# TOWARDS AN ISLAMIC STOCK EXCHANGE IN A TRANSITIONAL STAGE

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*The paper deals with the structure and operation of an Islamic stock exchange. Several issues have been discussed. The first of these is related to speculation. Though speculation is often blamed for the volatility of share prices, the paper contends that a reasonable degree of speculation is still required in an Islamic stock exchange. To regulate speculation in an Islamic stock exchange, an aim that the paper advocates, several methods have been suggested. The second major question which has been addressed in the paper is related to price mechanism. Although some writers have suggested price ceiling in an Islamic stock exchange, the paper argues that price fixation should be avoided. The paper also discusses the organizational structure of an Islamic stock market and the code of conduct appropriate to it.*

## 1. INTRODUCTION

### 1.1 Stock Market

The term "stock market" or the American equivalent "securities market" arouses mixed images of fast movements, grand life-styles, surprising fortunes and, sudden heart-attacks! These images, however, do not reveal the important function of the stock market of acting as a financial intermediary, besides other financial institutions.

Like other markets, the stock market has commodities, prices mechanisms and a market place. The commodities are shares and stocks, bits of paper representing rights to the holder, the buyer, and obligations on the issuer, the original seller. Shares portray a corporation's assets and gross income. The degree of risk involved and the extent of obligation incorporated in each is not the same. Shares are riskier but are expected to be more rewarding. The issuer of the securities can be government, public authorities or corporations. Between shares and stocks lie other types of papers, such as preference shares and convertibles.

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These commodities are of two important types: brand new which are the newly issued securities, and second hand which are the existing securities changing hands among existing holders. While the former is referred to as the primary market, the later is called the secondary market. What distinguishes the stock market in this respect is that the secondary market is much larger than the primary market in terms of size and importance.

The price of commodities in the stock market is determined by the forces of demand and supply -- the way prices are determined in a free market economy. The more successful the company is, the stronger the demand for its share will be. In countries where stock markets are well established, the news of the market is broadcast daily in the country's national media.

The place of the stock market is the Stock Exchange that is usually located in the capital. This exchange is linked nationally with other exchanges in major cities and internationally with main exchanges in the world. Between the stock exchanges in Paris, London, New York, Tokyo and Hong Kong, securities are traded twenty four hours daily. Owing to the sensitive role of the stock exchange, the government, even in a free market economy, may interfere in the operational mechanism of the exchange by issuing regulatory rules. This varies, however, from one country to another so much so that exchanges can lie between the centrally run and the self regulated.

The stock exchange helps achieve various benefits. It:

- provides a market place where a large number of sellers and buyers can meet,
- helps remove the apprehension of investors, the buyers, regarding future liquidity problems, that may encourage the investors to accept a lower rate of return than they would have done in the absence of the exchange and consequently lead to reducing the cost of equity capital, hence reducing the average cost of capital of the firm,
- helps provide more representative prices of securities than the case would be with separately organized markets,
- provides a means of testing the validity of securities by assigning a value to these securities, that is influenced by the views of specialized experts in the market, and
- provides an effective way of absorbing new issues of securities which helps corporations to raise funds.

## 1.2 The Islamic Stock Market

Like stock market in general, the Islamic stock market will have, and should have, a market place, commodities and price mechanism. However, there will be certain variations from that of the non-Islamic market which will make the Islamic market quite distinct.

To begin with, the Islamic stock market will be free from interest-based securities. Only shares --ordinary shares--and risk bearing Islamically acceptable financing certificates are permitted in the Islamic stock exchange.[1]

To further the discussion of these features and explore the framework of the Islamic stock market the following issues will be explored in this paper: (a) the code of conduct, (b) speculation, (c) price mechanism, and (d) the structure of market place.

# 2. THE CODE OF CONDUCT

It might sound rhetorically plausible to say that since the Islamic stock market will be based on an Islamic code of ethical values that is primarily based on honesty, fairness, clarity, the interest of both the individual and the community, and eventually, efficiency, the market will be purged from undesirable practices and unhealthy symptoms that may exist in the non-Islamic market.[2]

But this argument cannot be accepted at face value. The ethical code, though important and divinely ordained, is not sufficient to guarantee the purification of the Islamic market from adverse variables. To reinforce the ethical code there must be a set of legislative rules emanating from the same religion, Islam. This is not unusual. Islam has always recognized the need for both the legislative and the educational approaches to dealing with religio-political issues, including those of socioeconomic nature.[3]

Consequently, it is expected that the Islamic stock market will not be fully self-regulated with no government intervention. Instead, a degree of state regulation should be accepted and indeed expected, even with the existence of such a strong religiously established code of conduct. In brief, though the Islamic code of conduct is important, the market still needs the support of law.

The Islamic market can be supervised through the *hisbah* system. This should be established gradually in the transitional period in order to enforce a particular code of conduct in the stock exchange. Besides, one of the basic duties of *hisbah* in this market is to establish a true information system the output of which should be made available to every one.

## 3. SPECULATION

Invariably, speculators are blamed for the volatility of share prices, or at least for a great part of it. Speculators buy securities only in anticipation of a price rise, or sell securities in anticipation of a price fall. As such they are accused of not being real investors. If the market is left alone, the argument goes, the prices will be influenced by the dealings of only the real investors and prices will be less volatile and more stable. The argument carries conviction.

But this need not be the case. Speculation, though not always commendable, does not have to be constantly reproached. There are favorable, as well as unfavorable, aspects of it. To fully appreciate this argument, it is necessary to shed some light on the nature and role of speculation in the capital market.

Speculation has been defined as "the practice of buying or selling with the motive of then selling and buying and thus making a profit. If prices .... have changed..... a speculator will hold only the asset or liability, hoping that at the time the contract matures, events will have moved into his favor.[4] The definition, however, does not explain how speculators reach a conclusion as to whether a share price will move up or down in the future. Nor does it tell us whether speculators rely on a personal instinct in estimating the move or on a more distinct computable procedure. The definition, therefore, needs to be widened in order to cover these points. Based on the above definition, speculation may be defined as the practice of (a) using available information to (b) anticipate future price movements of securities so that (c) an action of buying or selling securities may be taken with a view to (d) buying or selling securities in order to (e) realize capital gains and/or maximize the capitalized value of security-holdings. These four main components of the process of speculation should be viewed as an integrated part without any of which speculation cannot be regarded as compete.

### 3.1 Speculation and the Islamic Stock Market

Building upon the above, several points need to be pointed out with particular reference to the Islamic stock exchange. These include:

a)All investors, or at least a great part of them, could be said to be speculators .They buy securities on the hope that their prices will move up in the future and they will be able to realize capital gains. They would, rightly, be accused of naiveté if they do not do that. Even for those who do not sell when prices move up, they refrain from selling on the hope that the prices will move up even further. Had they known that prices would fall they would have acted differently. This is quite legitimate. The objective of these investors is to maximize their holdings even if not to instantly realize capital gains. The difference between speculators and other investors is that while the former buy and sell in a very short time the latter take longer to do so.

b)Speculation can hardly be viewed as a game of chance. The decision taken in speculation is the result of neither the turn of a card nor casting of a dice. Instead, it is based on the analysis of large data that include several factors: economic, financial, political, governmental, personal profile of management, and status of work force, on the national and international level. This requires a great deal of work, knowledge and expertise. The process also necessitates a high ability to read the results produced and to properly interpret various signals. This needs credentials and competence.

c)Speculation has mistakenly been equated with gambling. This need not be the case. From the above definition it can be seen that speculation involves a great deal of computation which in the light of the highly developed computation techniques of today can hardly be a game of chance. It is a process that relies on the analysis of a lot of economic and financial data, companies' financial reports, political decisions, information about management skill and aptitude as well as the personal profile of decision makers. All this information is analyzed before a decision for buying or selling securities is taken, a matter that requires a great deal of knowledge and skill. But the notion of equating speculation with gambling is a misconception that is inherited from the past when speculation was more of a personal guess than a very careful calculation. Nor can the stock exchange be equated with gambling casinos. It is a complete market in which very little, if ever, is left to chance. Neither can the market afford a mere chance in its operations, nor can countries’ economies sustain it.

