Towards an Islamic Stock Market

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TOWARDS AN ISLAMIC STOCK MARKET

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This paper examines the functioning of the stock market from an Islamic perspective, and the need of an Islamic economy for capital markets and stock exchange with a view to assessing their roles in the Islamic economy. The basic questions of gambling, risk and options, all in relation to the operation of a stock exchange, are discussed to examine their permissibility from the shari'ah point of view.

1. INTRODUCTION

Human societies have at every time and place economic resources which vary in terms of quantity and quality. However, the ability of these societies to achieve economic development (roughly defined as sustainable and continuous improvement in the prosperity of all members of the society) does not depend upon that quantity or quality, as much as it depends upon the social organization that is capable of achieving the optimum use of these resources.

It is always the case that human societies consist of two categories of individuals, namely those who have such economic resources that are in excess of their immediate needs, and others whose resources are less than their immediate needs. It is possible that they may have consumer needs or use their resources for investment purposes. It has been realized since ancient times that finding an effective method for the transfer of resources between these two categories will result in enhancing the level of prosperity for all individuals.

The invention of money has led to increasing the efficiency of economic activity, not only for the possibility of expressing economic resources in monetary units, but also for the emergence of the concept of financial intermediation. The origins of the concept of financial intermediation can be traced back to the history of the oldest societies. Man has sought, since ancient times, to design methods whereby it would be possible to transfer financial surpluses in an organized and rewarding manner from the surplus units to deficit units so that the community can achieve the optimum utilization of the available resources.

The early Islamic communities were no exception to this rule. Even in pre-Islamic times, the people of Makkah pursued precise methods and arrangements for the mobilization of savings and transferring surpluses towards financing the principal economic activity at that time which was international trade. They used to undertake winter and summer journies for the purpose of trade.[1]

Financial intermediation continued in the Islamic communities to be combined with business activities, as well as in the family and professional relations of these communities. Such was the case in most of the communities in ancient times. Institutions specializing in financial intermediation were not as yet known to these societies. It was only after the creation of commercial banks in the late medieval era in Europe[2] that the function of financial intermediation became a specialized economic activity. This

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became possible for the following two reasons: first, the relaxation of the laws relating to the prohibition of usury;[3] second, the discovery of the possibilities created by the Fractional Reserve System. Without these two reasons, it would not have been possible to set up a banking institution. The first reason made it possible to realize returns on a borrower-lender basis, hence the specialization in financial intermediation. The second reason made possible the creation of credit money which is the backbone of the function of financial intermediation.

Modern banking was introduced into Islamic countries only during the colonial period. These countries began to gain independence in the middle of the twentieth century. It was quite clear that no modern society could function, and be able to sustain a reasonable rate of economic growth, without institutionalized financial intermediation. However, they felt that the banking model left behind by the colonists was repugnant to Islamic *shari'ah*, since it was based upon usury in the form of interest debited (borrowers) and credited (to savers). Therefore, Islamic jurists attempted to find an appropriate form of institutional financial intermediation that would be harmonious with *shari'ah*; thus, the concept of Islamic banking was introduced on the basis of "*mudarabah*"[4] transactions. In this way, it was possible to set up an organization that would undertake the functions of financial intermediation without being dependent upon usury, but would be based on the principle of participation in profit and loss and the spread of investment risk. Rather than borrow from savers (depositors) and lend to investors (and borrowers in general), an Islamic bank would be a *mudarib*, vis-a-vis savers (who became financiers) and then a financier, vis-a-vis the investor. The Bank shares the profit with the latter and then with the former. This is financial intermediation *par excellence*.

The attainment of the highest possible level of economic development and growth, an ultimate objective for most communities, requires an optimum use of all available economic resources. This is the role of the financial intermediary as a tool, by which the highest level of economic efficiency and the optimum allocation of resources (with other requirements), can be achieved, so that each resource is developed ensuring the highest production levels. Although banks play a major role in attracting savings and directing them towards investment purposes, capital markets which include stock exchanges currently have considerable significance in achieving this end. In spite of the fact that Muslims have been successful in finding an alternative formula to conventional banking institutions for the last two decades, they now need to Islamize the operations of capital markets. In this study we will deal with the stock market and see how its functioning can be modified to ensure that it meets the requirements of *shari'ah*.

2. NEED OF ISLAMIC ECONOMY FOR CAPITAL MARKETS

Financial intermediation institutions, including capital markets, are tools seeking to achieve economic efficiency. Therefore, their significance depends upon the importance of their results. At a time when economic growth rates are the criteria for judging competition among nations and at the time when the attainment of a continuous rise in the living conditions of all individuals has become the goal sought by all communities, capital markets have gained considerable importance. Many studies have proved the close link between the rate of economic growth and the development of financial institutions.[5]

If this is the case for societies in general, they are particularly significant for an Islamic society for the following two reasons:

(a) Islamic economy is based upon participatory financing. Since lending has no place in commercial activities and is not a tool of financing production, the tools and institutions of attracting savings by way of participation in capital, as well as in investment risks and gains, are suitable institutions for an Islamic economy. This is because they provide a process, whereby funds are made available to investors by savers within the legally prescribed restrictions of *shari'ah*.

(b) The activities of the present model of the Islamic bank depend mostly upon investment (rather than on lending). However, it does not have the formula through which it can invest savings for a very short term. Therefore, we note that the majority of Islamic banks suffer from surplus cash liquidity, which cannot be allowed by prudent management policies to be used in areas which are not liquid. Thus, the financial markets can play the role of supplementary institutions which complement the role of Islamic banks, as they provide the tools through which the optimum use of the available financial resources can be achieved for the bank, whilst realizing the required balance between liquidity and profitability.

3. FUNCTION OF THE STOCK EXCHANGE IN MODERN ECONOMICS

The stock exchange is regarded as one of the most vital financial intermediation institutions in the modern economy. Its functions complement those of other institutions, such as commercial banks, insurance companies and similar organizations.

