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Stock Exchange Transactions: Shari'a Viewpoints

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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 of attracting 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 could not undertake its required functions. In other words, the degree of efficiency and effectiveness of the stock markets, as we know them, cannot be reached except by operating as a whole.

It would, for example, be simplistic to believe that the degree of efficiency and effectiveness of a modern stock market can be reached when restricting it only to "legitimate" sellers and buyers of stock, keeping away "speculators", albeit speculation is not permitted by the *Shari'a*. What we will try to do here is to identify the permissibility, from a *Shari'a* point of view, of some of the transactions taking place in a stock market.

This is a prerequisite of designing a model of an Islamic stock market, where any essential arrangements and transactions not permitted are not eliminated but replaced with substitutes that are permissible.

The Need for Financial Intermediation

Human societies have, at every time and place 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 so much upon that quantity or quality as upon having a social organization capable of achieving the optimum exploitation of these resources.

Since ancient times, human societies have consisted of two categories of individuals, namely, those who have economic resources that are in excess of their immediate needs, and those 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 would result in enhancing the level of prosperity for all individuals in the society.

The invention of money has, no doubt, led to the increasing efficiency of economic activity, not only because of the possibility of expressing economic resources by monetary units, but also through the emergence of the concept of financial intermediation, i.e., mediating between those who have excess resources and whose resources are deficient. The origins of the concept of financial

intermediation can 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 groups with a surplus to those with a deficit so that the community could achieve the optimum utilisation 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 structures for the mobilization of savings, directing financial surpluses towards financing the principal economic activity at that time, which was international trade.

The financial intermediation function continued in the Islamic communities and was not separated from business activities or 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

It then became possible for the following two reasons:

- (a) Relaxation by the church and by the laws in Europe of the prohibition of usury.
- (b) Discovery of the possibilities created by the Fractional Reserve System.²

Without these two conditions it would not have been possible for a banking institution to be set up during that era, for financial intermediation used the contractual relationship of "lending" and "borrowing". The second reason enabled 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 *Shari'a* rules on transactions, in *Shari'a* since it was based upon usury, in the form of interest being debited and credited to accounts. Therefore, the Islamic jurists attempted to find an appropriate form that would be harmonious with the rules of the *Shari'a*. 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 intermediation without being dependent upon usury, being 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, the ultimate objective of all communities, requires the optimum use of the available economic resources, the role of financial intermediaries as tools of this objective becomes very decisive. Although banks play a major role in attracting savings and directing them towards investment purposes, capital markets, including stock exchanges, currently play a considerable part in achieving this end. In spite of the fact that Muslims have been successful in finding an alternative formula to that of conventional banking institutions, they have yet to "Islamize" the working of capital market operations. In this study, we will deal with stock markets, which are an integral part of the capital market, in an attempt to spell out the *Shari'a* rules on some of the major transactions that take place in modern exchanges.

Functions of the Stock Exchanges in Modern Economies

Stock exchanges are regarded as some of the most vital financial intermediation institutions in contemporary economics. 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 as follows:

- a) Finding an effective means of saving and investment by providing tools which are capable of attracting savings and directing them for investment purposes. On the one hand, this method, through the medium of shares and other securities designed to pool small savings, encourages 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 helps to support the process of building the infrastructure of the economy and raising the rate of economic growth.
- b) Striking a balance between the preferences of savers and those of 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 suitable contracts, to create a link that can meet the requirements of both sides at the same time.
- c) Allocating resources in a manner to ensure their optimum use. Through stock exchanges, it is feasible to direct available financial resources to the best possible use, so that resources are only acquired by the most efficient user.
- d) Making available a tool through which the financial investment risks may 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 part of the risk to another party. This is the function carried out by options contracts in the modern market.

Stock Market Transactions—Some *Shari'a* Viewpoints

We will try, in what follows, to spell out the *Shari'a* role in the major transactions of stock markets and their principal instruments.

Shares (or Stocks)

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. Shareholders are "owners". Yet the company has an independent existence from its "owners". The "limited liability" characteristic of a joint stock company has been of the most significance in its phenomenal rise in the last century, but has caused the most problems in fitting it into the Islamic *Shari'a*. Liability is of great consequence to the acceptability of Islamic contractual arrangements.

Unfortunately, the "limited liability" clause has no equivalent in the standard forms of contracts in the *Shari'a*.³ Yet almost all the *Shari'a* scholars who addressed this query decided that the model of a joint stock company is, in principle, acceptable to the *Shari'a*.