d)A related point is that by the same token, it may be suggested that in the absence of information, speculation comes very near to gambling and the lesser the information available the more speculation becomes close to gambling. This may be true, but it is not necessarily a problem that is confined to speculation. The lack of information becomes a problem for all decision makers. In the absence of information every thing, speculation or otherwise, becomes uncertain and any decision taken in the dark becomes irrational. In such circumstances, many will suffer as a result of lack of reliable information: national planners, entrepreneurs, brokers, jobbers (price makers), investors, and a host of other decision makers. The problem of lack of information is not, and should not be confined to speculation. To say that the absence of information leads speculation to become closer to gambling is to say the same for many other actions taken in the process of decision making. This is only to emphasize the importance of reliable information not only to speculation but to the process of decision making in general.

e)The difference between speculation and *nagash* should be also made clear. In *nagash*, while a transaction is in the process of being concluded between two parties, the seller and the buyer, a third party interferes with the intention of increasing the price for the buyer. This is prohibited in Islam as stated in the *sunnah*. Meanwhile, sale auctions are not prohibited. In the sale auction a group of buyers compete for the purchase of an object that is eventually sold to the highest bidder. Though the line may seem to be very fine between the *nagash* and the auction sale the difference is categorical: the second buyer in the *nagash* is not a genuine buyer but he is there only to increase the price on the buyer without the intention of buying. The case of buyers in sale auction is different. They are all interested buyers with the full intention of concluding the transaction. This is why the *nagash* is prohibited while the sale auction is not. In speculation, speculators are not *nagash*-buyers, they have the full intention and readiness to conclude the transaction and to bear the consequences of the deal. Interestingly enough, nor are the speculators exactly auction buyers. They do not bid against each other in competition to buy the security. In theory they do not even know whether someone else is buying and if so for how much. All what they know is the price of the share in the market as conveyed to them by the jobber (or the American equivalent, price-maker)[5] and as influenced by the power of demand and supply. But if any group of individuals acted explicitly or tacitly in such a way as to create some conditions in the market with a view to deceiving the general public and in this manner influencing prices against the interest of the market, this would be regarded as *nagash*. Regulations can be introduced via the surveillance of *hisbah* to curb these artificial activities.

f)Turning our attention to the *gharar* and speculation, it suffices to say that in speculation the conditions of the deal are clear to both parities with no ambiguity on either. Each party is clear as to the quantity, specification, price, time and place of delivery of the object. Also, the object of the transaction, which is the purchased security, is available in the market at the time of transaction and is bound to be available at the time of delivery.

g)Speculation may help stabilize prices. At the time when prices of securities may be artificially moving up or down, speculators who have the ability to judge and properly calculate what can be viewed as the real value of the security can act in a manner that can offset the effect of the artificial move. To put another way, speculators can establish what can be regarded as an upper as well as a lower level of the price of a security. Within these levels prices may vibrate due to short term market forces but they would not be allowed to move above or below the established maximum or minimum level. If they do, speculators will move in to buy when prices become lower than they should be, or sell when they get higher than they ought to be. They are more able than others to do that because they are the experts in the field. As such, this helps stabilize prices.

h)Speculation may help activate the market. At times when the market is weak, with very few investors willing to buy or sell, speculators may enter the market buying and selling securities. This can help activate the market. The implications of this can be seen in relation to the ability of firms to raise funds. In a weak market, firms may not be able to issue a share offer as it is unlikely to bring about the required fund. In an active market this can be done.

i)To reinforce the above points further, it suffices to refer to two important points: (a) the efficient market hypothesis that states that in an efficient capital market, that is fully reflecting all available information, the investor, even if he is entirely a speculator, cannot out perform the market, meaning that he cannot achieve a higher rate of return than other investors, and (b) the fact that when prices in the stock exchange change markedly, they do so in response to changes in the economic conditions, governmental policies, political stability, balance of payment, and natural disasters. Despite the several explanations of the international market crash of October 1987 - the Black Monday - the main explanation given was related to US budget deficit more than to any other factor. No claim was made to condemn speculation as being behind the crash. This point, as well as the previous one of the capital market hypothesis, reinforces that speculation is not a contaminating factor in the stock market.

From the above, it can be concluded that the Islamic securities market should not be envisaged as speculation-free market. A reasonable degree of speculation would be required, and indeed needed, if the market is to be active and operative. There is no doubt in my mind that excessive speculation should not be allowed, but it is equally clear that a market without an acceptable degree of speculation would not be workable. Healthy speculation, I contend, is what we should aim for. Speculators, who are more informed than others, are important as a source of information particularly to those who are less informed and who neither have the information nor have the ability to interpret it. The greater the availability and interpretation of information becomes restricted to the wide base of investors the more important the role of well informed speculators as market leaders becomes. Speculation can be necessary to activate the Islamic stock market and provide the less informed investors with important signals upon which they act. By being more able than others to analyze the available economic and financial information, nationally and internationally, speculators can act quicker, buying or selling, and consequently provide important signals to other investors on the state of the market.

The problem is, as is always the case with unquantifiable values, how much speculation is reasonable and healthy? The degree of reasonability, which will vary from one market to another and from time to time, can be obtained by organizing speculation. This can be done through organizing various factors that help regulate speculation, as shown below.

## 3.2 Means of Regulating Speculation

### 3.2.1 Account periods

The financial year of the stock exchange is divided into account periods; the duration of each is usually two weeks.[6] The length of this period can give the speculator a great chance to operate: he can buy shares even if he does not have any cash, on the hope that towards the end of the period the price of the share will go up so he can sell the shares which he previously bought at the beginning of the period and make a profit after paying the commission and other costs. Similarly he can sell shares even if he does not have any on the hope that by the end of the period the price will fall so he can buy the shares at a lower price, deliver the shares which he previously sold and did not have, and make a profit after paying the cost of the transactions. If the speculator's expectation about price movements is correct, he can make a handsome profit, but if his expectation was wrong he would end up with a loss. Therefore, the length of the account period gives the speculators a chance to speculate. The longer the period, the greater the chance the speculator has.

However, speculators can be divided into genuine and non-genuine. Non-genuine speculators are those who do not have enough instant fund to pay for shares they buy, or do not, at the time of sale, own the shares they sell. By contrast, genuine speculators are those who have the fund with which they can buy the shares and own the shares which they want to sell. Both, however, have one thing in common: undertaking short term transactions for the purpose of making profit.

In order to restrict, or organize, speculation in the Islamic stock market the account period could be kept as short as possible. The duration of the account period could be restricted to one week with the Settlement Day being the first working day, Saturday, after the end of the period. Transactions undertaken during the period should be settled on the Saturday following the end of the period. Adjustment could be made to accommodate public holidays. This will give the less genuine speculator less chance to maneuver.

Although, in order to curb speculation, it is tempting to suggest that the Settlement Day be the day of transaction (as in the case of some stock exchanges in the Middle East), this is not recommended. This is for various reasons:

- it will not be practical as it might cause some logistic problems and hardships to various parties in the market including brokers,
- it will not help the market to operate smoothly,
- it will not give brokers/jobbers enough time to balance their books, and
- it will not help activate enough interest to the genuine speculator.

In any case, it is more likely that the rule of the `same day settlement' will be honored in the breach rather than in the implementation.

However, a question may arise as to whether the view of extending the settlement period beyond that of the same day, the one-week account period, conforms to *shari'ah* principles. A suspicion may arise as to whether the seller in this case is "selling what he does not own", which is not permissible in Islam. However, the transaction can be regarded as comparable to the *salam* transaction. In the *salam* contract, which is the mirror image of credit sale contract, the goods are delivered to the purchaser later, i.e., after the date of concluding the contract, while the price is paid in advance.

Yet, another argument may arise. In the *salam* contract the price of goods should be paid in advance even if the goods are to be delivered later. By contrast, the price of buying the shares is paid after one week when the shares are delivered. The argument, nevertheless, does not carry full conviction.