The functions of the stock exchange may be summed up as follows:

(a) It is an instrument which is capable of attracting savings and directing them for investment purposes. On the saving side, this method will pool small savings and encourage low income individuals to participate in capital ventures by spreading the investment risks among a large number of participants. With the principle of limited liability, risks are reduced for any one investor. On the investment side, this method reduces the cost of financing for companies. All this will help support the process of building capital infrastructure of the economy and raising the rates of economic growth.

(b) Matching the preferences of savers and investors is possible through the basic idea of a stock exchange. The parties offering savings have specific preferences relating to liquidity and risk that may not conform with the investor's preferences. However, designing suitable contracts and instruments will create the link that would meet the requirements of both sides at the same time, hence, financing a long term project through short term financing, etc.

(c) Stock exchanges make available a tool through which investment risks can be priced, and a method of transferring and exchanging these risks among investors. Furthermore, an investor may pay a fixed price for transferring only a portion of that risk to another party. This function is carried out by option contracts in modern markets.

(d) They provide an effective tool for evaluating the performance of the private sector and public companies, and the facility for exchange of information about investment opportunities. These facilities will help improve the investors' decisions.

By carrying out these functions, stock exchanges help to achieve the best possible use of resources. In order to carry out its economic role, the stock exchange has to have cer-

tain kinds of trading opportunities, dealings and contracts, which in totality form a dynamic and lively system of trading. This system, if limited by too many restrictions, would result in the sacrificing of its efficiency and ability to undertake these basic roles.

This is the assumption on which we will build our model of an Islamic stock exchange.

4. A MODEL FOR AN ISLAMIC STOCK EXCHANGE

Stock exchanges originally began as meeting places for sellers and buyers of securities. Over the ages, these exchanges have developed to the degree of complexity and influence that they have attained in modern times. During this long period, the trend has certain clearly defined features. With every development and with the introduction of every new kind of transaction, there was an injection of more efficiency in the exchange and in market operations. Therefore, the model of the markets, as we see it today, is similar to an organic being, where the types of transactions and contracts represent its limbs, nerves and living cells. That being the case, it would not be possible to restrict ourselves to identifying the "permissible" transactions and conclude that an Islamic model should be limited to them. Rather, we should think of the market in a dynamic way; that is, we should ask, what are the dealings and transactions that are required to give life to the market? The approach we adopt tends to identify the basic elements without which the exchange cannot, in my own view, operate. Then, we go on to build up Islamically acceptable formulas for these elements. We will deal with these elements, however, after first elaborating our position towards two topics that have a close link with the activities of stock exchanges.

4.1 Risk in Stock Exchanges

The concept of risk, uncertainty, *gharar* and gambling are, sometimes, confused with each other. The description of the opportunities provided by the market presented here involves an element of risk, which is one of the principal criticisms of the contemporary stock exchange activities. Many scholars maintain that the bulk of stock transactions do not serve a useful economic purpose, but are merely a cover for speculative or gambling activities. According to *shari'ah*, gambling is forbidden as stated in the Holy Quran: "Ye who believe! Intoxicants and gambling, (Dedication of) stones, And (divination by) arrows, Are an abomination Of Satan's handiwork: Eschew such (abominations). That ye may prosper. Avoid them"[6] So it is essential here, to distinguish between gambling and taking risks in the stock exchange. We should also explain the economic significance of these transactions which have the above-mentioned description. Every business transaction necessarily implies an element of uncertainty. Probably an important reason for concluding most business transactions is the difference in individual expectations over what will happen in the future and their perception of risk. A trader who buys a certain commodity to sell at some time in the future, takes his decision on the basis of his forecasts of future prices (assuming that these decisions are prudent, so that he attempts to make a profit, not a loss). Therefore, he is willing to pay a current price today, based on the price he expects will prevail in the future. Indeed, there is no guarantee for the realization of such expectation. This is a risk that is embodied in any business activity.[7]

It is a natural inclination to minimize the element of risk undertaken, and to avoid it if possible. Nevertheless, the ability of individuals to take risks varies; hence, the sense of initiative differs between one promoter and another. Furthermore, there is an established link between the expected yield and the risk involved in investment activities. The greater the risk due to the lack of certainty, the more the expected return should be, as we have already mentioned that return is a reward for risk taking. It remains, however, that these activities are genuine and involve the production or exchange of real goods and services, and are not speculative or gambling. Gambling, however is a different matter. The underlying object of a contract of gambling is risk and nothing else. It does not relate to the exchange or production of real goods or services. The gambler only makes payment for buying to gain a bigger sum of money. A gambling contract, hence, does not involve a useful transaction. It only results in the re-distribution of part of the participants' income in a haphazard manner.

Islamic *shari'ah* absolutely prohibits gambling. It is also forbids *gharar* sales, and other business contracts of a speculative nature. *Gharar* jeopardizes exchange contracts; hence, it is not allowed. Whenever, it is feared that the contract will have unknown consequences it is likely that such a transaction would create enmity, hatred, injustice and illegal loss of people's funds. *Gharar* sales are linked to the question of the ability to deliver the goods subject to the sale. Examples in the books of *fiqh* are usually, selling fish in the water, birds in the sky, untamed camels, green or half grown grains, spoils before their division or such other sales that are usually conditional upon the presence of an uncertain event.

It is not allowed to engage in a transaction, when taking delivery of the sold goods by one of the contracting parties, or the receipt of the consideration, is only probable. It is a basic stipulation in Islamic *shari'ah* that sales of *gharar* are forbidden. Therefore, business contracts in the stock markets must be drafted in such a manner, as to render them safe from these elements which render the exchange contracts illegal. Meanwhile, it is vital to note that the fact that the realization of the buyer's objectives and the profit he hopes to make from the contract is merely a probable matter and consequently, has nothing to do with the concept of *gharar*. For example, let us assume that the midyear holiday was imminent and the climate was expected to be suitable for going to the beach. So a large number of people were "expected" to go to the beach. For this purpose, I bought a number of items which are sold on such occasions (such as swimwear, umbrellas, etc..). What actually happened was that a cold wave took place preventing people from going to the beach; hence a substantial loss was suffered. This is something which has nothing to do with the game of chance and does not imply *gharar*. In this case, the purchase contract is legal and valid and fulfills all the required elements of permissibility in *shari'ah*. What will happen to me after that is merely a commercial risk that has no relationship with the validity or illegality of the contract.[8] Most of what happens at the stock exchanges is, as will be dealt with in detail, similar to what we have just described and is not related to the conditions that invalidate contracts.

