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INTRODUCTION

Stock exchanges began originally as meeting places for sellers and buyers of securities which were limited to government bonds. Over the centuries, these exchanges developed to reach the degree of complexity and influence that they have in modern times. During this long period, the trend had clearly defined features; with every development and with the introduction of each type of transaction, the market becomes more efficient and more capable of growth and attraction of an increasing number of participants and offering a widening scope of options and instruments. Yet, the model of the market, as we see it today, is more or less an organic being, where the types of transactions and contracts represent its limbs, nerves and living cells. It is thus indivisible, otherwise its living parts would be lost and it would become no more than an incapable and ineffective body that cannot undertake its required functions. In other words, the degree of efficiency and effectiveness of the stock markets, as we know them, can't be reached except by taking it as a whole. It would, for example, be simplistic to believe that the degree of efficiency of effectiveness of a modern stock market can be reached with restricting it only to "legitimate" sellers and buyers of stock keeping away "spectators", albeit speculation is not permitted in shariah. What we try to do here is to identify the permissibility, from a *shariah* point of view, of some of the transactions taking place in a stock market.

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This is a prerequisite to designing a model of an Islamic stock market, where the essential arrangements and transactions are not eliminated, but also replaced with substitute that are permissible.

The Need for Financial Intermediation

Human societies have, at every time and place, amounts of resources which vary in terms of quantity and quality. However, the ability of these societies to achieve economic development (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 exploitation of these resources.

Since ancient times, human societies consisted 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. Man has realised since the age of antiquity that finding an effective method for the transfer of resources between the above two categories will result in enhancing the level of prosperity for all individuals.

The invention of money has, no doubt, led to increasing efficiency of economic activity, not only for the possibility and expressing economic resources by monetary units, but also for the emergence of the concept of financial intermediation i.e. mediating between those who have excess resources and those who are deficient. The origins of the concept of financial intermediation could be traced back to the history of the old societies. Man has sought since ancient times to design methods whereby it would be possible to transfer financial surpluses in an organised and rewarding manner from the surplus groups to the deficit groups so that the community can achieve the optimum utilisation of the available resources.

The early Islamic communities were no exception of this rule. Even in pre-Islamic times, the people of Makkah pursued precise methods and structures for the mobilization of savings, directing the financial surpluses towards financing the principal economic activity at that time which was international trade.

The financial intermediation function continued in the Islamic communities not separated from business activities, family and professional relations in these communities. Such was the case in most of the communities in ancient times. Specialized financial intermediation institutions did not emerge except after the creation of commercial banks in the late medieval era in Europe.[1] This became possible for the following two reasons: First: Relaxation by the Church and by the laws in Europe of the prohibition of usury. Second: Discovery of the possibilities created by the Fractional Reserve System.[2] Without these two reasons it would not have been possible for a banking institutions to be set up during that era. The first enabled it to realise returns, hence getting specialized in financial intermediation while using the contractual relationship of "lending" and "borrowing". The second reason enables it to generate cash liquidity (money creation) which is the backbone of modern banking.

When Islamic countries started to gain their independence in the middle of the twentieth century, learned Muslims realised the need for professional organisations acting as financial intermediaries as they would have a direct influence on giving a boost to economic development. However, they felt that the banking model left behind by the colonists was against the rules of transactions in shariah since it was based upon the charging of usury in the form of interest debited and credited to accounts. Therefore, the Islamic jurists attempted to find an appropriate form that would be harmonious with the rules of shariah. So the concept of Islamic banking was introduced on the basis of "mudaraba" transactions. In this model, it was possible to set up an organisation that would undertake the functions of financial intermediaries without being dependent upon usury, but would be more based on the principle of participation in profit and loss and the spread of investment risks.

Since the attainment of the highest possible level of economic development, an ultimate objective in all communities, requires the optimum use of the available economic resources, the role financial intermediaries as tools through which the highest level of economic efficiency become very decisive. Although banks play a major role in attracting savings and directing them towards investment purposes, capital markets, including stock exchanges, currently have considerable consequence in achieving this end. In spite of the fact that Muslims have been successful in finding an alternative formula to conventional banking institutions, they are yet to "Islamize" the working of capital market operations. In this study we will deal with the stock markets which is an integral part of the capital market in an attempt to spell out the shariah rules on some of the major transactions that take place in modern exchanges.

Function of the Stock Exchange in Modern Economies

Stock exchanges are regarded as some of the most vital financial intermediation institutions in the contemporary economies. Their function complements that of other institutions such as commercial banks, insurance companies and similar organisations.