There is a difference of opinion as to whether the price should be paid instantly at the time of concluding the contract or this can be postponed to a later stage. The Hanafite, Shafie'ts and Hanbalite jurists are of the view that the price of goods in the *salam* sale contract should be paid <u>instantly</u> at the time of concluding the contract before the parties separate (*fi majlis al aqd wa qabl at tafarroq*).

The Malikites have different opinions. Their views are as follows:[7]

- It is permissible to postpone the payment of the price for three days, whether this is stipulated in the contract or not.
- If the contract stipulates the postponement of payment for three days the debt has to be paid in time with no further delay, otherwise the contract becomes null and void.
- If the contract does not state a postponement provision and there is a delay of payment for more than three days the Malikite jurists are divided into two groups: the first does not allow the delay and renders the contract void while the second does allow it. In allowing the delay, the length of delay is not quite decisive, this can be left to the custom of trade, (*urf al-tujjar*).

The suggested delay in the case of the Islamic stock exchange is in line with the view of the above group of the Malikite school. It is:

- in line with the Malikite opinion that views the postponement of three days as permissible, and
- in line with the other Malikite opinion that refers the matter concerning the delay to the custom of the trade, *urf al-tujjar*, in case of no stipulation on the fixed three-day postponements.

Bearing in mind that the custom of the trade in the stock exchange allows for a two-week account period, it follows that one group of a school of thought is in agreement with the proposal of having a settlement period beyond one day, three-days or one-week account period. The suggestion in this paper cannot, therefore, be totally rejected. What is partially accepted cannot be wholly rejected. Stock exchanges in the Islamic world may adopt the three-day account period or may extend the period to one week, relying on one or the other of the above Malikite opinions. Several factors can be considered in the choice of the account period: the degree of stock market activity, availability of means of controlling the market and the desire to control it, degree of closeness with other markets in the world, size of stock market, the state of liquidity, etc.[8]

This section of the Malikite school shows that as a group of old jurists tried to derive rules from the *shari'ah* that would best serve prevailing trade and economic circumstances, the thinking of contemporary jurists should not be deprived from trying to find ways to best solve current economic, financial and trade problems - all within the rules of the *shari'ah*.

### 3.2.2 Buying securities on margin

Brokerage firms may offer the buyer credit facilities to buy the securities he wishes. Both, the firm and the buyer, benefit from the transaction: the firm earns due commission and the buyer buys the shares he wants. The transaction may or may not be on the basis of interest. While the interest based transaction enables the firm to receive extra income in the form of interest, the interest-free transaction is motivated by the sheer competition in the brokerage market. Meanwhile, the risk of default on the part of the client is under control: the securities are deposited with the brokerage firm until the loan is paid off. Though this does not guarantee that the client will certainly pay, it does put some pressure on him to pay off. Meanwhile, if for whatever reason the client cannot pay the firm can always sell the securities and collect the cash.

But the credit given does not have to cover the purchase price in full. The buyer is often asked to pay part of the price as down payment while the rest is covered by the credit supplier. In technical terms the portion paid by the buyer is called the "margin". Therefore, if the buyer is supplying 40% of the purchase price and the rest is financed by the brokerage firm the transaction is said to be concluded on 40% margin. The relationship between the minimum margin, borne by the buyer, and the credit margin, given by the brokerage firm, is reciprocal: the lower the minimum margin the higher the credit margin, and vice versa. The concerned central authority such as the Central bank, the Federal Reserve Board in the USA, or the Treasury usually has the authority to fix the "minimum margin".[9] Usually the regulation is imposed from above through a central governmental agency, though it may also emanate from within the self-regulated financial associations. The Building Societies Association in the UK is an example of these associations.

Providing that the credit facility is given on interest free basis, against a share in profit, this mechanism can be used in the Islamic stock market to regulate speculation. To begin with, the "minimum margin" should be kept to a maximum and the credit margin to a minimum, so that this method may be used fully to reduce speculation. The Maximum-Minimum-Margin may be altered to influence the market: if the market is not active enough, the margin may be reduced to allow the buyers to buy and the sellers to sell, and if it is too active the margin can be raised to discourage the buyers from buying and the sellers from selling, and so on.

Naturally, Muslim economists are concerned about the use of this method in the stock market. On the one hand, they are worried the method may lead to high speculative activities, while, on the other hand, seeing its benefits, they acknowledge the need for the method to stimulate the stock market. Expressing this view, Mannan cautions, "it would, however, not be advisable to use it (*the method*)[10] widely or indiscriminately in view of the danger that it can open a back-door for unrestricted speculation and gambling in the securities market.", and advises, "safeguards would, therefore, be needed to regulate the use of "margin" depending on whether there is a need to stimulate the market or to curb its speculative activities" (Mannan, 1990). This highlights the view that the method *per se* is not necessarily the cause for undesirable market symptoms, including speculation. Rather, it is how the method is used in influencing the market that leads to undesirable or desirable results. This of course applies not only to the stock market but also to many other markets.

In addition to the authority that may be given to government agencies to control the level of minimum-margin, the stock exchange may also be given such powers in the Islamic setting of stock market. The Islamic stock exchange board may supervise the giving of credit by brokerage firms so as to ensure that the general policy is adhered to.

### 3.2.3 The use of Islamic finance

Instead of relying on credit facilities, Islamic modes of finance may be used in the Islamic stock market. Partners may enter into a *mudarabah* agreement whereby one - the *mudarib* or the entrepreneur - uses his labor and expertise and the other - *sahib-al-mal* or the capital supplier - his capital. The *mudarib* in this partnership is the one who assumes authority on technical matters relating to the buying and selling of securities in the Islamic stock market. On the other hand, the capital supplier plays the role of the financier who provides the required capital. As in *mudarabah* contract in general, the profit would be distributed according to the agreement and the losses would be borne by the capital supplier. Therefore, dividends realized during the period of holding the securities as well as capital gains achieved at their sale will be shared by the partners according to predetermined percentages specified in the agreement. Capital losses at the time of sale will, on the other hand, be borne by the capital supplier. Other forms of Islamic partnership, *sharikah*, may also be used for this purpose.

With the use of Islamic modes of finance the scope of the minimum-margin technique to restrict speculation becomes limited. Investors in the stock market are less affected by the availability of credit through brokerage firms and money suppliers, and consequently are less influenced by credit restriction policies. This may be seen to imply that the Islamic stock market may become more prone to speculation. But this is not necessarily true. The market may even be less speculative. This is because the capital invested in the stock market will be coming from real savings that are genuinely directed to buying shares. Investments in the stock market, therefore, will be more representative of the funds directed specifically for this particular type of investment. Furthermore, the possible criticism of the buying-stock-on-margin method of being an artificial means of credit creation that leads to falsely affecting the speculative aspects of the market has been answered: only the investors with funds will be able to undertake stock market transactions.

Turning our attention to the role of the buying-stock-on-margin method in stimulating the stock market, we see that the Islamic modes of finance still have an edge. True, the central authority will not have much control over the supply of Islamic finance that is directed to the stock market for the purpose of stimulation, but it is also true that Islamic banks in the Islamic setting may be more willing than conventional banks to get into the stock market. This is so because, in comparison with conventional banks, Islamic banks: (a) are allowed to do so, at least in principle, (b) do not have similar interest-based investment opportunities, and (c) are more entrepreneurial. The limitation of this proposition is that in reality, however, Islamic banks are still concentrating on *murabahah* financing for a major part of their operations. Until such time as the Islamic banks widely diversify their operations and enter into the stock market activities as entrepreneurs, their role in the stock market will remain limited. Alternatively, other forms of Islamic finance such as *mudarabah, murabahah* and *musharakah* on the basis of "margin" may be used with the possession of securities as collateral. Some Islamic banks such as those of *al-Baraka* group have taken the initiative of applying *murabahah* to the purchase of shares. Other banks may follow suit.