There is no doubt that the possibility of the presence of a number of investors seeking to use financial papers and instruments traded on the exchange floor for gambling purposes is always there. However, it is not always possible to design the means of preventing such practices. The simplified procedures for transferring title to such papers, may tempt some people to use them for gambling purposes rather than as a useful investment. Not only that it is difficult to specifically identify those who belong to the gambling group; it is also the case that due to the similarity of the forms of contracts,

every action taken to restrict their activities will constitute a burden on the stock exchange's efficiency and will make it lose a degree of its resilience.[9] Later on we will submit some proposals for realization of this purpose.

4.2 Risk-Return Trade Off

Every investment activity (at the stock exchange and elsewhere) involves a certain degree of risk and an expected return. People are not willing to take a greater degree of risk except against a greater amount of expected return.

Similarly, they reduce the possibility of exposure to risk by accepting a relatively lower amount of expected return. Indeed, this is the nature of things, and an aspect of the conduct in business and human behavior in general. There is nothing in this approach that conflicts with the rules of *shari'ah,* so long as the methods used in pursuing it are permitted. This statement is particularly valid for all types of contracts allowed in Islamic *shari'ah.*

At one extreme, we find that *shari'ah* forbids receiving a return on loans since this would be tantamount to usury. A loan contract does not usually involve any risk (from a contractual point of view). Since there is no risk, obtaining a consideration is not permissible (although entering into a contract is permitted). At the other extreme we find that *shari'ah* prohibits gambling, hence any contract which implies nothing but risk is not permissible. This demonstrates the care given by *shari'ah* to the relationship between risk and return.

Between the two extremes there are several degrees of risk and return which are traded off by way of increase and decrease. *Shari'ah* allows the contracting parties to adopt any suitable risk reduction techniques, i.e., giving up a portion of the expected return for avoiding a greater degree of risk. For example, it is allowed in *mudarabah* contracts that an investor (*rab-al-mal*) may lay down conditions to be complied with by the agent (*mudarib*) with a view to reducing risk (such as not to take the funds to a risky place and not to deal with debts or sell on credit, etc.). Should the agent violate these conditions, he shall be solely liable for the risk, which would not become the responsibility of the investor.

The greater part of modern stock exchange transactions have been basically designed to give an investor a wider choice between risk and return, and an opportunity to give up a certain portion of the return for protecting himself from a certain degree of risk. As Markowitz (1952) pointed out, while investors seek to achieve the highest possible return, they always wish to avoid risk. Therefore, a prudent investor always seeks to form a balanced investment portfolio or reduce the risk to the extent of a specific level of return. Therefore, capital market transactions cannot be efficient except through the availability of way for the formation of such a balanced portfolio, such as standardizing and methods of measuring risks and pricing them, and finding ways to facilitate their transfer from one investor to another for an acceptable cost.

4.3 Relationship Between Stock Exchanges and the Banking System

The stock exchange, which acts as an organization of financial intermediation, is considered as supplementary to the banking system. When banks operate merely as financial intermediaries (such as the banks that carry on business against the charging of interest), returns realized from deposits tend to represent the minimum level of return

and of risk to the investors (savers). In his famous theory of investment, interest and money, Keynes pointed out that the existence of opportunities for investment of funds in usurious lending makes all other investment opportunities judged on the same basis as these opportunities. Furthermore, in countries where the government issues interest bearing debt bonds, these bonds become a basis for evaluation of all other investment opportunities, a yardstick by which risk and return of all other investments are measured. Then, it will not be possible for people involved in investment dealings to have any desire to accept any risk that is greater than the risk involved in government bonds unless a higher return is expected. In his famous theory, Sharpe pointed out how the expected return and risk involved in the balanced investment portfolio depends upon a comparison with the opportunity of the guaranteed return made available by the banking system.[10]

For an Islamic economy, a stock exchange may also complement the banking system. Then, it would be possible to consider the investment opportunities offered by Islamic banks, as a basis for measuring the return and risk in other investment portfolios.

On the theoretical level, it is assumed that these banks should not offer any investment opportunities with a secure return and principal (similar to the usurious bank deposits or the government debt bonds). Therefore, this will result in raising the level of risk accepted by investors at stock exchanges, because they ultimately compare between that and the banking opportunities (opportunity cost). However, this is merely a theoretical notion. It is only in cases where the whole banking sector is Islamized that banks can play this role. Furthermore, in an open economy the fixed return opportunity provided by foreign markets may represent a basis for comparison.

4.4 Overall Structure

We have already stated that there are basic requirements, without which the capital markets in general and stock markets in particular cannot carry out their expected economic functions. Therefore, we do not find it useful to follow an approach of ignoring the stock market transactions and brushing aside everything that we feel is not permitted in Islam, arguing that the remainder should be the basis for the Islamic market. Indeed, we do not feel that this is a useful approach. What we feel is more appropriate is to identify the components that we have already dealt with and then build up a structure of the Islamic market depending upon what is legally permitted and alternatives for whatever is not allowed, in order that we can ensure full compliance with the rules of *shari'ah* and, at the same time, a market that is vigorous and bristle. Here we will attempt to outline this overall structure, and then we will identify the permitted aspects and find the alternatives for whatever is not permitted.

Theoretical studies are usually concerned with the element of market efficiency, as reflected in all the data relating to the market conditions and the economic positions of the issuers of such securities and instrument. Our attention will focus on the elements without which the market cannot operate efficiently. In other words, we will deal with the basic minimum of the forms of transactions which must be offered by the market to the persons dealing in it.

