Commission and by members of the Syariah Advisory Council. Syariah-compliant corporations are required to earn no more than 5 per cent of turnover or profits before tax from interest income. Corporations with funds stored in the conventional banking system can easily find themselves in violation of this single criteria for maintaining their Syariah-compliant status. The solution is logistically simple and potentially profitable – to move funds from the conventional banking system to the Islamic banking system. As a consequence, at present the single notable influence on corporate behavior of the Syariah Advisory Council's uniform definition of Syariah-compliance appears to be a steady pressure for Malaysian corporations to withdraw savings from the conventional banking system and to increase savings in the Islamic banking system.

Two potentially reversible trends suggest that Islamic Finance may have a larger influence on Malaysian corporations' behavior in future. Firstly, as the size of the Islamic banking system grows relative to the conventional banking system, the pool of funds invested under an Islamic mandate will also grow. This will make stock market prices increasingly sensitive to whether corporations' behavior meets Islamic criteria. Secondly, the federal

government, the largest investor in the Malaysian capital market, is under pressure to increasingly invest using Islamic criteria. The federal government is either directly or indirectly responsible for the investment of funds under a forced savings scheme for all workers (the Employee Provident Fund) as well as the management of optional savings and pension schemes designed to redress racial inequalities in economic growth (e.g. *Permodalan Nasional Berhad*). At present, with the exception of a few state governments, these funds can be invested in any corporation with the exception of those involved in alcohol, gambling, and (sometimes) tobacco. Malaysian money managers of these funds describe this mandate as 'ethical' rather than Islamic – a weaker set of non-financial constraints on their decision-making disconnected from the Syariah Advisory Council. There are conflicting political pressures on the government both to maximize its returns for its citizen-investors as well as to invest according to a wide range of political criteria. Although Malaysia is a multiethnic and multireligious country, the state is under some pressure by Malay nationalism, the *dakwah* movement and pan-Islamism, to increasingly invest according to Islamic criteria, as operationalized by the SAC (see also Abdul Razak Baginda and Schier 2002; Gomez and Jomo 1999).

In future, if government and government-linked funds are increasingly invested under an Islamic mandate, and/or as the Islamic banking system grows relative to the size of the conventional banking system, stock market prices will grow increasingly sensitive to whether a corporation's behavior meets Syariah-compliance. The stock market prices of Syariah-compliant corporations may increasingly have an 'Islamic premium' while non-compliant corporations may absorb a 'penalty.' For non-compliant corporations, there are numerous potential consequences of this. These include a decline in the 'paper' wealth of managers holding stock, a decline in the corporation's capacity to acquire loans by using its stock as collateral, a decrease in investors' and/or consumers' confidence in the corporation and an increase in the corporation's cost of future financing (Demirgüç-Kunt and Levine 2001). Corporate boards of directors therefore have numerous personal and professional interests in sustaining their corporations' stock market prices. In future, Malaysian corporations that are listed as Syariah-compliant, regardless of the religious make-up of the corporation's board of directors or management, may have an increasing material interest in maintaining their corporation's categorization as Syariah-compliant by avoiding corporate behavior that the SAC may regard as contrary to Islamic principles.

Conclusion

In this Chapter, I have argued that the investment mandates to which clients subscribe in order to constrain money managers' behavior are, at best, a weak constraint. Because clients have an 'implicit mandate' of making money and due to clients' reliance on money managers to interpret whether this is achieved, what the mandate is, and whether the mandate is being enacted, I prefer to view mandates as a marketing exercise to attract funds, as well as a social construction coproduced by money managers and their clients in an asymmetrical relationship to ease the cognitive and organizational tasks of the former. The weakness of mandates as a guide to money managers' investment and disinvestment behavior is a partial explanation for the failure of Socially Responsible Investing in the United States to reflect investors' interest in ethical constraints, as well as to reflect their ethical criteria. In the U.S., in 2006, approximately only $7.00 in every $100.00 was invested according to 'ethical criteria,' and these ethical criteria were diverse and often contradictory, thereby decreasing any potential for this small segment of investors to influence corporate behavior.