### 3.2.4 Taxation

One may be tempted to use taxation as a means of curbing speculation in the Islamic stock market. Capital gains tax on net gains on the sale of securities and surcharge tax on the income generated from securities, dividends, can always be suggested, and have been practised. Differentiating between sources of taxable income and gain, and treating labor favorably in comparison with other sources, taxes on capital gains and income generated from securities tend to be higher than those on other sources. In the Islamic stock market, taxes of this type may be deemed to be effective in producing the desired results, e.g. curbing speculation and, simultaneously, generating revenue for the state.

But taxation has always been double-edged. While the tax may produce the required results in one area, it creates side effects in another - a lesson that has recently been learnt by many countries.[11]

The argument against the use of taxes in the Islamic stock market can be highlighted as follows:

First, capital gains generated as well as dividends realized from securities are already subject to *zakah* in the manner specified in the *shari'ah*.

Second, which is related to the previous point, imposing a tax on the same *zakatable* base renders a double financial charge that is neither morally fair nor economically sound.

Third, it is debatable whether in the righteous Islamic setting the state has a financial right to the wealth of its subjects beyond that of *zakah*.

Four, imposing a capital gains tax on every gain achieved involves practical complications.[12]

Fifth, imposing a tax on capital gains after every transaction is bound to have a disincentive effect at a time when the stock market activities in the Islamic world need to be encouraged.

### 3.2.5 Commission

The purchase or sale of shares is not undertaken directly by the buyer or the seller. Between the two there is the broker who brings the buyer and the seller together. Moreover, the function of the stock market broker is not limited to only linking the buyer and the seller, it extends to guaranteeing that the transaction will be implemented in the manner it was agreed. Many deals are concluded by telephone, or even on the PC lines in the recent development of the stock market and as such no documents change hands or contracts are signed. "My word is my bond", is the market motto, which stresses that the market is built on trust and confidence. The trust, if this needs to be emphasized, is not necessarily between the buyer and the seller. It is mainly between the buying broker and the selling one - the members of the stock exchange. The buyer may change his mind and the seller may fail to deliver, but the broker can afford neither. If the client let him down the broker has to pick up the bill.

Therefore, the broker's role is fourfold:

•to seek information about the market for the benefit of his client,
•to link the buyer with the seller,
•to select the best possible deal for his client, and
•to bear the risk of default if the need arises.

For this, the broker charges a commission. Owing to the continually changing financial circumstances in an active stock market, in terms of the demand and supply of shares and the effect of these on share prices, the broker has to investigate the market every time he strikes a deal. He, therefore, demands a commission for every transaction.

Text books in the financial management literature stress the importance of taking into account the cost of the transaction, mainly brokerage commission, when dealing in stock market operations. The commission reduces the capital gain, increases the capital loss, or transfers a gain into a loss. The more frequent are the transactions, the higher is the total commission and the lower is the rate of return.[13] The advice, therefore, is to minimize the frequency of transactions in the same share as much as possible, in other words, to buy the share and leave it alone.

The brokerage commission seems to be pertinent to the job in hand - regulating speculation in the Islamic stock market. It is pertinent for various reasons:

•it meets the criterion for justice as it is payment for a rendered service,
•it is not artificially imposed to affect the market,
•its rationale is more acceptable to the investor than taxes as it reflects the idea that it is the price of a service, not a reflection of the mere authoritative power of the state,
•it helps contribute to the process of attracting the investor to the Islamic stock market as it avoids the complexity of the calculation of capital gains tax,
•in a free market economy it helps enhancing the feeling of competition as it is devoid of the government's interference through taxation, and
•it helps to promote one of the important service sectors in the stock market.

For these reasons, the brokerage charge, while acting as a deterrent to irrational speculative forces, is far more superior to taxation. Furthermore, the commission charge is not necessarily beyond the control of the regulatory body of the stock market. The board of stock exchange can be empowered if the need arises to fix a minimum or a maximum charge for the brokerage service. This will have a bearing on the process of stimulating the activities of the stock market if the government so desired.

### 3.2.6 Service charge

A service charge may be imposed on the transactions undertaken in the stock exchange. The revenue generated from the charge can be directed to the exchange's resources - after all, the exchange provides a service to the buyer and seller. The charge may take one of four forms:

•fixed, regardless of the value of the transaction or the number of shares traded,
•variable, in proportion to the value of the transaction,
•fixed to a certain value after which it turns variable in proportion to the value of the transaction, and
•variable, in relation to the number of shares traded.

Each method has bearing on the revenue generated and the concept of fairness. The effect of the charge on the revenue generated will depend upon the size of transactions undertaken in the exchange. This will vary from one exchange to another. If the aim is to maximize revenue the exchange can study the frequency of transactions, the number of shares traded in each transaction, and the value of transaction. Depending upon the findings of the study the exchange can choose the method that helps maximize revenue.

If the aim, on the other hand, is to achieve fairness, the criterion of fairness should be first determined. Is it the horizontal equality among the participants regardless of their payment capacity represented in the value of their transactions? Is it a vertical equality where the circumstances of the participant, represented in the value of transactions, are taken into account? Or is it somewhere in between? In other words, should fairness be measured in terms of number of pounds, number of shares or number of transactions? While the concept of equality of sacrifice and its relation to the utility function for the tax payer is taken into account in the first case, it is not so done in the second or the third one.[14]

Levying a service charge on the stock exchange operations helps achieving the two main purposes with which we are concerned in the Islamic stock market: taming speculation and stimulating the market. The choice of method and the determination of the amount charged can play a significant role in regulating the number and value of transactions in the market. While the charge can be increased to halt speculative forces, it can be reduced to encourage stimulating activities.

In addition to the above effect, the charge will help replenish the resources of the Islamic stock market. The development in the application of technology to stock market operations has been quite remarkable in recent years. For the Islamic stock exchange to keep pace with this worldwide development the exchange will be in continuous need for funds. Levying an earmarked service charge, the revenue of which is to be given to the exchange, will help provide finance for this development. Better still, the charge can be specifically referred to as a charge for the technological development in the operations of the stock exchange. This will:

- urge the exchange authority to spend the revenue for the purposes for which it was assigned,
- provide an informal pressure on the exchange authority to speed up the modernization of its operations, and
- provide unions and other organizations that have connection with the exchange with a tool for observing that the funds are spent on modernization.

The levy as such is of particular importance to the Islamic countries all of which, with the exception of a few, suffer from lack of resources.

## 4. PRICE MECHANISM

There are two approaches to share price valuation in the financial literature: the fundamental approach, and the technical approach. Variations of these two approaches also exist: the middle of the road approach, and the price ceiling method. Because of their relevance, these approaches will be examined briefly from an Islamic perspective.

### 4.1 The Fundamental Approach

In the fundamentalists' view, the share has an intrinsic value that can be calculated by the use of mathematical models. These models are mainly two: the dividends model and the earnings model. The basic technique is, however, the same in both the models.

In the dividends model the value of the share is calculated by discounting the expected stream of dividends that will be received over the period of holding the share plus the discounted terminal value of the share at the time of disposal. The terminal value includes potential gains or losses. Since the share is not refundable, the terminal value at the time of disposal is calculated, once more, as the discounted value of the expected stream of dividends to perpetuity. This boils down to calculating the value of the share as the capitalized value of dividends. For the shareholder, however, the value can be calculated in the above manner for the period during which he anticipates to hold the share.

In mathematical terms, this can be represented as follows:

$$Vo = \sum_{t=1}^{t} \sum_{i=1}^{I} Dt/(I+i)' 1 \qquad (1)$$

Giving that the share does not have a maturity date, equation (1) can be simplified into:

$$\mathbf{Vo = D1/i} \qquad (2)$$

Allowing for growth of dividends, equation (2) becomes:

$$\mathbf{Vo = D1/i - g} \qquad (3)$$

Where:
$Vo$ = Value of the share at period o, i.e. today.
$D_t$ = Dividends distributed at time t.
i = Discount rate, the prevailing rate of interest adjusted by the level of risk involved.
g = Rate of growth of dividends.
t = Period.