The functions of the stock exchange may be summed up in the following:

(a) Finding an effective means of saving and investment by providing the savings tools which are capable of attracting savings and directing them for investment purposes. On the one hand, this method results in spreading the investment risks through the formula of shares and other securities designed to pool small savings and encouraging low-income individuals to participate in capital ventures by spreading the investment risks among a large number of participants. On the other hand, this method reduces the cost of finance for companies. All this will help support the process of building capital infrastructure of the economy and raising the rates of economic growth.

(b) Striking the balance between preferences of savers and investors since the parties offering savings have specific preferences relating to liquidity and risk that may not conform with the investors' preferences, it is possible through the stock exchanges and by designing the suitable contracts to create the link that could meet the requirements of both sides at the same time.

(c) Allocation of resources in a manner ensuring the achievement of the optimum use. Through the stock exchanges, it will be feasible to direct the available financial resources to the best possible use so that the resources could only be acquired by the most efficient user.

(d) Making available a tool through which the financial investment risks could be priced and the methods may be introduced to make available the possibility of transferring and exchanging these risks among investors. A certain investor may pay a fixed price for transferring a part of the risk to another party. This is the function carried out by options contracts in the modern markets.

(e) Providing an effective tool for controlling the private sector performance, particularly that of the public companies, and providing the facility for exchange of information about investment opportunities. These facilities will help to improve the investors' decisions.

Stock Market Transaction, Some Shariah Viewpoints

We will try, in what follows, to spell out the shariah role about the major transactions in stock market and the principal instruments.

1. Shares (or Stock)

Shares are units into which a company's equity is divided. Therefore a share represents indivisible portion of the company's total assets, real and monetary. Share holders are the "owners". Yet, the company has an independent existence from its owners. The "limited liability" characteristic of the joint-stock company may be the most significant in its phenomenal rise in the last century and the most problematic in the Islamic shariah. Liability is of great consequence in the Islamically acceptable manner of contractual arrangements.

Unfortunately, the "limited liability" clause has no equivalent in the standard forms of contracts in shariah[3]. Yet almost all the shariah scholars who addressed this query, decided that the model of joint-stock company is, in principle, acceptable in shariah[4].

If we assume here that this is the view of the majority of scholars, we can then say that shares (common stock) as units of ownership are a permissible contract.

If we assume that this is the view of the majority of shariah scholars, one can say then that joint stock company is a permissible contract, and that it is agreeable to shariah under the following conditions.

(a) That the company avoids, in all its activities, prohibited acts and contracts. For example, it should not engage in the production or distribution of *haram* commodities (such as liquor) or activities (gambling or riba). Contemporary scholars debated the permissibility of holding stocks of companies that, while refraining from producing or distributing haram commodities and services, they borrow from conventional banks, and may deposit their excess liquidity in interest-bearing accounts. Without undermining the fact that shariah does give weight to "the degree" of the misdeeds, dealing in the shares of such companies, in general, is not permissible in shariah[5].

(b) Properties of any company consists of real assets (i.e. non-financial) and collectible financial obligation (i.e. debt or accounts receivable). Since a share represents a portion of the total assets of the company, the existence of "debt" in these assets means that a share partly represents, in actuality, debt. Since debt is not subject to sale in Islamic sharoaj[6], dealing in such shares is not permissible. However, since extending credit to customers is common practice in business, it is quite unlikely that any company is free of this attribute. Hence it was ruled that it is sufficient for permissibility to have the "majority" of holdings in real assets and not financial collectible obligation. While "majority" is, by definition, more than half scholars couldn't agree how much more (i.e. over the 50%) is satisfactory.

Non-Voting Common Stock

Sometimes a class of non-voting common stock is issued for the purpose of raising additional money without losing control of the company. This practice is not very common, and in some stock exchanges, like NYSE, this type of stock is not listed. Non-voting shares usually sell for a lower price than voting one for obvious reasons.

As for the shariah view, one can cite to positions on the non-voting stocks. The first thinks that discriminating between the owners of one company is repugnant to shariah because it is unjust to the owners who hold such class of shares.[7]

The other thinks that the arrangement is not unparalleled in Islamic shariah. Mudaraba, it is claimed, is a company with a limited voting rights of rabul mal (financial partner), since he is not allowed, in the standard form of this contract, to interfere in the working of the company once it is established.[8] Therefore a joint stock company with limited voting rights of a group of its owners is permissible in shariah according to this view.[9] Certainly a buyer of a non-voting share is fully aware of this characteristic of the stock at the time of purchase. Hence he is not defrauded, which significantly undermines the objection of the first position.