In most of the world's stock markets with an Islamic capital market (including the United States), money managed using Islamic criteria is treated like any other mandate; the specifications and the day-to-day operationalization of the mandate's principles vary by asset management firm. In Malaysia, in contrast, due to global and national Islamic finance social movements, there has been a single quasi-governmental body (the Syariah Advisory Council) associated with the national stock market regulators that twice per year updates a list of which corporations are Syariah-compliant (that is, not violating Islamic criteria of ethical investment) and non-Syariah-compliant. This nation-wide coordinating mechanism has created a bifurcation of the stock market into a large Syariah-compliant segment and a relatively smaller non-Syariah-compliant segment with fewer potential investors. If a Malaysian corporation is recategorized by the Syariah Advisory Council from Syariah-compliant to non-Syariah-compliant, fund managers with Islamic mandates are required to sell the corporation. At this point in time, the size of Islamic funds is not sufficiently large to create material incentives for corporate management, regardless of their religious affiliation, to maintain their Syariah-compliant status by avoiding corporate behaviors at odds with Islamic principles. The one significant exception to this is a pressure on Syariah-compliant corporations to move their surplus funds to the Islamic banking

system from the conventional banking system. In future, if Malaysia's Islamic banking system continues to grow as a percentage of the finance industry, and/or if popular or political pressure requires the federal government to invest its substantial funds under an Islamic mandate, Malaysian corporations will grow under increasing pressure to behave according to Islamic criteria, as written and judged by the Syariah Advisory Council.

In conclusion, ethical investing has a potentially large influence on corporate behavior. Drawing on ethnographic interview evidence of the ways that money managers make their investment and disinvestment decisions, as well as the academic literature on money managers' behavior in the United States, I suggest that a social movement promoting ethical investment is insufficient to alter corporate behavior. However, as observed in Malaysia, if the social movement puts pressure on the government to alter the market structure of the stock exchange so that a common ethical standard and common interpretation of that standard is provided to the capital market (in Malaysia, this is the Syariah Advisory Council), stock market prices can be socially constructed to be sensitive to corporations' ethical behavior. In Malaysia, this acts as a guide to corporate behavior in compliance with the ethical criteria set out and interpreted by the Syariah Advisory Council. In other countries' stock markets, the ethical regulations could be non-religious and shaped by the national regulatory authority, just as current financial regulations are designed to shape corporate behavior.

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Notes

1. MMA, a financial services company, was formerly known as Mennonite Mutual Aid. Note that in contrast to MMA 2003's title, the report's data is a random sample that includes respondents that do not self-identify as religious or spiritual.

2. In the MMA survey of investors' concerns, on a 5-point scale in which 5 is "very likely to avoid investing" and 1 is "not likely to avoid investing," sweatshops, product safety, high executive compensation, and environment respectively received 4.0, 3.9, 3.8, and 3.6.

3. This ranking is based on the total net assets of funds *without* a mandate to invest in one or more social criteria. For example, the two highest ranked social screens were Tobacco and Alcohol, suggesting that these are the most common social constraints on investment (used singly or in combination with other criteria) in SRI funds.

4. Note that the 1/3 figure and the 7 per cent figure are not strictly comparable because not all investors have equal wealth or make equally large investments in the stock market. Nevertheless this comparison does provide an indication of a significant gap between investors' preferences and existing investment behavior.

5. I suggest that this influence is “weak” because shareholders have very little influence over U.S. corporate behavior in Annual General Meetings. Arguably the influence is larger for large investors who capture a seat on the Board of Directors—although to gain a seat also requires extra-democratic persuasion (Bogle 2005; Sobering 1981). Were we to include shareholder activism in our definition of SRI, the number of dollars invested would rise to almost $10 in every $100.00 under professional management (Social Investment Forum 2006).

6. The 15.3 per cent back-of-the-envelope calculations are based on Malaysian data (e.g., Bank Negara 2006 and Securities Commission 2006b) and the Social Investment Forum’s (2006: 2, 38-39) definition of social investment. Specifically, since 8 per cent of all unit trust (pension) funds are Syariah-compliant (Securities Commission 2006b), and RM98,484.89 million is held in unit trusts, then approximately RM7878.79 million is managed in Syariah-based unit trusts. An additional RM7790.47 million is managed by the Employee Provident Fund which my interviewees report is managed using “ethical criteria” (see main text for a Malaysia-specific definition distinct from Islamic Finance). An additional RM3341.97 million is managed by diverse government agencies and government bodies which my interviewees report is managed according to clients’ criteria, which is typically Islamic or ethical criteria. This totals to RM19011.33 million total funds managed using Islamic or ethical criteria out of RM124,162.65 million total funds managed under licensed fund managers (Bank Negara 2006), and therefore 15.3 per cent. To the degree this estimate based on aggregate data is accurate, it is comparable to the survey-based Social Investment Forum (2006) estimate.