It should be noted that there are innumerable kinds of contracts and transactions. Nevertheless, the market operations do not necessitate the presence of all these transactions, but its activities depend upon certain essential elements which in our opinion represent the overall structure for the stock exchange operation. These are:

(a) The market must make available securities and financial instruments with various degrees of risk and returns enabling an investor to form an investment portfolio that is compatible with his preferences and expectations. In contemporary markets, these securities start with government bonds, which ensure a guaranteed nominal value and a fixed regular return. At the other end, there are the shares issued by unknown companies, first issues and things like derivatives and junk bonds which involve a great deal of risk but very high expected return.
(b) The market should avail ways and methods of pricing the risk involved in maintaining securities, so that an investor may select the degree of risk which is compatible with his preferences. An investor can pay a sum of money to protect himself from the risk involved in the investment to whatever degree he desires. The market should offer the facility whereby it is possible to assess risks and the means of transferring them between investors. In conventional stock market, options of all kinds constitute the basic means of realizing this aim.
(c) Standardization allows all market contracts and transactions to have a specific uniformity. This is evident in the concept of shares themselves. Their standard form plays a principal role in the success of public companies. Standardization is the means of creating a secondary market for securities, hence making available to the investor the element of liquidity security, which is the essential element for the success of financial markets or perhaps their most important feature.

The significance of the principle of standardization is not more evident than it is in options. Options have been around for many years but they did not become vital financial instruments except when the Chicago Board set up the option exchange. So these contracts were standardized as from the year 1973. In this way, they became similar financial investments in everything, such as the effective date, expiry date, number of securities and exchange conditions. The only element which is allowed to differ is the price which is determined by the forces of supply and demand.
(d) The market should remain in continuous operation through strict exchange regulations and effective supervision by the market authority of: various types of transactions, their procedures, method of buying and selling, entering the market, conclusion of contracts, organizing of the operations of market makers (or specialists), provision of guarantees for the performance of contracts, and making available of the necessary information to help the investor make the proper decision.

In our opinion these requirements constitute the basic minimum for ensuring the success of a modern exchange market. Later we will assess these elements from the *shari'ah* perspective in order to adopt acceptable Islamic formulas for each of them. This will be done after we have discussed some of the ways and means of keeping the market safe from the threat of gambling.

4.5 Keeping the Market Safe from Gambling

We have already discussed the possibility of the available financial instruments and securities on the stock markets for being used for gambling purposes, rather than for investment. However, the fact that this is a possibility and a likelihood does not provide a sufficient justification for doing away with a large number of market transactions which are otherwise useful and beneficial. Such policy is not even common in *shari'ah*.[11]

In fact, it is not possible to know the real aims of investors in the stock market except

in an approximate manner, because the forms and modes of contracts do not reveal the real intentions and aims. However, this is something that could be noted from the tendencies of all investors, when it could be judged that the entire market is heading to a course of gambling. Hence, while it is difficult to say much about the individual investor, there is no doubt that it is vital to make the market totally safe from gambling and to direct it towards realizing the useful economic aims of genuine investment and economic growth. So it is possible to adopt a number of measures to help direct the market towards this goal. These include the following:

(a) Use of the tax system for guiding the market towards investment rather than gambling. For example, it is possible to impose higher tax rates on capital gains realized within a short period of time. Those who make profit from buying stock and selling them within a short period of time must pay a higher rate of tax. Whoever keeps the stock for a longer period of time and sells them after, say, five years, should be exempted from the tax, etc.

(b) It is noted in international stock exchanges that institutional investors such as pension funds, insurance companies and investment funds and big investors in general are responsible for pushing the market to speculative activities.[12] Thus, these organizations should be subject to restrictions preventing them from indulging in such practices and directing their funds towards useful investments rather than gambling. At the Tokyo Stock Exchange, such funds are not allowed to invest a percentage higher than that fixed by the Exchange. The restriction is also applied in Saudi Arabia.

(c) Putting restrictions on price changes, so that no dealer could be allowed to push prices upwards or downwards in a rapid fashion so as to allow for games of chance. This measure is adopted by some exchanges in different parts of the world at present. In the Tokyo Stock Exchange for example, a share price is not allowed to rise by more than 10 percent during one day. The maximum level allowed is 20 percent for any other shares.[13]

4.6 Range of Securities and Financial Instruments in the Market

Contemporary financial markets offer a wide range of securities and financial instruments starting from the fixed term and low risk note, such as government bonds where the return and nominal value are guaranteed by the government (which seldom become bankrupt), and ending with the high return and high risk securities. Between these two types there is a wide choice of instruments giving the investor the opportunity to form an investment portfolio that can realize his personal preferences with regard to the degree of risk and anticipated return.

According to the prevailing financial practices, it is inconceivable for a stock exchange to be efficient when it is only a place for the purchase and sale of company shares. This understanding is not based upon a logical contradiction, but is based upon the fact that the stock market is the crucible, where the opportunity cost of investing in that market equals the other opportunities available outside the market. Within the framework of an economic system, where banks provide the opportunity for the realization of a guaranteed return on a secured principal, (such as saving deposits for which fixed interest is paid in the usurious banks), the minimum accepted level risk and return in the stock exchange should not be less than that of the opportunity cost. Thus, what forms the components of the above range should only depend upon the investment opportunities available outside the stock market.

Therefore, it is possible to imagine a closed Islamic economic system, where the opportunity of a guaranteed return is not available on secured principal of an invested capital in any area of the economy. In this case, the stock exchange is not required in that economy to provide an opportunity of guaranteed return as part of the choice of the familiar securities and financial instruments. Assuming that the banking system is designed on the lines of the Islamic pattern, the best investment opportunities in the stock market must at least be no less than the opportunities offered by the Islamic banks. This, however, is yet to be a reality in any Islamic country to what one expects; statistics in developed countries show that bonds are considered the most important securities in which investors deal on the stock markets. Bonds are debt instruments which are negotiable and ensure the payment of a guaranteed return. This particular form is an example of forbidden usury, and therefore we do not assume that it should exist in an Islamic stock market. Would there be any similar instruments in an Islamic stock market? How about the debt instruments for which no interest is paid but the loan principal is only guaranteed (which should in essence be *qard hasan*)? Is trading in them permitted? Should they be permitted? Would there be any benefit expected from such trading?