1.2 Shares other than Common Stock

Common stock are one type of shares in a stock market, albeit, the most typical and widely transacted. Almost all the shariah examination which was done by ulama in recent years deals with this type of stock. A joint-stock company was looked at, as simply a method to extend the rights of ownership in a company. The latter being as shariah with a "lot" rather than a "few" owners, and to shares as a document showing the percentage owned by the holder. It has always been firmly ruled out that a stock has an independent existence from the underlying portion of the company's assets it represents. Therefore, only common stock in the very simplest form were considered. Once we move to the sophisticated common, i.e. one with guarantees or option for purchase of other stock or warrants or differentiated rights of voting ... etc. we find that the matter is yet to be dealt with and the shariah rule is not yet determined.

1.2.1 Preferred Stocks

The preferred comes in a wide variety of categories and classes. It can be very similar to the common, with only one distinguished feature such as a priority at the distribution of profit and in case of bankruptcy. It could also be very dissimilar to the common, with guarantees of principal and return to make it close to a bond (or debenture) and hence it will turn into a debt, rather than equity, instrument. A review of the literature shows that the whole class of preferred with all its varieties is reckoned to be inlawful in shariah[10]. Adjustable rate preferred is certainly no exception.

Purchasing Stock on Margin

It is quite common in organized stock markets to purchase securities on margin through a broker. In this type of contract an investor can buy more shares with the same amount of money. The margin refers to the amount of ownership, the investor must have in each share he purchases. The remaining amount is covered through a loan from the broker. Interest is, of course, paid on such loans, and the stock is held by the broker as a collateral on that loan. The privileges of ownership of stocks, such as voting, is enjoyed by the owner. The stocks kept with the broker are, on the other hand, used for short sales, which will be discussed later.

The fact that borrowing with interest is involved in such a transaction clearly makes it void, since interest is riba. However, what if borrowing with interest is not included? (i.e. the broker gives non-interest loans). The transaction will remain unacceptable for two reasons: firstly, it includes a loan that produces an obvious benefit to the lender (albeit with no interest) namely, holding the stock and using them in other profitable transactions. The rule that Islamic shariah every loan that benefits the lender is riba[11]. Secondly, that the transaction includes two contracts paired together in one. It involves sale and lending contracts. The rule in shariah that combined contracts void each other.[12]

Short Selling

Short selling is the sale of a security that is not owned by the seller at the time of the sale. The seller borrows the security from or through a broker, and later buys the same from the open market to repay the debt. The rationale of such a transaction is not ambiguous; if an investor expects prices of a stock to fall after, say 90 days, he can make money by borrowing the same, selling and then buying when prices fall (to repay the loan) and keep the difference for himself. The involved risk are enormous, since prices can go up not down.

To determine the permissibility of such a transaction one needs to, firstly, ascertain the nature and essence of a "stock". What is a stock? If it is a fungible[13] (like money) then a loan is conceivable in shariah view. When a fungible is borrowed it becomes the ownership of the borrower, and can, therefore, be used by him in whatever fashion he deemed useful for him (and of course permissible). But if the essence of stock is that it is not a fungible then a loan contract is not viable in shariah. What really takes place then is not borrowing.

While the loan in the first possibility may itself be permissible, the transaction involves two contracts (or more) joined together. Furthermore, the benefit that accures to the lender (broker) is obvious since he keeps the sale price as collateral for the stock loan. One can immediately see that transaction, the way it is done in the west can't be permissible.

If stocks are assumed to be non-fungible, (i.e. not capable of mutual substitution) lending is not imaginable. It can't be said, therefore, that what takes place in this transaction is borrowing of stocks but a transaction of numerous contracts joined together. Firstly, the broker is an agent who borrows money on behalf of the investor to buy him stocks and sell them. He keeps the value of these stocks as collateral. Later the broker uses this money as agent of the investor to buy stocks at cheaper price and the difference will go to him (i.e. investor) while stocks will go to a third party who own them in the first place, since they were kept as a collateral in connection with a third transaction ... etc. Unfortunately, Islamic way of financial transaction doesn't work this way. Contracts ought to always be separable if they are joined, each one voids the other. Furthermore, borrowing for investment purposes is alien to the Islamic economic system. Lending is only for benevolent and compassionate purposes, and never to finance profit-making projects. Those are to be financed by equity and participation in profit and loss. Furthermore, permissibility of agency for the purpose of eliciting loans for someone else is quite doubtful.

Options

Options are contracts that give their owners the right to conduct a specified transaction, such as buying or selling a certain number of shares of a given common stock at a set price within a stated period of time.[14] Options provide a means of shifting risk from parties who are presently exposed to it for a price. The major categories of options are calls, puts, stock index options, interest-rate options and options on futures.