Notably, equation (3) holds only when "i" is greater than "g", otherwise equation (1) is used.

Figure (1) shows the value of three hypothetical shares with different growth rates of dividends over a number of years. In the Figure share A has an abnormally high rate of growth in early years that is expected to decrease to a normal level after a number of years; share B has a normal rate of growth over the years; share C has a declining rate of growth, and share D has an expected zero rate of growth of dividends. The discount rate is assumed constant in the graph, though this assumption can be relaxed and a variation of rates can be shown. Though this will affect the results, it will not affect the method of calculation.

The advocates of the earnings model (Modigliani and Miller)[15] argue that it is the company's earnings, not dividends, that influence the value of the share. Also, in adjusting the discount factor for the level of risk involved, no adjustment should be made in their view for the financial risk that is related to the capital structure of the firm. With the exception of the effect of taxation, a highly geared company is as good as a low geared one. Arbitration will bring the values of shares together if there is any difference in value resulting only from differences in financial structures. The pattern of the mathematical calculation of the intrinsic value of the share is, nevertheless, similar. This will be as in the above equations except that dividends, $D_t$ will be replaced by earnings, $E_t$ remain the same.

Figure (1)

The value of the share is affected by four main factors: level of dividends (or earnings), growth rate of dividends (or earnings), level of risk involved, and the discount factor prevailing in the economy.

These factors are also applicable to the Islamic stock market. The difference between the Islamic setting and that of non-Islamic revolves only around the discount factor.

In the non-Islamic market the discount factor is the prevailing rate of interest adjusted by the degree of risk involved. The prevailing rate of interest is influenced by the minimum lending rate of interest that is determined by the central bank. In technical terms, the discount rate boils down to being the company's cost of capital.

Due to the prohibition of interest in Islamic economics, the prevailing rate of interest will not be relevant to the calculation of the value of the share in the Islamic stock market. Nevertheless, time has a value in Islamic economics - credit sale is permitted in Islam and the credit price is allowed to be higher than cash price. Therefore, there does not seem to be contradiction *in principle* between discounting in Islamic economics and discounting in conventional economics.[16] Discounting a stream of dividends, or earnings, for the purpose of calculating the value of the share is not, therefore, in contradiction with the *shari'ah* principles. What remains is to find a suitable discount factor to replace the rate of interest.

The market average rate of return can be suggested as a suitable candidate for discounting in the Islamic capital market. The rate which incorporates both dividends and capital gains reflects the performance of the market as a whole. This rate can be adjusted for the risk involved. Risk is expressed as the volatility of the value of the variable around its mean. Taking the market rate of return on share as the average rate, the risk involved can be measured in terms of the volatility of the rate of return on share for a particular share in relation to the market rate of return.

For better results, the rate of return on share in the industry concerned can be used instead of that of the market. This helps in obtaining a more representative comparison between the performance of the share under valuation and that of the industry to which the share belongs. Adjusting the rate of return of the industry in relation to the market rate of return, and/or the share rate of return to the industry rate, would lead to the calculation of the price of risk involved.

In the Islamic capital market, the price of risk will depend on three factors:

- the minimum acceptable rate of return,
- the actual average rate of return, and
- the covariance between the share's rate of return and the market average (or the covariance between the industry rate of return and that of the market, if the aim is to calculate the price of risk for the industry).

The expected rate of return on share will depend on the price of risk. In mathematical terms, the expected rate of return of the share can be shown as follows:

$$E(Ri,t) = a + bE(Rm, t) + ei,t$$

$$b = (COV (Ri,RM)/(RM)$$

Where:

$E(Ri,t)$ = the expected rate of return for the share i at time t

a =the intercept term, constant.

b =the slope term that measures the relationship between the rate of return of the share and the market index rate of return, which is calculated as above.

RM,t = the rate of return on the market index at time t.

*ei*,t =a random error term; the part of the return that is not correlated with the market return.

Figure (2) shows this relationship graphically.

This concept of price or risk has been implied in the calculation of the cost of equity capital. In the Capital Asset Pricing Model (CAPM), cost of equity capital is calculated as:

$$Ka = Rf + B(Rm-Rf)$$

Where:

Ka = cost of equity

Rf = risk-free rate of return

B = covariance between the share's rate of return and market rate of return

In the Islamic capital market "Rf" will be the least acceptable rate of return below which it will not be economic for the investor to invest. This is the rate which will merely generate enough return to maintain capital after paying *zakah*. This rate will be: Z/(1-Z)

As *zakah* rate on capital can be taken as 2.5%, and on the assumption that *zakah* is the only tax imposed, the minimum acceptable rate of return becomes:

= 2.5% (1-2.5%)
= 2.564%

From a financial point of view, shares, as well as investments in general, will not be acceptable unless their rate of return is at least 2.564%. Below this rate, capital will decrease at the rate of *zakah*.

Figure (2):The relationship between the rate of return on share for the company and the market index.

In figure (2), Y axis represents the rate of return on share in the industry to which the company belongs (expressed in terms of a national index, e.g. Financial Times Index), and X axis depicts the return on the share of the company under examination. Historical information, taken weekly, monthly or yearly for a number of years can be used to establish the trend of relationship. In the figure, there are three different examples of companies, or shares, each has a different value of `b'. Share A has a `b' greater than 1, share B equal to 1, and share C less than 1. When the return on the industry increases by x% the return on share for the company is expected to increase by x% multiplied by the value of `b'. For example if the value of `b' for the share of the company A is 1.5 and the rate of return on the industry increased by 10% the rate of return on the share of the company is expected to increase by 15%. Notably, the share with a high value of `b' is more rewarding in terms of rate of return than the one with low value. The opposite is true in time of depression, the share with the lowest value of `b' is the least suffering. when the rate of return in the industry declines, that of the share does not decline at the same rate. Hence the terms aggressive and defensive are associated with companies the shares of which have a high or low value of `b' respectively.

The problem with the Islamic capital market is that the information required for the above calculation is not always available. Historical records are not accessible and the organization of the stock market is not well advanced. This is the case at least in many Islamic countries. Building a trend of the market rate of return from which a market index and the `b' parameter can be calculated is not, therefore, an easy task. Until such time when most needed data become available, an alternative such as the estimated average rate of return in the industry can be used. This rate can be derived from companies' accounting records. Care should be taken, however, to ensure the homogeneity of accounting policies relating to: (a) disclosure system, (b) definitions, and (c) methods. Standardization of accounting policies could of course be applied. As accounting standardization has not yet materialized, the proper application of the generally acceptable accounting principles should at least be observed.

## 4.2 The Technical Approach

The advocates of the technical approach to share valuation argue that it does not help to talk about a share's intrinsic value. Share prices are what they are because this is how the market wants them to be. Though the term market in this respect might seem vague, it refers to the great number of buyers and sellers of shares in the stock exchange. In other words, like the price of other goods, the price of shares is determined by the power of demand and supply. This is particularly applicable to free market economies where market forces are expected to play an influential role in decision making.

Islam advocates free market structure. This is reflected in the following characteristics:

- Prices should be determined by market forces.
- Information should be made available to both the buyer and the seller.
- All forms of monopolistic power are condemned.

The state of laissez-faire is not advocated in the Islamic market structure, either. The government may intervene if the market is unstable but only as much as to rectify the situation (Ibn-Taimiya, 1262-1328).

In line with the technical approach to share valuation, share prices in the Islamic stock market will be also influenced by market forces: demand and supply. As in the non-Islamic market, the intrinsic value of the share may or may not coincide with the market value. The reason for this variation is that while the intrinsic value provides a calculated value of the share, the market value reflects changes in the mode of the market. Besides being affected by most recent development in the economic and political environment, the mode of the market is also influenced by the psychology condition of buyers and sellers, their ability to interpret market signals, and the bearing of that on people's expectation of market behavior. People rank between extreme optimism and complete pessimism, as they lie between entire risk seeking and full risk aversion. This is bound to have bearing on their expectation of true market behavior and anticipated price movements. Even personal events may affect the value of the share if it is believed that the events will have bearing on the affairs of the company. It is not unusual to hear of personal scandals toppling governments, and it is therefore understandable if such events have powerful adverse effects on company boards of management.