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 permissible in contracts and that the joint stock company is permissible in a contract 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 which, while refraining from producing or distributing *haram* commodities and services, borrow from conventional banks, and may deposit their excess liquidity in interest-bearing accounts. Notwithstanding the fact that the *Shari'a* does give weight to "the degree" of the misdeeds, dealing in the shares of such companies is not, in general, permissible in the *Shari'a*.⁴

- (b) The properties of any company consist of real assets (i.e. non-financial) and collectible financial obligations (i.e., debts 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 the Islamic *Shari'a*,⁵ 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 debts. Hence, it was ruled that it is sufficient for permissibility to have the "majority" of holdings in real assets and not financial collectible obligations. While a "majority" is, by definition, more than half, scholars could not agree how much more (i.e., over the 50%) was 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, such as the NYSE, this type of stock is not listed. Non-voting shares usually sell for a lower price than voting ones for obvious reasons. As for the *Shari'a* view, one

can cite two positions on non-voting stocks. The first is that discriminating between the owners of one company is repugnant to the *Shari'a* because it is unjust to the owners who hold such class of shares.⁶

The other is that the arrangement is not unparalleled in the Islamic *Shari'a*. *Mudaraba*, it is claimed, is a company with limited voting rights for the *rab'al-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.⁷ Therefore, a joint stock company with limited voting rights for a group of its owners is permissible in the *Shari'a* according to this view.⁸ 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 being defrauded, which significantly undermines the objection of the first position.

Shares other than Common Stock

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

Preferred Stocks

The preferred stock comes in a wide variety of categories and classes. It may be very similar to the common one, with only one distinguishing feature such as priority at the distribution of profit and in case of bankruptcy. It may also be very dissimilar to the common one, with guarantees of the principal and return to make it close to a bond (or debenture), hence turning into a debt rather than an equity instrument. A review of the literature shows that the whole class of preferred stocks with all its varieties, is reckoned to be unlawful in the *Shari'a*.⁹ Adjustable rate preferred stocks are 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, are enjoyed by the owner. The stocks kept by 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 it in other profitable transactions. The rule in the Islamic *Shari'a* is that every loan that benefits the lender is *riba*.¹⁰ Secondly, the transaction includes two contracts. The rule in the *Shari'a* is that combined contracts void each other.

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 risks involved are enormous, since the price may go up and not down.

To determine the permissibility of such a transaction, one needs, firstly, to ascertain the nature and essence of a "stock". What is a stock? If it is a fungible¹¹ (like money), then a loan is conceivable in the *Shari'a* view. When a fungible is borrowed, it becomes as though owned by the borrower and can therefore be used by him in whatever fashion he deems useful (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 the *Shari'a*. 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 accrues to the lender (broker) is obvious, since he keeps the sale price as collateral for the stock loan. One can immediately see that in this transaction, the way it is done in the West cannot be permissible by the *Shari'a*.

If stocks are assumed to be non-fungible, (i.e., not capable of mutual substitution), lending is not imaginable. It cannot be said, therefore, that what takes place in this transaction is the borrowing of stocks; it is rather 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 a cheaper price and

the difference will go to him (i.e., the investor), while the stocks will go to a third party who owned them in the first place, since they were kept as collateral in connection with a third transaction, etc. Unfortunately, the Islamic way of doing financial transactions does not work this way. Contracts ought always to be separable as, if they are joined, each one voids the other. Furthermore, borrowing for investment purposes is alien to the Islamic economic system.

Lending may only be done for benevolent and compassionate purposes and never to finance profit-making projects which are to be financed by equity and participation in profit-and-loss schemes. Furthermore, the 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.¹² Options provide a means of shifting risk, for a price, from parties who are presently exposed to it. 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 market liquidity, stabilize the market by reducing fluctuations in prices, provide an insurance-like protection to legitimate investors and finally, improve the choices open to investors and hence, attract more people, since their preferences will be better served.

Many *Shari'a* scholars, however, think that the whole concept of "option" trading serves no useful purpose; rather it is a scheme the goal of which is to legitimize the practice of gambling. There is no denying that options are prone to be used for gambling. Nevertheless, one ought not to ignore the useful ends they

serve.

Options and the *Shari'a* Jurisprudence

The idea of an "option" does exist in the Islamic *fiqh*, albeit distinct from the above described formula. An option in the *Shari'a*, 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 them. Thus it cannot have a price of its own, nor can it be traded separately. An 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 with the saying of the Prophet (peace be upon him) "Sellers and buyers enjoy options unless they are separated..." Therefore the trader is allowed a period of time in which to decide whether to accept the proposal and which is equivalent to the period of the option given. According to Abu Hanifa, the period is three days, but the majority of *scholars* allow an "appropriate" length of time, which could be more or less than three days. The idea of the option in the *Shari'a* is not unrelated to 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 the *Shari'a* does not restrict transactions to standard contracts, we need to ascertain the subject matter of this contract in order to decide permissibility.

The underlying "things" in an option contract are a "right" and an "obligation". They are sold and traded in the market. The problem here is that the *Shari'a* does not recognize such abstract matters as the subject of a sale contract. Therefore, a market for option trading is repugnant to the *Shari'a*.