Jurists have discussed the question of the selling of debt. They unanimously agree that it is not permissible (except in very special circumstances not applicable here). Al Mughni by Ibn Qudama (Volume 4, p.53) said it was the general consensus among scholars that a debt may not be sold. The same point was stressed by Ibn Al Munthir in "*al ijmaa*" (consensus). There are different forms for the sale of a debt, the most important of which is the sale by a man of a debt owed by another person with a debt owed to a third party. Another form is when a buyer buys *al- salam* debt upon maturity when he is unable to deliver the goods for deferred price on the sale of the deferred which have not yet been received. All these are forms similar to the case in question which involve negotiating debt instruments. What happens in this instance is the sale of a debt against a tangible property.[14]

Generally, jurists do not permit the sale of a debt except to the person who owes that debt (subject to certain requirements). Al Malkiya allow the sale of a debt by another form of property. Probably the sale of a debt against the same kind of debt is subject to the case called *da wa tajjal* (discount the debt and advance the payment), but the general consensus among jurists is that it is not admissible.

However, the author of Ie'elaa Al Sunan said it was permissible for Malik to sell all debts to a person who is not the debtor. This was quoted in one of the opinions of Ahmed Ibn Hanbal. He also suggested the sale of *al-salam* debt by whoever owes such debt.[15]

Meanwhile, we should also note something else. If the above instrument is defined as a negotiable instrument, it shall be subject to the rule of *sarf* (exchange of money) rather than sale, considering that it is traded as money for money where it is required that transaction should not be spot (differed) and amount is same since it is the same currency. If all these conditions are adhered to, we don't expect any interest on such an instrument to appear.

This transaction is similar to an assignment deed. In his book *Bedeyet Al Mujtahid*, Ibn Rushd said an assignment deed is a valid transaction which is an exception from the sale of debt by a debt. The only difference between them lies in the fact that an assignor (in the assignment deed) is the debtor but the assignor in this instance is the creditor (assuming that the sale of the deed is an assignment by the holder thereof, i.e. the credi-

tor to a new holder).

The second point is that there is no room for the forces of supply and demand in fixing the price of the deed since it is a debt for a certain sum known in money, hence no settlement may be made for a lower or a higher sum than the nominal value. Consequently, there is no possibility for the emergence of a secondary market for such deeds. It could be said that debt instruments (like bonds whose nominal value is guaranteed by the issuer) cannot be traded in an Islamic market even though the element of interest is not there.

4.7 Options as a Means of Realizing Investor's Risk and Return Preferences

Options in property, commodity trading and securities initially began as an over-the-counter transaction. They were not standardized contracts, hence they were not negotiable and for this reason no secondary market was created for them. The first ever organized options market was set up in 1973 in the City of Chicago, as the Chicago Board Option Exchange established a specialized options market where contracts were designed in a standard form making it possible to negotiate them and deal in them as securities. This move was complemented by the introduction of the Black School theory for pricing of options which had a vital effect on the interest of investors in dealing in such contracts. All this caused an increase in option trading activities so that now more than a million options contracts are traded in the United States with billions of dollars changing hands for such business. Options markets spread in the 1980s so that now there are more than 40 stock exchanges trading in option contracts throughout the world.

Options are divided into different kinds and forms depending upon the issuer. They may be basically divided into two groups: call option which gives the buyer "the right" to buy a specific number of shares of a certain company or any other securities for a fixed price during a particular period, which is often 90 days. This contract does not involve any obligation on the buyer of this option, i.e. who pays the price to buy the underlying stock but the right to buy, which is exercised at any time during the fixed period (in the European model it is exercised on the last day only). It however, creates an obligation on the seller, who receives the option's price to present the securities to the buyer at the price fixed in the contract if the latter so wishes. The contract is standard in everything except the price which is fixed through the forces of supply and demand.

The second type is the put option which is a contract that gives its buyer, one who pays the price the right to sell a certain number of shares or other securities for a fixed price during a specific period. He is under no obligation to sell as he has the option. The seller who receives the option price is obliged to buy when the other party wishes to sell at the fixed price during the fixed period.

4.8 Economic Significance of Options in the Stock Market

Option contracts have numerous advantages and significant economic effects on stock exchanges. They contribute to increasing the market efficiency and hence realizing the objectives of the stock markets. In particular, options contracts have the following benefits:

(a) They bring about an increase in the liquidity of the market. It is noted that one of

the main advantages of the stock markets is their ability to provide investment opportunities that, while financing long term projects, can be short term to the investor, which will increase the overall investment. The negotiable nature of options contracts leads to further achieving this end.

(b) Options contracts lead to reduction in the effects of fluctuations in the prices of securities to which these contracts apply.[16] Studies have shown that the return realized by the investor in the long term is usually higher, in case the standard deviation (or yield fluctuation) is smaller, even though the return is lower, in case the annual yield is higher and the standard deviation (or yield fluctuation) is also higher, because the lean years will eat up the returns of the good years.[17]

(c) Investing in the stock market involves a high level of commercial risk due to price fluctuations and the influence of the moods of other investors on the market, as well as the current political and economic development.

(d) Since investment decisions in the stock market almost totally depend upon future forecasts, any event believed to influence the economic situation will necessarily affect the market trends. For this purpose, investors need a method, which is similar in nature to insurance, while preventing the occurrence of whatever is not required to happen, investors can still minimize its adverse effects. Options can play such a role.

(e) Options give the investor the opportunity to rearrange his investment portfolio by choosing the most appropriate position for his preferences, relating to the risk-return trade off. This method of achieving the required balance cannot always be attained by relying upon buying and selling shares, bonds and securities which may involve costly fees and may not be possible all together. An investor can, through these derivative institutions, choose to take a higher degree of risk by selling options and obtain a possibility of a higher return. He may waive the expected yield by buying options against not being exposed to high risks.