To support their point of view, the advocates of the technical approach argue further that share prices do not follow any particular pattern. The lack of correlation between the historical share price movements, that has been testified empirically, supports this view. The price of today is not indicative of the price of tomorrow. Prices tend to move in a random pattern. Plotting price movement of a particular share, or even a bundle of shares, in a graph would appear as that in Figure (3). This suggests that the prices of shares move randomly, which implies that knowing past prices does not help anticipate future prices. No investor therefore can outperform the others by the use of this type of information.

The difference between the intrinsic value and the market value is that while the former takes long to adjust to new changes in economic and non-economic parameters, the latter adjusts to these changes on the spot. Also, the former takes into account the changes that tend to be of a stable nature. Temporary changes that are canceled out over time are not taken into account. This introduces the third approach to share valuation, the middle of the road approach.

Figure (3): Share price fluctuation

### 4.3 The middle of the road approach

The proponents of this approach suggest that there is no real contradiction between share valuation according to the fundamental approach and that of the technical approach. The intrinsic value as calculated by using mathematical modes determines the loge run upper and lower limits of values within which market values fluctuate.  The levels reflect what the market experts think the price can rise up or go down to, before this can raise alarm.  The limits, upper and lower, will move up or down in the long run to reflect stable changes in the economic and market conditions. Unstable daily, weekly and monthly changes that have temporary consequences will have similar temporary effect on the market.  The market price of shares will move up and down daily, weekly and monthly by the force of these changes. This is depicted in Figure (4) which shows price movements of a hypothetical share over time. In the figure prices move up and down within the maximum and the minimum value as fundamentally calculated.  Prices may however move beyond these two levels, as shown in the figure, though this is quickly adjusted to bring the price within the range of its expected value.

Figure (4): Long run share price movements.

In the Islamic stock market, share price movements will tend to be less volatile than those in the non-Islamic market. This is because of two main reasons: (a) speculation will be regulated, as explained above, and (b) market information may not travel very fast, which is related not to Islam *per se* but to the level of technological development in Muslim countries.

The second reason should not be viewed favorably, however.Despite the "favorable" result of making the Islamic stock market less volatile, it has four main defects:

- it deprives investors form valuable information that may have implications for their decisions, which is against the basic philosophy of the Islamic market,
- it renders the Islamic market inefficient,

- it places international Muslim investors at a disadvantage as they are bound to lose out internationally because of this reason, and
- it fosters the wrong environment for spreading false rumors in the stock market.

### 4.4 Price Fixation

The fixing of a maximum price by the government in the Islamic stock exchange has been suggested (Metwally, 1984). The government, the argument goes, should fix a maximum price for the share so that the market price may never go beyond it. The fixed price can be reviewed from time to time by the stock management committee. Shares may be traded at a price lower than the maximum, however. The maximum share price for each company is calculated as: net worth/number of shares (ibid).

This boils down to fixing a price ceiling for the share. The ceiling is in fact the book value of the share that is influenced by the value of the company's assets and liabilities, i.e net equity, and the number of shares.

I maintain, however, that fixing a price ceiling on the value of the share in the Islamic stock exchange should be avoided. The determination of a maximum price for the share is: (a) non-Islamic, (b) ambiguous and (c) difficult to achieve. This is explained as follows:

First, it is non-Islamic. It violates the basic Islamic principles of market structure. Price fixation is not recommended in Islam, the Prophet is reported to have declined to fix prices. Even when the fixing of prices was defended by the jurist Ibn-Taimiya (1261-1328) it was based on the condition that price fixing was intended to combat cases of market abnormality caused by impairing the conditions of free competition. As long as the market is normal prices should be left alone. Notably, this is a lesson that has been confirmed in the centrally planned economies beginning from the late eighties and early nineties of this century. What is said about pricing in the Islamic market in general is applicable to pricing in the stock market in particular.

Second, it is ambiguous. This is because: (a) it is not clear what method of calculation ought to be used to determine the maximum price, or (b) how often this process of calculation, dividing net equity as taken from the company's balance sheet by the number of existing shares, has been suggested as mentioned above. But this value, even with the assumption that the calculation is accepted, can serve as not only the maximum value of the share but also the very **minimum value**. Looking at the business as a going concern, the book value of the share, that is, the value based on the historical value of the company's net assets as shown in the balance sheet, can be the **minimum** value of the company's share. This, however, will depend upon the success of the business and the increase of the market value of the company's assets over its historical value. Hardly, if ever, does the historical value of assets exceed the market value (or the net realizable value). Put another way, if the suggested book value can be accepted as a maximum value, it can equally be taken as a minimum value - a confusing issue.

The frequency of updating the maximum price is another source of ambiguity. Normally, trading in shares takes place daily, or at least this is the assumption as long as the share is available for dealing. The financial position of the company as projected in the balance sheet also changes daily as long as the company is open for trading. As the financial position is changeable at the conclusion of every transaction and the trading in the share is variable at the end of every deal, the question therefore is: how long would the determined maximum (minimum) price last before it need to be reviewed? One day, is the ideal answer. But this is too costly. Less frequent changes than daily will therefore be suggested, weekly, monthly, quarterly; which is bound to open the door for arbitrariness and the rule of thumb. This should be avoided in one of the most, if not the most, sensitive areas of stock exchange activities.

Third, putting a maximum value on the share, based on the company's financial position as shown in the balance sheet, is not operational. This is for various reasons:

a)Assets and liabilities are valued in the balance sheet at historical cost which is not necessarily related to market value. Consequently, the share will most likely be undervalued. The size of undervaluation will depend upon the difference between the historical cost and the market value of the item. This under-valuation can be dramatic. For example, depending upon the age of the asset and its rate of depreciation, some assets may be shown in the balance sheet at virtually symbolic values. Buildings are an obvious example. The historical cost of buildings in the balance sheet is usually substantially lower than the market value. The opposite is also true. Research and development balances may not have a significant market value although they have high historical costs in the balance sheet. Accounting methods other than historical cost methods may be used, but this, as shown below, does not provide a solution to the problem.

b)Even if inflation accounting techniques are applied the application will not be without complications. Standardization will be required to guarantee reliable results. The standardization will be in relation to two main issues: (a) the method used, one of the generally acceptable inflation accounting methods, and (b) the frequency of adjusting final accounts by inflationary changes. The more frequent the accounts are adjusted the more representative the accounts will be but the more costly this will become. The cost and inconvenience of this exercise will be high. This will be the case particularly if the balance sheet is meant to serve as a reliable source of information for the calculation of the maximum value of the share. To reflect a realistic financial position, and hence realistic value of the share, a balance sheet (and a profit and loss account) adjusted through the use of inflation accounting techniques has to be prepared every time the government fixes the maximum price. Although ideally the maximum price ought to be determined daily, as long as the share is available for trading in the stock exchange every day, this may prove impossible. Less frequent adjustments may therefore be used, quarterly or bi-annually, but this will lead to arbitrariness and unreliability.

c)Even without the use of inflationary accounting, and regardless of the problem of frequency of adjustment, accounting standardization should be introduced to reflect comparative financial data for the companies the shares of which are traded in the market. This is not an easy task.

d)Although the balance sheet shows the financial position of the business at a moment in time, it does not portray the ability of the company's assets to generate income. What interests the potential shareholder is not only how much the net worth of the company is but, perhaps more important, how much profit the company can generate in future. The buyer of the share does not buy a share in the company's net assets, he instead buys a stream of future dividends and an expected capital gain at the time when he disposes of the share. The market value of the share reflects these expectations.

e)Not all the assets of the company are shown in the balance sheet, and even if they are, not all companies follow the same policy of disclosing these assets. Intangible assets are an obvious example. Goodwill, for instance, is not always shown in the balance sheet, and, if it is, not all companies follow the same accounting policies as to its depreciation and valuation.

f)If the company issued new shares or purchased some of its existing shares during the period of calculation, there would be a problem of determining the number of shares in the formula of calculation. One way of solving the problem is to use the average number of shares during the period. Another way is to introduce the rule that when the company issues new shares these should be priced at the already existing maximum price. Similarly, shares when purchased by the company should be purchased at the maximum price. This does not solve the problem. This is for two main reasons: (a) it is very likely that the company issues new shares, or buy some of its existing shares, after the maximum price has been reviewed by the government agency, and (b) the company, for sound financial reasons, may wish to sell the new issue at a price lower than the prevailing price.