Thirdly, even if we assume that the option contract is not separable from the sale contract (of the underlying stock), i.e., by, say, ruling out naked options, we are still faced with the problem of paired contractual obligations.¹³ The transaction consists of two sale contracts in one, which results in the invalidity of both.

Call Options

Calls are contracts that give their owners the right to buy a certain stock at a specified price within a stated time period.¹⁴ While some speculators may write (i.e. sell) naked options,¹⁵ 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 "hedge" against a decline in the price of the stock.¹⁶

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

The option as a speculative device is, clearly, unacceptable to the *Shari'a*. Nevertheless, one ought not to 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 the *Shari'a*. The fact 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 the option must be 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. It is called *arborn* (or advance) and allows the buyer to advance a small percentage of the agreed price so that he can have time to decide. If his decision is not in the affirmative,

then this advance payment is kept by the seller.¹⁷ 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 the price of the option.

Put Options

Puts are contracts that give their owners the right to sell a specified stock at a set price within a given time period.¹⁸ An investor who expects prices to decrease can sell a put to protect his investment. If his expectation is fulfilled, he can exercise his right, hence selling above the market price (which has gone down). While there is, obviously, plenty of room for speculators in this, the need for such a contract is legitimate in most cases.

Once more, the substance of the put is not the underlying stock but the right and obligation of the parties concerned, which makes it objectionable from a *Shari'a* point of view.

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

Index Options

If the purpose of trading in the stock markets is, from a saver's point of view, to profit, and since the latter depends on the 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 takes place. It is because of this that index options are quite popular, where one can speculate on the whole market, as if one were buying and selling every stock in the exchange. Obviously, this is pure gambling. What one buys or sells (when one 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 the *Shari'a*, is not permissible, even for charitable purposes, let alone profit-making.

Futures

The idea of future contracts is quite old, although their use in organised exchange markets is recent and goes back only to the 1970s. In a future contract, 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 futures planning to close their position before the delivery date, albeit they are legally obliged to take delivery at that date.

This contract is quite similar to *salam*, which is permissible in the *Shari'a*. In *salam*, the price is advanced, while the delivery takes place at 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 of the permissibility of *salam* to advance and pay the whole price at the moment of contracting. This never takes place in futures. The price is

paid at the time of delivery from an investor (or speculative) point of view; it does not make sense to pay the amount in full in advance. Furthermore, the seller of the option does not need the finance (in contrast to *salam*); rather he wants to unload the 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 is engaging in a prohibited contract called in the *Shari'a* the sale of non-owned goods. But in modern exchanges, the commodity is sold many times before delivery date. In fact, most of the profits are made by those who speculate between the two dates.

One might argue 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, simply, himself issues another future for the same quantity and dates of delivery. But one contract would then cancel the other and he would be a speculator. Such a viewpoint would only be acceptable if there were enough distinguishing characters in each contract (i.e., in terms of quantity and date), which is rarely the case. Hence it is just a formula to cover up a transaction repugnant to the *Shari'a*.

Notes

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 has been claimed by some writers that "limited

liability" is not foreign to the *Shari'a* since *waqf* and *Bait al-Mal* are limited in liability. However, there is an important dissimilarity. Unlike "limited liability" in joint stock companies, in *waqf* and *Bait al-Mal* the manager can be held responsible if the liability arises from his mismanagement. In both cases, liability is always joined with responsibility.

4. This is the conclusion of a workshop organized jointly by the Islamic Development Bank and the

Islamic Fiqh Academy of the Organisation of Islamic Conference in Jeddah, Dec. 3-4, 1990, as well as of numerous *Shari'a* scholars.

5. Debt obligation is allowed to be transferred at par value subject to the agreement of the creditor, but it cannot be negotiated, and, of course, bears no interest.
6. Abdulaziz Al-Khyat, cited in Mabid Al-Jarhi, p. 131.
7. Clearly the fact that *mudaraba* is a partnership in profit and not in assets is not without effect on this argument.
8. Sami Hamoud is one who supports such an idea.
9. See, for example, Elgari, M.A., Al-Aswag Al Maliah, and Al-Rawqi, S.Z., *Al Sharikah Al Musahimah fi Al Nizam al Saudi*.

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

10. That there is *riba* whenever the lender benefits from a loan is an established principle in the *Shari'a*.
11. According to Webster, a fungible is of such a 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.
12. Currier, Chet, *The Investors Encyclopaedia*, New York, Franklin Watts, 1987, p. 206.
13. Two sales in one.
14. Currier, Chet: *The Investor's Encyclopaedia*, N.Y. Franklin Watts, 1987, p. 206.
16. *Op. cit.*, p. 212.
16. There remains the possibility of an increase in price, which will cause the option-holder to exercise his right i.e. call the stock away from the investor.
17. Not all scholars allow such a contract. Nevertheless, we know that at least the *Hanbali* school allows it.
18. Currier, Chet, *ibid*, p. 217..

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