Options have an important role to play in any stock market. They increase the market liquidity, stabilize the market by reducing fluctuations in prices, it provide an insurance-like protection to legitimate investors and finally improve the choices open to investors, hence attract more people since preferences will be served better.

Many shariah scholars, however, think the whole concept of "option" trading doesn't serve any useful purpose. Rather it is a scheme the goal of which is to legitimize the practice of gambling. There judgement is, therefore, negative about options. There is no denying that options are quite prone to be used for gambling. One, nevertheless, ought not ignore the useful ends they serve.

Option and the Shariah Jurisprudence

The idea of "option" does exist in the Islamic fiqh, albeit distinct from the above described formula. Option in shariah is affiliated to a sale contract (and to other permissible contracts which are "optionable"). The option is part of the conditions of the sale and not separable from it. Thus it can't have a price of its own it can not be traded separately. Option is defined, therefore, as giving the right to one of the contracting parties (or both) to follow through with or call off the contract within a specified period of time.

This is in accordance to the saying of the Prophet (peace be upon him) sellers and buyers enjoy the option unless they are separated...[15] Therefore, acceptance of the proposal to sell (or buy) is allowed a period of time which is equivalent to the period of the option given. According to Abu Hanifa the period is three days, but the majority of ulama allow an "appropriate" length of time which could be more or less than three days.

The idea of option in shariah is not unrelated to the stock market options. The dissimilarities, however, are enormous.

Firstly, stock market options create a right (enjoyed by the buyer) and an obligation (maintained by the seller). They are independent contracts autonomous from the sale or purchase of the underlying stocks.

Secondly, even if we say that options are new contracts and that shariah doesn't restrict transaction to only standard contracts, we need to decide permissibility to ascertain the subject matter of this contract.

The underlying "thing" in an option contract is a "right" and as "obligation". They are sold and traded in the market. The problem here is that shariah doesn't recognize these abstract matters to be the substitute of a sale contract.[16] Therefore, a market for option trading is repugnant to shariah. Thirdly, even if we assume that the option contract is not separable from the sale contract (of the underlying stock), i.e. by say assuming out the naked options, we are still faced with the problem of paired contractual obligations.[17] The transaction consists of two sale contracts in one, which results in the invalidity of both.

Call Option

Calls are contracts that give their owners the right to buy a certain stock of a specified price within a stated time period.[18] While some speculators may write (i.e. sell) naked options,[19] the majority are covered options written by conservative investors who want to protect the stocks they already own. The call in this case will be a "bedge" against a decline in the price of the stock.[20]

Many traders in calls operate without intending to exercise them but to profit from changes in market price. Furthermore, some option writers sell what is called "naked option", i.e. writing options on stocks they don't own, just for the purpose of making profit, which will be realized of these expectations about prices materialize.

Options as a speculative device is, clearly, unacceptable in shariah. One, nevertheless, ought not overextend the definition of speculation. There are many legitimate and Islamically desirable uses of options in stock markets. In particular, the hedging aspect of options is quite in line with the recognized needs of individuals which is not contradictory to shariah. The problem remains, however, that an option contract should not have an existence independent of a sale (or lease) contract. This means that what is paid for option is part of the total sale price of the underlying good or paper. There is one form of sale contract in Islamic jurisprudence which allows an option at a price. The sale of arborn (or advance) allow the buyer to advance a small percentage of the agreed upon price so that he can have time to decide. If this decision was not on the affirmative, then this advanced payment is kept by the seller.[21] Notice that the option is only for the buyer, the seller is obliged to honour his commitment.This shows that the amount paid, while it is a percentage of the total price, it is in reality a price of the option.

Put Option

Puts are contracts that give their owners the right to sell a specified stock at a set price within a given time period.[22] An investor who expects prices to decrease can sell a put to protect his investment. If expectation takes place he can exercise the contract. Hence, selling above the market price (which has gone down) while there is, obviously, plenty of room for speculators, the need for such a contract is legitimate in most of the case.

Once more, the substance of the put is not the underlying stock but the right and obligation of the properties which makes objectionable from a shariah point of view.

It is clearly wrong to think that a put has any similarity to the contract of salam which is permissible in shariah. A salam is a sale contract where the price is advanced while the subject (the underlying commodity) is delivered at a future date.