Fourth, believing that by fixing the maximum price of the share the stock exchange may be in breach of the *shari'ah* principles the dealers may prefer to take their business elsewhere. This may encourage the unlisted security market which, though not illegitimate, is not under the full control of the exchange.

Finally, fixing a maximum price is unfair to the company that is doing better than others though having a similar book value. While the book value per share (the maximum value) is similar, the market value can be substantially different. The company whose share has a would-be-higher market value would suffer.

## 5. MARKET STRUCTURE

As mentioned earlier, although the Islamic code of conduct is a basic prerequisite for the operation of the Islamic stock exchange, it is not *per se* sufficient to guarantee that the Islamic stock exchange will be free from misconduct. There is still need for the support of law. This will be reflected in the degree of government involvement in the work of the exchange which will be projected in the latter's organizational structure.

### 5.1 Organizational Structure

On the top of the Islamic stock exchange comes a government agency that observes, directs and controls the work of the exchange. This is in line with the institution of *hisbah*. However, as flexibility is needed to help achieving smooth running of operations a balance between control and flexibility is desirable. To strike such a balance the government may constitute a board that, though administratively autonomous, is accountable to government. The board may draw the general policies of the stock exchange such as: laying down the conditions for company listing, establishing clearing houses, allowing foreign competition among brokerage firms, and fixing commission policies. From the investor's point of view the establishment of this supervisory board would help: (a) ensure that market irregularities are under the surveillance of the state, (b) stress that the market operates in conformity with Islamic principles, and (c) encourage the small investors to get into the stock market and hence (d) widen the base of share ownership.

Distinguished from other forms of stock exchanges, the Islamic exchange will have a Religious Supervisory Body on the top of the organization structure. The main functions of this board will be:

- to ensure that the activities of the exchange are run in accordance with the rules of the *shari'ah*,
- to provide necessary advice and guidance,
- to issue religious opinion, *fatwa*, whenever the need arises or to arrange for the issuance of these *fatwas* with other religious scholars, and
- to work towards providing *shari'ah* training and education programs to those working in the field.

### 5.2 Single Capacity or Dual Capacity

The stock exchange single capacity system is that which does not give the broker the right to trade with other brokers directly. Trading has to be carried out through jobbers. By contrast, the dual capacity system is that which gives the stock brokers the right to do so. In effect, the broker in the latter system acts as a broker and a jobber.

Favoring a market with a minimum role of the middle man, Muslim economists may advocate a stock market that is based on the dual capacity system. To them this may appear as helping to reduce costs, speeding up operations, and improving service, especially when the role of the broker still exists. Also, jobbing firms may find it difficult to cope with deals of large numbers of shares, especially if the market is dominated by large institutional investors. To act as principals, buying shares on their own behalf with a view to selling them in future, jobbers, in an institutional market, need large funds that may not always be available.

However, in the context of Islamic stock exchange, the single capacity system can be more advantageous. This is for the following reasons:

- In the absence of jobbers in the dual capacity system, the market becomes less competitive and consequently less beneficial to the final investors.

- By acting as a jobber, the stock broker in effect buys from, or sells to, himself on behalf of his clients. This will make him unwilling to buy from, or sell to, another broker whose prices may be more beneficial to the client.
- Giving advice to the client by the stock broker will be biased towards his own interest.
- By contrast to jobbers who specialize in certain share(s), stock brokers by trading in all types of shares will spread their skill thin or will bear substantial costs to develop and maintain the required expertise.
- Share prices in the dual capacity system can be influenced by the policies of highly influential brokerage firms which may lead to sharp fluctuations in the price of a share. This is in contrast to the single capacity system where jobbers help smooth changes in the price of the share.
- In general, the market under the single capacity system is more beneficial to the final investor.

The single capacity system is, therefore, preferable in the Islamic stock exchange.

### 5.3 Seaq

There is no reason in principle why the Islamic stock exchange should not use the SEAQ, Stock Exchange Automated Quotation, system. International stock exchanges tend to move towards the application of more advanced technology in their operations. London International Stock Exchange introduced SEAQ to its operations in 1986 among four main changes in what became known as the Big Bang.[17] The limitation on the use of the automated quotation as far as the Islamic stock exchange is concerned will be related to the availability of technology and the ability to pay for it.

However, the application of SEAQ might lead to adverse consequences. Unnecessary fluctuation in share prices might indeed be the side-product of using the automated technique more than being the result of real price changes. This has been echoed in the interest circles in the capital market, though concrete research has yet to prove the point. By the use of computer programs on widely available PC terminals stock brokers may tend to act quickly on computer flashing messages: sell or buy. They may do so without sufficient examination of circumstantial evidence that caused the message to appear. A temporary drop, or rise, in the price of the share that might be adjusted during the day may be reason for unnecessary concern. The time of day as well as the day of week, Monday to Friday: start or end of week, may be taken into account when making a buy or sell decision. There seems to be unexplainable perception that the time of day, and the day of week, has some bearing on the mode of the market and consequently the way prices go. This does not, obviously, appear on the screen.

In conclusion, while the use of technology in the Islamic stock exchange is, and should be, encouraged special care should be taken to minimize the effect of potential technology hazard when technology is applied to stock exchange in Muslim countries at present. It might be advisable that the Islamic stock exchange should avoid using the automated system right from the start. Refinement period during which staff competence and expertise can be developed may be needed first, before automated quotation may be used. Emphasis should be placed on the role of personnel in the exchange, which lies within the essence of the Islamic philosophy that places man highly in the universe. Proper training should of course be given and expertise acquired before the automated system can be implemented.

### 5.4 Minimum Commission

Generally, there are two policies with respect to stock brokers' commission: open ended policy or minimum commission policy. The body that decides upon the policy is the board of stock exchange which, in the Islamic setting, is suggested to be part of the government machinery, as mentioned above.

To the broker, the advantage of the minimum commission policy is that the broker in a competitive market will not have to reduce his commission in order to increase his business. The more competitive the market is the more beneficial this policy will be. To the investor, the policy helps widen the base of the brokerage industry and alleviate potential monopolistic aspects. This will have favorable effect on the choice of service and the level of competition beyond that of the minimum commission. For the institutional investor this can be a considerable advantage. Against these advantages, the policy could be said to favor the rich investor compared with limited benefits to the small one. Under the minimum commission policy the small investor may forgo the opportunity to acquire the service at a lower commission. Also, trading in small number of shares will tend to be costly compared with trading in large numbers which is not encouraging to the small investor. The policy then will not help foster a policy of widening the base of share ownership if the government wishes to do so.

The minimum commission policy does not seem to suit the Islamic stock exchange. This is for several reasons:

•it does not fit in with the spirit of pricing in the Islamic market based on market forces,
•it is not in harmony with the principle of fairness as it favors the rich against the poor,
•it is less encouraging for the small investor and the government policy of fostering a wide share ownership base.

### 5.5 Brokerage Profession

Stock exchange brokerage is a highly specialized profession, or at least it should be viewed as such, with a highly sensitive role to play. To maintain a satisfactory standard of the service, the profession should be purged from any undesirable elements that lack qualification and expertise. Therefore, the brokerage profession should be under continuous scrutiny.