7. This is the correct spelling in Malaysia. This article also uses *Shariah*, a common transliteration in English.

8. The exceptions are governments that by fiat have required that their entire banking system conform to Islamic criteria. In 2004 these are Sudan, Iran and contestably Pakistan (Kahf 2004: 30-32; Iqbal and Molyneux 2005: 36-71).

9. Moody’s Investors Service, a credit rating agency, estimates that $300 billion is invested in Islamic mutual funds and an additional $250 billion in Islamic banks (IOSCO 2004: 35; Prystay 2006; Warde 2000: 6). As Warde (2000: 6-9) outlines, such figures are point estimates with wide margins of error since a census of Islamic financial institutions is nonexistent and the reporting standards in many emerging markets are poor.

10. Aysha is a pseudonym, like all interviewees' names in this article.

11. I wish to thank Julie Hogeland for debating my original formulation.

12. For example, consider the aforementioned American Century Heritage Fund that invested outside of its mandate in risky Argentine debt. The risk of the Argentine government choosing in future not to repay its creditors is real but unobservable unless it occurs. Prior to the default in 2001, the American Century Heritage Fund needed not explain to its investors that its high returns were in part a function of their decision to purchase such risky debt. After the default, the fund lost investors' money and the fund could interpret this poor performance as a consequence of a rare and risky event."

13. The two primary standard-setting bodies is the Islamic Fiqh Academy and the International Association of Islamic Banks (Henry and Wilson 2004: 5; Iqbal and Molyneux 2005: 108; Warde 2000: 229). Arguably such standard-setting has increasingly fragmented in recent years as academic Islamic finance research institutes create new interpretations of Shariah principles outside of the "new power alliance" (Kahf 2004) of Shariah religious scholars and financial industry economists.

14. In 2004 the only other countries with Shariah certification conducted by national regulators was Indonesia, Sudan and Pakistan (IOSCO 2004: 64-65). None of these countries in 2004 had an economically significant stock market relative to the size of their respective national economies.

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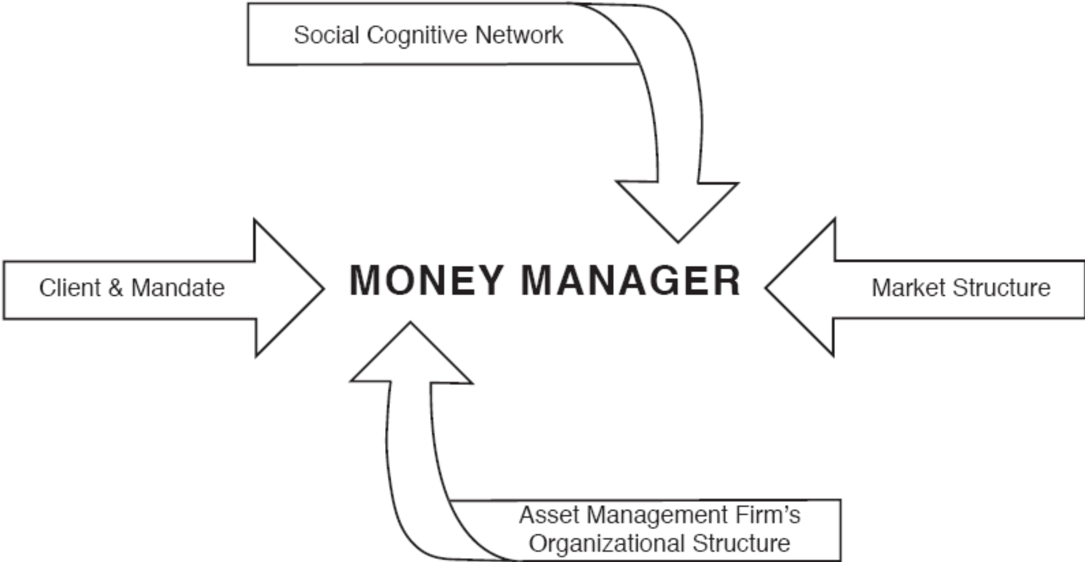

Figure 1