4.9 Some Possible *Shari'ah* Objections to the Form of Options Prevailing in Contemporary Stock Markets

The forms of options of the two kinds which we have dealt with raise some *shari'ah* objections which are now discussed.

(a) Options contracts do not serve any useful purpose, but are only a method of gambling by way of sale and purchase of securities. They are one kind of game of chance and matters in *shari'ah* are judged by their ends. We have already mentioned that the possibility of using this type of contract for gambling purposes is not ruled out. However, this element does not accompany the options concept by necessity. It may not be difficult to lay down rules and restrictions preventing a contract of this sort from being used as a form of gambling, as will be dealt with in detail later on. As regards the useful economic purposes served by options, we have already discussed some of them.

(b) The legitimate options in Islam are affiliated to sale contracts (and to the other contracts which accept the option principle). Therefore, it relates to it and is not separable from it and has no independent existence of its own. Thus, it cannot have a price of its own. However, this objection is based upon the assumption that the said option is similar to the option known in Islamic jurisprudence which is giving the right to one of the contracting parties or both to sign the contract or terminate it in accordance with the Prophetic Tradition which says: "Parties to sale contract have an option until they depart". In such sales, acceptance of a proposal is allowed a period of time which is

equivalent to the period of the option given. According to Abu Hanifa, three days are allowed for such acceptance and it is the general practice that the period depends on the nature of the contract and should be appropriate to that. However, the truth is that the options traded on the stock exchanges are different from the options dealt with by scholars of *shari'ah*. According to the rules of *shari'ah*, an option is part of the sale contract (or rental agreement, etc.), but on the stock market it is an independent contract that is separate and has an existence of its own, with two contracting parties, a certain form of contract the object of which is a right and an obligation. As for the consequence thereof in terms of selling shares or such other items at the end of the contract, this is an independent matter which has its own price and its own will.

(c) If we consider the above contract as an independent agreement that is separate from the sale contract and that its subject is a "right" and an "obligation", i.e., a right for the buyer and an obligation towards the seller, the problem here is that in *shari'ah*, the subject involved is not eligible to become the substance of a sale contract. The said right does not have a tangible and material quality, but is indeed intangible that may not be sold or bought, considering that it is not a property. It is only similar to a preemptive right (*shofaah*, right of custody and guardianship) all of which, while allowed in *shari'ah* are intangible rights that are not allowed to be sold or relinquished against monetary consideration.

4.10 Islamic Form of Options

Initially, we would like to point out the significance of the availability of options contracts on the exchange markets, considering that they supplement the operations of these markets. It is, therefore, not useful to say that we should just ignore them since their existence could create juristic problems. It is better to understand the real implication of the existence of such contracts and the purposes that they serve and then tax them to achieve what we are seeking by methods allowing us to avoid the legal problems and complications.

As we have already seen an option is both a right and an obligation. So, whoever pays the price of an option gains the right of sale or purchase during a fixed period of time in respect of stocks or other securities. The person who receives the price will be bound to sell or buy the shares (or other securities) during a fixed period of time. The price of such shares will be fixed and agreed upon in the first part of the contract.

The call option and put option are not always together, although they could be combined in what is called the straddle option. It is established that both did not appear on the stock markets at the same time, as the former emerged in 1973 and the latter became known only in 1977.[18]

Therefore, the form of both contracts need not be similar, as both are separate contracts that are independent of each other. In order to find an Islamically acceptable formula for such transactions, we are not bound by the ways of trading in such options on the international financial markets. The aim is merely to create a type of contract that could realize the function and serve the purpose; and that is basically a means for pricing of risk and its transferability from one investor to the other.

(A) Call Option

We have already said that a call option is a contract the buyer of which (who pays the

price) has the right to buy a specific number of shares in a certain company for a fixed price during a particular period, and it is also the obligation of the seller (who receives the option price) to sell these shares to him when he so decides.

What we are looking for is a form of contract that can undertake the same functions but should be within the limits prescribed by the provisions of Islamic *shari'ah* and does not involve any of the corrupting factors such as uncertainty (*gharar*), misrepresentation (*jahalah*), usury or gambling. This objective may be achieved by using a transaction known as Sale of *Arboon*.

Sale of *arboon* is a transaction whereby the buyer pays only a small part of the price of a commodity (for instance, two Dirhams), on the understanding that the seller will retain this amount if the sale is not finally concluded due to the withdrawal of the buyer. According to *shari'ah* this type of sale may not be permissible as the majority of jurists are opposed to allowing it. However, the followers of Ibn Hanbal argue in favor of this type of sale and is one of the antique rules of this particular school of *fiqh*.

Ibn Al Qayem has found proof of the admissibility of this kind of contract in the statement of Al Bukhari who quoted Ibn Sirin when he said: "A man told the operator of a caravan I would like to join your passengers, but if I did not depart with you on a certain day you would be entitled to a sum of one hundred Dirhams . When he did not travel on the set date, he willingly agreed to comply with the condition." Such contract is deemed binding upon the seller who has no power to abstain from executing it. The buyer, however, has the option to buy within the mutually agreed period.

Thus, the sale of *arboon* (*arboon* being the advance payment) is very similar to the call option as explained earlier. The only difference lies in the fact that what is paid as part of the advance sale is a portion of the price, but what is paid towards the call option as it is defined in international markets, is a separate sum for the option itself.

Achieving a balance between the two formulas is not difficult. If we assume the presence of a central authority (or several central authorities) such as the stock exchange authority or the clearing house that concludes these contracts. It may sell the shares under standard contracts including 100 shares, for instance, for a fixed price on the basis of delivering them within a specific period (for example 90 days). Instead of the investor's payment of a price for the option, he may pay a certain percentage of that amount on the basis of advance on the sale. If he feels that it is in his interest to go ahead with the sale during the period of time specified, he may sign the buying contract. If he feels that this course of action is not in his interest, he will give up his claim to the advance. Such percentage may be raised or reduced depending on the factors of supply and demand. What is paid against the transfer of the risk is not in the least affected by the fact that such payment is a lump sum or a percentage of a sum known well in advance.