In the Islamic stock exchange, a self regulated brokerage professional body should be structured under the supervision of the state within a modern form of the Islamic *hisbah* institution. The aim of the body would be to:

•purge the profession from impostors,
•set up a code of conduct to which all should adhere,
•establish and develop standards of service that are acceptable, nationally and internationally,
•establish and continuously review the qualifying conditions for entering into the profession,
•control the new entrants to the profession with a view to ensuring that they are suitably qualified,
•provide training to existing members in order to familiarize them with new technology in the field,
•provide supervised training to potential personnel, and
•represent the profession in government and other bodies formally and informally.

### 5.6 New Company Listing and the Finance of Industry

Various advantages are gained from listing:

•it gives the company a more prestigious image,
•it provides the company with a better chance to be known internationally,
•it provides the company with a convenient market place and, because of all this,

•listing has real implications on the demand for the company's shares, the price of the share and the ability of the company to raise funds.

Not all companies are allowed to join the exchange through listing. Certain rules and regulations need to be satisfied. For the Islamic stock exchange the following rules may be considered:

•A certain percentage of the company's shares should be made available for public subscription, a rule which aims to encourage the private company to "go public" in order to dilute the influence of the few.
•The capitalized value of the company should be above a certain minimum, a regulation that aims to ensure that the exchange will not be overcrowded with small companies of little significance.
•Proper documents should be deposited with the exchange or a government office (department of trade and industry, companies' register or the like) and should be made available to the concerned reader.
•Annual final accounts should be deposited with the exchange or a government agency in the above manner and should be made available to public.
•Publishable financial reports, such as annual or bi-annual final accounts, should be published in the national Press.
•Regulations and procedures should be laid down by the exchange to organize the call for general subscription.

The dilemma is that while the government, in organizing the stock exchange, or the exchange in organizing itself, aims to purge the exchange of those little companies that have very minor significance on the market, it, by so doing, prevents small businesses from using the exchange as a market place for raising funds. The government has also the responsibility to protect the public and for that it may demand certain control procedures that may turn to be too costly to small companies. This boils down to the fact that small companies and new industries that are hungry for funds are denied access to an important means of channelling finance.

I hasten to emphasize that this problem is not particularly related to developing countries, nor would it be so to the Islamic sock exchange. London, New York and other stock exchanges have faced the same problem, that led to the development of other outside markets. In the UK, for example, the USM (Unlisted Securities Market) was developed in the late eighties and since then it has grown into a recognizable market. That was mainly due to the rules of the LSE for company listing which made the

Exchange inaccessible to many small companies. Learning the lesson, the rules have been reviewed by the LSE board with a view to relaxing some conditions in order to make the Exchange more accessible.

Variations of the above rules will suit different countries' needs. For example, some countries may find that fifty per cent of the company's shares, or slightly more, should be offered for public subscription if it is to be allowed to be listed. Other countries may consider that around 35 per cent will be sufficient to produce the required effect. Regardless of the degree of tightness in the law, which varies from one country to another, general control rules should be applied to protect the public on the one hand and organize the work of the exchange on the other.

## NOTES

1.The scope of this paper does not allow for the exploration of the Islamic financing certificates. For further discussion of the topic see, for example, Al Qari (1993) and Mannan (1990).

2.For comprehensive references on the rules of *shari'ah* covering transactions in general, see for example: (a) Khafif, "Rules of *Shari'ah Muaamalat*", *Dar-al-Arabi*, Kuwait, (no date), (b) Abu-Sulaiman, Abdel-Wahab, "*Fiqh al-Dharura* and its contemporary application", Jeddah: IRTI, IDB, 1414H/1993, (c) Hassan, Hussain Hamid, "*Fiqh al-Maslaha* and its contemporary application", Jeddah: IRTI, IDB, 1414H/1993, and (d) Dharir, al-Siddiq, "*al-Gharar* in contracts and its effect in contemporary application", IRTI, IDB, 1414H/1993, (all in Arabic).

3.Even in matters that are regarded of a highly religious nature, such as *zakah*, the Islamic state at the time of the first caliph Abu Bakr, had to resort to force to reinforce the rules in what became known as the "Apostasy War". To support this further, it suffices to say that although stealing is forbidden in Islam, as well as in other religions and codes of conduct, the punishment for stealing in Islam is as sever as the amputation of the thief's hand. The corporal punishment for the consumption of alcoholic beverage is another example. This demonstrates strongly how both educational and legislative approaches are used together when necessary.

4.Pearce, David W. (ed), (1986), *Macmillan Dictionary of Modern Economics*, The Macmillan Press Ltd., 3rd ed.

5.Neither the intention nor the scope of this paper allows for an explanation of the mechanism of the stock exchange; the interested reader may refer to an introductory book on the subject.

6.The stock exchange year, for example, can be divided into twenty-four account periods each of which is two weeks except for the four periods that fall on four public holidays, the duration of which is three weeks. Each transaction undertaken during the account period is to be settled on the Settlement Day which falls on the second working day a week after the end of the account period; eleven days after the end of the account period. At the Settlement Day the buyer and the seller are required to settle their account: the former to pay for what he purchased during the period and the latter to deliver the securities he sold during the same period. In effect, both the buyer and the seller can have as many as twenty five days, if the transaction is carried out on the first day of the account before each is required to fulfill his commitment.

7.See "*al-Sharh al Kabeer*", by al-Dardeer, part 3, pp.196. Also, see Khafif, Ali, "Rules of *Shari'ah Muamalat*", ibid. For a specialized discussion on *bai salam* see Hammad, M.N, "*Fiqh al Salam*", IRTI, IDB, 1415/1994.

8.This topic can be the subject of another research paper.

9.Notably, regulating the credit limits is applicable to buying not only securities, but also other goods such as cars, house-hold appliances, real estate, and so on. The fixation of the minimum margin can be used to regulate the market. If the market for certain goods, or on the whole, is very active, the demand may be curbed through increasing the level of the minimum margin. Needless to say that this can be used in conjunction with other policies, such as the minimum lending rate of interest (of the Central Bank) and taxation.

10.The author's editing.

11.In their tax reform, many countries have come to believe that a lower rate of taxes is sometime better than a higher rate. This is mainly related to the disincentive effect of taxation. The UK tax reform of the mid 1980's is an example. Besides lowering the maximum rate in the progressive structure of income tax rate from 80% to a two tier rate of 30% and 40%, the corporation tax rate was reduced from above 50% to 35% with the rate of the small company equated with the basic rate of income tax that was about 5% lower. The surcharge tax was abolished and the capital gains tax rate was combined with that of the income tax. The effect of the British reform was favorable.

12.The following are some examples:

- the net gain has to be properly calculated for every transaction taking the cost of transaction into account,
- it is very likely that the cost of purchase includes a portion related to yet unsold securities, which involves the problems of cost allocation with its various methods,
- in order to calculate the tax properly, there is a need for the calculation of indexation allowances after every transaction, which is already a complicated exercise because it requires calculating an indexation factor such as the retail price index on at least a monthly basis,
- the need to calculate the threshold allowances for every operation, and
- the need to re-calculate the tax on total transactions at the end of the tax year in order to prepare a final settlement.

13.Rate of return is calculated by dividing dividends and capital gains after costs of transaction by the purchase price of the share.

14.There are three interpretations for the concept of "equality of sacrifice":

- equal absolute sacrifice, which means that individuals sacrifice the same loss in total utility,
- equal proportional sacrifice, meaning that each individual loses an equal proportion of utility in relation to total utility, and
- equal marginal sacrifice, which means that for each individual income will be reduced by taxes to a point where the marginal utility of income after tax is equal.

15.Millier, M.H. and Modigliani, F. (1961) "Dividends policy, growth and the valuation of shares", *Journal of Business*, 34, 411-33.

16.For example Ridha Saadallah, "Concept of Time in Islamic Economics", *Islamic Economic Studies*, Vol.2, No.1, 1994, (IRTI/IDB).

17.The other three changes are: the abolition of the minimum commission, the introduction of dual capacity, and permissibility of international competition.

18.See for example, Brown C.V. and Jackson, P.M., "Public Sector Economics", Basil Blackwell, 1986.

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