Index Option

If the purpose of transacting in stock markets, from savers point of view is to profit, and since the latter depends on ability to predict the direction of the market, then there is no need to buy and sell. Rather, it is sufficient to cash the difference between what is expected and what really took place. It is because of this index options are quite popular, where one can speculate on the whole market, as if he buys and sells every stock in the exchange. Obviously this is pure gambling. What one buys or sells (when he buys an index option) is a chance to win an amount of money not specified (the difference between current price and future price). Gambling in shariah is not permissible even for charitable purposes, let alone profit making.

Futures

Future contracts are quite old, although their use in organised exchange markets is recent and goes back only to the 1970's. In a future, the seller promises to deliver something in the future (commodity or stock or even an index), while the buyer advances part of the price and makes a legal commitment to take delivery of the underlying subject of the contract at a future date. Many participants in the future markets have, nevertheless, no intention of ever taking or making delivery. They enter into future planning to close their position before delivery dates, albeit they are legally obliged at the date of delivery.

This contract is quite similar to *salam* which is permissible in shariah. In salam the price is advanced while the delivery takes place in a future date. Unlike options, the underlying subject of future contracts is the commodity not the right or obligation, it is in this sense similar to salam. The dissimilarities are, however, overwhelming:

(a) It is a condition for the permissibility of *salam* to advance and pay the whole price at the moment of contrcting. This never takes place in futures. The price is paid at the time of delivery for an investor (for speculative) point of view, it doesn't make sense to pay amount in full up-front. Furthermore, the seller of option doesn't need finance (in contract to salam), rather he wants to unload risk.

(b) The commodity that is underlined in a *salam* contract is not to be sold before delivery date. If this happens then the seller engages in a prohibited contract in shariah call: sale of non-owned. In modern exchanges, the commodity is sold many times before delivery dates. In fact, most of the profits are made by those who speculate between the two dates. One may say that what is being sold in each transaction is a new salam, therefore there is no sale of the commodity prior to delivery. The holder of a future, therefore, himself issues another future for the same quantity and dates of delivery. One will then cancel the other and he will be speculator. This can only be acceptable if there is enough distinguishing characters of each contract (i.e. in term of quantity and dates) which is rarely the case. Hence, it is just a formula to cover up a transaction repugnant to shariah.

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1. It was believed that Divan Al Jahbatha, an institution founded in the second Abbasid era, represented the nucleus of the banking institution as we know it today. However, what we know about Divan Al Jahbatha albeit quite limited is completely different from the concept of financial intermediation.

2. Fractional Reserve.

3. It had been claimed by some writers that 'limited liability' is not foreign to shariah since waqf and Bait al-Mal are limited in liability. However, there is an important dissimilarity. Unlike 'limited liability' in joint stock companies, liability in waqf and Bait al-Mal since the manager can be held responsible if the liability arises from his mismanagement. In both cases, liability is always joined with responsibility.

4. See for example.

5. This is the conclusion of a workshop organized jointly by Islamic Development Bank and the Islamic Fiqh Academy of the Organization of Islamic Conference in Jeddah, Dec. 3-4, 1990, as well as numerous *shariah* scholars.

6. This is called in *shariah*. Debt obligation is allowed to be transferred at par values Arabic ' subject to the agreement of creditor but it can' be negotiated, and of course, bears no interest.

7. Abdul Aziz Al-Khyat, cited in Mabid Al-Jarhi, p 131.

8. Clearly the fact that mudaraba is a partnership in profit and not in assets is not without effect on this argument.

9. Sami Hamoud is one who supports such an idea.

10. See for example Elgari, M.A., Al-Aswag Al Maliah, and Al-Rawqi, S.Z. Al Sharikah Al Musabinah fi Al Nizam al Saudi.

    This rule arise from the prohibition of riba is defined as an additional payment on a loan, a preferred relates to this definition. The principal is guaranteed which makes it a loan, hence an addition even if not fixed, voids the contract.

11. 'There is *riba* whenever the lender benefit from a loan' is an established principle in *shariah*.

12.

13. According to Webster, fungible is such kind or nature that one specimen or part may be used in place of another specimen or equal part in the satisfaction of an obligation.

14. Currier, Chet., *The Investors Encyclopedia*, New York, Franklin Watts, 1987, p 206.

15.

16. Though some rights in *shariah* are subject to inheritance and some are subject to cash settlement such as the right of the wife on her husband in case of divorce. But not are transferable to a third party through sale.

17. Two sales in one.

18. Currier, Chet., *The Investors Encyclopedia*, New York., Franklin Watts, 1987, p 206.

19. Op cit, p 212.

20. There remains the possibility of an increase in price which will cause the option holder to exercise i.e. calling the stock away from the investor.

21. Not all ulama allow such contract. Nevertheless we know that at least the *Hanbali* school does allow it.

22. Currier, Chet., Ibid, p 217.