Therefore, the formula suggested above is quite appropriate to serve as a model for the call option which does not involve any contradiction with the rules and requirements of *shari'ah*.

(B) Put Option

As discussed earlier a put option is a contract whereby the person who pays the price enjoys the right to sell a certain number of shares against a fixed price during a specific period of time. He is involved in the transaction by option, as he is not bound to sell but the obligation "to buy" is undertaken by the persons who receives the price.

An Islamic formula for this transaction may be reached on the basis of the following assumptions:

(a) We may envisage that the said contract involves the rendering of a service by a certain party to the holder of shares who wishes to sell his shares. The fee paid for this service is fixed by the investor in agreement with that party (there is nothing wrong in fixing such price by the forces of supply and demand). Such a contract is a legally binding contract to which there are two parties in addition to a proposal and an acceptance. The fact that a fee is charged for the service does not render it invalid from *shari'ah* point of view. Nevertheless, the matter requires fixing the period and not only the effort and the service rendered. It would not serve the purpose, if that party looks for a buyer as soon as possible. What is required is that a buyer should be found within a certain period (for example 90 days) during which an investor will have the option. It is customary that someone is hired either for a period of time or to carry out a certain task. There is disagreement between scholars on the permissibility of combining the period i.e. length of time, and the task.[19] However, such a combination was permitted by the Al-Hanabilah and by Abu Yusuf. Therefore, there is nothing wrong with endorsing the argument about the admissibility of combining the period and the business in this kind of contract.

(b) We may envisage that the party referred to is some central authority such as the stock exchange administration or a clearing house at the exchange, or the market maker but not the stockbrokers or investors.[20] There is a clear difference between our suggestion and the practice prevailing in the international stock markets. The function of this party is actually the rendering of the said service. Such a party is not a stockbroker who is an agent. If one appoints an agent to sell something for a fee, the latter, while he is permitted to arrange the sale, guarantees that such sale will take place. This will then involve payment against the guarantee which is not permitted. In this instance the concerned party has the task of providing the service against a fee. Therefore, it was suggested that it was public entity.

(c) This entity should act in a manner similar to the formula of the European rather than the American options, so that an investor may exercise an option on the last day of its term, not on any day before the end of its validity. In such a case, it will enter into a contract with the investor obliging it to find a buyer for his shares to buy them for a fixed price after 90 days (for example) from the date of the contract. It will charge for this service a fee. Such entity will give a guarantee that it is obliged to find a buyer for the shares of the assured of obtaining what he wants against payment of that fee. Consequently, this formula will realize the aim of the investor to rid himself of the risk against the price paid to such a central authority.

(d) In this case, a contract is standardized. All its details are similar except for the fee of the service; the price of the option in the contemporary form which is fixed by the forces of supply and demand. Therefore, there should not be a wide range of contracts. It will be sufficient to have one or two kinds. The price of the shares to which the option relates is fixed in the contract so that the forecasts and market conditions would only influence the price of the option itself or, in our formula, the price of the service.

(e) The above central authority receives the spot and forward buying requests and matches them against the sale requests. So if they match in terms of types and prices, this authority would not face any problem in handling the above explained formula. This is something which is likely to happen in most of the cases, since the contracts are standardized in a manner that would reduce the difference between them. Such authori-

ty may make the matching process on a daily basis. Thus, it would have provided the required service, i.e. finding a buyer for the stock of that seller.
(f) If the required matching is not achieved and that entity is not able to find a buyer for the stocks held by the person requesting the service, while it has given a commitment and received the fee for the service, it cannot in any way withdraw from the contract. This is because the main idea of the required formula is to achieve for the holder of the stocks a commitment by enabling him to get rid of the risk of maintaining the shares. In this case of nonmatching between the sale orders and buying orders there are three probable situations:
(f-1) If the fee for the service equals the difference between the prevailing stock price and the price of the stocks contained in the above mentioned service contract (the one specified by the seller), the authority may return to the investor his money, which would be tantamount to the termination of the contract and giving a refund of the fee due to the inability to provide the service. For instance, there was an investor who asked for a buyer for his sharers at the rate of 100 Riyals per share. In consideration of offering this service, he paid a sum of five Riyals per share. When the time came for exercising the option, the prevailing price was 95 Riyals per share. In this case, it is the same for the investor that the authority sells his shares as provided for in the contract or to sell his shares at the prevailing price of 95 Riyals per share and return to him a sum of five Riyals per share which equals the fee.
(f-2) In case the prevailing market price is higher than the price fixed in the service by a margin exceeding the fee for the service, the investors will dispense with the said service and the fee charged for it, because it is more beneficial for them to maintain his shares or sell them directly at the prevailing price. This does not constitute a problem for that authority, even if it fails to match the sale order with the buying order. For example, an investor asked for finding a buyer for his shares at the rate of 100 Riyals per share and paid a sum of five Riyals for the service. When the time came for executing the contract, he found that the prevailing price was 120 Riyals per share. He will be better off to give up the fee paid for the service and instead he will sell his shares at the prevailing price.
(f-3) The third case is where the prevailing price is less than the agreed price and the desire of the investor is to obtain the service, i.e. exercising the option according to the conventional formulas. If the said authority is able to match the sale orders with the buying orders, it would not face any problem.[21] But in case the buy orders fall short of the sale orders, it will be obliged to find a buyer for the shares of that investor at the mutually agreed price. So there is no alternative for the said authority to sell the shares at the prevailing price and to pay to the investor the difference between the two pieces. However, we believe that the third case is not likely in view of the development of the computer systems and the sophistication of the accounting facilities.

4.11 Measures Essential to Avoid the Element of Gambling

It is essential to avoid the element of gambling from this exercise and to prevent anyone from using it for that purpose. Therefore, the following measures which are not common in the stock markets should be adopted:
(a) The dealings of the central authority should be limited to the actual stock holders. The shares should be deposited with this authority at the beginning of the contract or alternatively proof of the existence and title to the stock should be proved. This condi-

tion should cancel what is called as short sale for the sale of the shares by someone, who does not own them but only wishes to speculate.
(b) A contract will become valid on the last day of its term (i.e. an option will only be exercised on the last day). Thus, the buyer of the service would not find the opportunity for benefiting from the daily price fluctuations.
(c) Contracts will be terminated at the first hour of the opening of the market on the last day of the contract. This action will lessen the pressures on the market for raising the prices in a direction which is favorable to those investors on the last day.

