Views and Comments

Commodity Exchange and Stock Exchange in an Islamic Economy

I would like to take this opportunity to respond to Muhammad Akram Khan's article "Commodity Exchange and Stock Exchange in an Islamic Economy," which appeared in the *American Journal of Islamic Social Sciences* 5, no. 1 (September 1988): 91-114. The explanations advanced are from my personal understanding of Islamic and Western finance systems and are not a defense of Western financial markets. But I believe that the Islamic financial system should provide a better alternative.

To begin with, I have no disagreement with Khan about interest-bearing instruments being *ḥarām*. However, I do disagree with him in the following areas:

Common Stocks (*Muḍārabah* Certificates)

As regards the physical possession of share certificates, the importance of such possession (a commodity) is given in the following hadith: "Ibn 'Abbās reported Allah's Messenger as saying: 'He who buys foodgrain should not sell it until he has weighed it (and then taken possession of it)'" (Siddiqui 1986, #3643). In the attached footnote (#1983), Siddiqui further states that: "Imām Shāfi'ī subscribes to the view of Ibn 'Abbās that every salable thing, whether land, tree or grain, should be sold only by the buyer if he has taken possession of that. Imām Abū Ḥanīfah is of the view that if it is a question of the sale of immovable property, the buyer can re-sell it before taking possession of it, the reason being that while destruction of the land is rare, that of the movable property is probable" (Ibid., vol. 3, p. 803).

I interpret this to imply that as long as a person owns an indestructible thing and can give it to the buyer according to a mutually acceptable agreement, it can be sold. In today's environment, the actual physical possession of stock certificates is expensive and, in addition, they can be lost, stolen, destroyed, or otherwise damaged. Keeping such certificates with a broker is less expensive. Moreover, the physical transfer takes place on the settlement date, which is five days after the transaction date. In the meantime, if the new owner can get a better price before the settlement date, he/she should not be prohibited from selling the stock certificates.

On the issue of speculation, one could curtail it by imposing a higher capital gains tax on short-term capital gains than on long-term capital gains or by levying a transfer fee.

Khan fails to mention a practice known as a "short sale" in his article. If someone wants to engage in this activity, he/she faces two options: it is prohibited, for one does not own the item; or it is allowed, based on the example of the Prophet's participation in a *salaf* (a noninterest-bearing loan) sale:

> 'Aṭā ibn Yasār reported that Abū Rāfi', the freedman of the Apostle of Allah, said: "The Apostle of Allah took on credit a small camel. When the camels of *ṣadaqah* arrived, and he asked me to pay back by a like camel, I said:. 'Apostle of Allah, the camels are big and four-years old.' The Apostle of Allah said: Give from them. Virtuous are they who pay their debts well" (Rahimuddin 1981, #1367).

In this case, the Prophet could have disposed of the camel purchased on credit in the way of his choice. In a short sale, the person who shorts a security borrows it on credit from the actual owner and sells it on the current market. The short seller is then responsible for replacing the borrowed security. The ulama have to look into this practice, for it offers certain advantages. For example, if there is a temporary overvaluation of a business, traders who go short help to "complete the markets." But short trading is not for the faint of heart, as it is riskier than going long (i.e., buying a security), as described in Fuller and Farrell (1987).

I agree with Khan that margin accounts have no place in an Islamic economy and that efforts must be made to avoid the manipulation of markets by insiders.

Khan does not mention the instances of shareholders' lack of control over the management of major corporations in which they have invested. There have been instances where an entrenched management works to benefit itself rather than to maximize the value of the shareholders' stock. The crusade of CALPERS (California Public Employees Retirement System) against such corporations should make us aware of this practice.

Forward and Futures Markets

I do not accept Khan's view that a forward contract is *ḥalāl* while a futures contract is *ḥarām*. Conceptually, both contracts are the same; it is only their features which differ. A futures contract is a standardized contract specifying the amount of the commodity and the delivery date. Since it is standardized, it may be bought and sold. A forward contract, on the other hand, is tailor-made for each transaction, a feature that makes it adaptable to the respective parties' specific needs. While a forward contract specifies the amount and delivery date, the uniqueness of its features means that the contract is not negotiable (i.e., there is no secondary market in forward contracts).

It is my opinion that Islam allows both contracts, subject to the restriction given below. The basis for my view is deduced from the fact that Prophet allowed the *salām* (forward buying) sale:

> Ibn 'Abbās reported that when the Prophet of Allah came to Medinah, they were paying one and two years in advance for fruits, so he said: "Those who pay in advance for anything must do so for a specified weight and for a definite time" (Siddiqui 1986, #3906).

Here payment was made in advance, and the delivery of a specified quantity of goods was made within a definite time period. Moreover, as Khan states, there are benefits to a forward contract. I would extend the same benefits to a futures contract except in cases which seem to involve a deliberate attempt to avoid the prohibition on interest. For example, financial engineers can create a synthetic six-month treasury bill by buying a Standard and Poors (S&P) 500 contract on the spot market and then selling a futures contract on the S&P 500 stock exchange after holding it for six months. Such a practice should be avoided. Moreover, speculation in futures and options is very risky. Care should be taken to ensure that such activities do not cause any loss or danger to the general health of a Muslim nation's economy.

Options

I disagree with Khan on the interpretation of the hadith on *'urbān* (down payment) given in *Muwaṭṭā Imām Mālik* (chapter 386, #1285). For example, the premium of a call option is the price of the option for giving the buyer the right to buy the underlying security at a specified price. The premium is not used as part of the purchase price (if this were the case, it would be an *'urbān* sale). The option buyer may not exercise this right. The premium compensates the seller for any loss as regards the security's future appreciation. The fund manager of Amana Mutual Fund, whose consultant is the North American Islamic Trust (NAIT), uses options to generate current income at the expense of future appreciation (*First Path Advisory Letter* 1989).

Futures Market on Options Sale

I believe that this activity is permissible as long as one does not use it to create a synthetic interest-bearing security and if it in no way harms the general health of a Muslim nation's economy.

Khan concludes his paper by emphasizing the evaluation of intrinsic value in an Islamic economy. In most Western countries, an accounting book value, which is akin to intrinsic value, is reported along with a financial analyst's view of what a security is worth based on discounted future cash flows. (An example of this is research reports published by Value Line, Inc.) What is important in an Islamic economy at present is an emphasis on economic justice. As an immigrant Muslim myself, I resent business practices by which a person can be easily cheated, the existence of a biased system of justice, and the notion that bribes are necessary to get one's work done. A nation cannot follow an Islamic economic system unless most of its people and leaders adhere to Islam. In other words, mere lip-service by some people is not enough. The reason I mention this is that most Muslim leaders are not very enthusiastic about Islamic finance. In fact, most Muslim countries do not even have a balanced budget and, moreover, they borrow money on interest. The Qur'anic verse most appropriate to mention here is: "Indeed, Allah does not change the condition of a people until they change what is in themselves..." (Qur'an 13:11). What is urgently needed is cooperation between the general Muslim public, Muslim businessmen, and the ulama with the intent of achieving an economic standard higher than even the West can provide.

References

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