4.12 Standardization of Contracts

The most important element for ensuring the success of the concept of stock markets is that they provide investors with high liquidity investment opportunities. While capital is committed to a long term investment in the building of industries and setting up of projects, the owner of capital will not be committed to that investment project except to the extent which he desires. The stock market also provides a medium for the sale and exchange of standardized securities. This is not merely restricted to shares but also applies to financial investments and derivatives, through which investment in such securities is undertaken.

Standardization is one of the basic features of modern stock markets and one of the most significant reasons for their success and efficiency. At present there are standardized forms of contracts for all transactions which are concluded in the stock markets. There are also standard form contracts for a wide range of over-the-counter transactions. For example, the stock option formula always provides that it is a contract that includes 100 shares in a certain company that expires on first January, April, July or October. All the characteristics of such options are similar in the contract with the exception of the price which is fixed by the forces of supply and demand. A contract is issued at a price always ending with a zero or the number five in order to facilitate dealings.

This feature is essential for the operations of the stock market since the drafting of contracts in this manner enhances the efficiency of dealings between investors, so that time and effort are saved and the possibility of disputes and differences between them is eliminated.

This particular quality raises some *shari'ah* problems. According to Islamic jurisprudence, a sale contract must fulfill certain characteristics without which it cannot be valid. The most important of these is the acceptance of a proposal whereby the mutual desires of two parties are satisfied. The first is the willingness of the seller to sell and the willingness of the buyer to buy. The objection raised here is that this standard form of contract is concluded by a single will only. It actually implies an acceptance without any proposal, hence one of the conditions of sale is forfeited. Thus, the said contract is rendered illegal.

While acknowledging that Allah, the Almighty, knows best, sale contracts are generally based upon the prevailing norms and depend upon the customary practices among people that they should be free of such elements as usury and misrepresentation, etc. Therefore, the argument regarding the inadmissibility of certain conditions requires strong evidence to this effect.

So the view about the lack of a proposal and the conclusion of the contract by the single will of a party is not to be taken for granted. This is because deciding the existence

of such a will does not require a preset formula, a certain wording, but everything that indicates the existence of such will and has become customary to people renders a contract valid and legal. It is likely that the said form of contract fulfills, in spite of its standardized form, the existence of two wills and is not concluded by a unilateral will.

Even if we go with the argument that claims the existence of a single will only, we do not take for granted that such form of contract is illegal. This is because some jurists maintain that it is sufficient in a contract to reflect the actual intention of the parties rather than the fulfillment of two wills. Ibn Al A'rabi cites in his book *Ahkam Al-Quran* the example of vows and will which are established by the unilateral will of the person who makes them. Therefore, we believe that the standardized form of contract should be recognized as legal in spite of being concluded by unilateral will of a certain party.

NOTES

1. In the annual commercial venture, the merchants of Makkah used to buy goods from Yemen (clothing, swords & arabic gum) during winter and then resell them during summer, to merchants from the Roman Empire in Syria.

2. It was believed that *Diwan Al Jahbatha*, an institution founded in the Second Abbasid era, represented the nucleus of the banking institution as we know it today. However, from what little we know about *Diwan Al Jahbatha*, it was completely different from the concept of financial intermediation.

3. For an interesting review of the history of the relation of these rules see: Birnie (1952).

4. *Mudarabah* is a partnership between a financier *(rab-al-mal)* and an agent *(mudarib)*, where the latter manages the concern and shares in the profit with the former at a pre-agreed ratio. Financial losses are borne by the financier.

5. See, for example, Jung (1986).

6. Al-Quran (5:93) Translation by A. Yusuf Ali.

7. For example, *al-salam* sale which is permissible in *shari'ah* requires cash payment in consideration of the goods that will be delivered in the future. There is no doubt that the price presently paid by the buyer depends upon his expectations about price levels at the time of receiving the commodity, since his aim is making profit from the transaction. *Shari'ah* did not preclude such a contract, rather it required the parties to comply with conditions which reduce the element of risk and descant the contract from gambling and *gharar* sale.

8. Clearly it would have been invalid, if I had bought these items on the condition that it would be a fine day at the beach during the holiday.

9. See, for instance, Qureshi (1988).

10. See the theory of Sharpe in Lorie *et al* (1985), p 135.

11. A rifle can be a tool for international murder and attacking lives and properties of others. However, the sale of weapons is not forbidden because the disadvantage of prohibition is much greater than the disadvantage of permitting it. The sale of such weapons is not recommended at times of tensions only. The same is true of selling grapes where it is likely that the buyer will produce wine from it.

12. This was the finding of the investigation conducted in the United States under the chairmanship of Nicholas Brady following the stock market crash in 1987 . See *Time Magazine*, 17 October 1988, p 27.

13. See *Business Week*, 12 February 1990, p 21.

14. For details, see Hamad (1986)

15. *Eala Al Sunan*, Volume 9, p 506.

16. *Gastineau* (1988), p 123.

17. *Gastineau*, p 310.

18. See the article entitled "Option" in *The New Palgrave: A Dictionary of Economics*, (1987). In this transaction we have seen that there is a transfer of a part of the risk with an assignment of a portion of the expected yield. Of course, this has useful effects on liquidity and on investment in the stock market.

19. In other words one is hired to work for one day, or hired to finish a certain job, but both together are problematic.

20. Such a practice is not unusual as it is known that 60 percent of the transactions at the Tokyo Stock Exchange are undertaken by four firms of stockbrokers. See *Business Week*, 12 February 1990, p 21.

21. The fall of the prevailing price below the bid price does not mean that there will not be any investor who will buy for a hundred what he can obtain for 95, since this same authority is involved in the sale of *arboon* (call options).

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