The Operation of the Modern Financial Markets for Stocks and Bonds and its Relevance to an Islamic Economy

*M. Raquibuz Zaman**

Introduction

The purpose of this paper is to analyze the structure and the operation of both the primary and the secondary markets for stocks and bonds, including the use of options, warrants, and rights in the securities market of a modern economy, such as the United States, with a view to ascertain which of these securities might be permissible to invest in under an Islamic economic system.

Section I starts with a brief description of the nature and operation of the primary and the secondary markets for securities. It then describes the nature and scope of each type of security in terms of risks and returns to the issuer and the investor. Section II starts with an interpretation of the Islamic injunctions with respect to trade and investment. It then proceeds to examine the extent and conditions under which investment in particular securities may be permissible under an Islamic Economic System. Section III summarizes the results of the study and concludes with some tentative suggestions.

I. INVESTING IN SECURITIES

A. *PRIMARY AND SECONDARY MARKETS FOR SECURITIES*

The *primary market* is the market where securities are first issued by corporations (or joint stock companies) and/or by governments. In the United States, as well as in other countries, the issuer of the security announces through the news media its intention to issue the security at a future date. Such an

* Dr. Zaman is a Professor of Finance and Economics in the School of Business, Ithaca College, Ithaca, New York. He is author of several papers and books on Islamic economics. He is Chairman, Research Group for Economics, Association of Muslim Social Scientists.

announcement includes information about the purpose of the new issue (i.e., it often provides some detailed information about how the newly raised funds are to be used, in what operations, and what are likely to be the results of such an investment), the face value or par value of each security, the total number of securities that will be offered for sale, and where and from whom (or which institution or institutions) the investing public can acquire such a security.

The placement of securities in the primary market may take any of the following forms: *first*, the securities may be *directly placed* (direct placement) by the issuer–i.e., the sellers of the stocks, bonds or options can directly sell their securities to the investors (i.e., the buyers of securities) at negotiated prices. Usually stocks are sold at a premium over their face or par value. Bonds, on the other hand, are sold at a discount. Direct placement is the cheapest way to issue securities because the issuer does not have to pay any middleman or intermediary to bring in the customers (i.e., the investors). It is also the cheapest way of buying securities on the part of the investors because they do not have to pay any commission or fee to the intermediary. However, direct placement often is not feasible because the issuers of securities may not be knowing the investors who may be interested in buying their securities. This brings us to the *second* way of placement of securities, which we can term as *underwriting* of securities. Underwriting means selling of securities to the intermediary or the underwriter at a discount and/or for a commission or fees. When a group of underwriters buy securities to resell them to the final investors at a profit, this group is called the underwriting syndicate. In the U.S. and in Europe, among other countries, the underwriters are usually investment banks. A group of such banks join together to place large issues. Placement through the underwriter or underwriting syndicate is more expensive than direct placement because the issuer has to sell them at a discount and, at times, has to pay additional amounts in the form of fees or commissions. The final investors also receive less for their money because they have to buy the securities at higher prices and, in addition, have to pay commission and fees to the underwriter or underwriting syndicate. Investment bankers do not always underwrite the issues of new securities. This brings us to our *third* method of placement of securities. When investment bankers do not buy the securities from the issuers to resell to the ultimate investors, but merely bring the issuers and the investors together for fees or commissions, it is known as the use of *best efforts*. Whether or not the use of best efforts is more or less expensive than issuing of securities through underwriters depends upon the reputation and economic strength of the issuing company or the government. If the issuer is a well known party and is known for its successful exploits, it costs less to use best efforts. However, if the issuer is a new party or a party which is known to have financial problems,

it is costlier for it to use best efforts. There is a *fourth* method of security placement. It is known as *standby underwriting. Standby underwriting* simply means that the issuer first tries to place his securities directly, but not being sure about his complete success in his attempt he signs a contract with an underwriter or an underwriting syndicate for the remaining issues he would not be able to place himself. In other words, the underwriter and the issuer agree on a price of the remaining securities, which is usually lower than the price the issuer can get for his securities under direct placement. Standby underwriting is a little bit less expensive than underwriting of the entire issue.

The funds, net of placement costs, that are raised by the issuers and bought by the final investors are used to purchase real economic assets (e.g., plants, equipment, raw materials, labor, etc.). It is these funds which ultimately determine the size of and the rate of growth in the real Gross National Product (GNP) of a country. Not every purchase of stocks, bonds, options or rights contributes directly to the expansion of economic activities. Such securities bought only in the primary market (i.e., first issue) contributes to real economic expansion because the receivers of these funds (i.e., the issuers of securities) are the ultimate producers of goods and services and they use funds for those purposes. However, the bulk of the transactions in securities take place in the secondary market where the buyers and the sellers are both investors in financial assets – they exchange one form of financial asset, say a security, for another form, like money. The buyers and the sellers of securities in the secondary market may both profit or lose from their transactions, but such transactions have little or no direct impact on the original issuer of the securities (i.e., the corporations, companies, establishments, and governments that originally raised funds by issuing them).

What are the *secondary markets* for securities, then? The most important among these are the established stock exchanges as the New York Stock Exchange (NYSE), the American Stock Exchange (AMEX), and the stock exchanges in cities like London, Paris, Frankfurt, Tokyo and Hong Kong. The commission brokers, traders and specialists that man these exchanges are all middlemen who buy or sell securities for their customers (investors) and/or for themselves for fees or commissions. Besides the established stock exchanges numerous brokerage firms throughout the country buy and sell listed or over-the-counter (OTC) securities to their customers.[1] OTC securities are the securities issued by smaller firms who do not have enough assets or do

---

1 Not all securities are listed in the established stock exchanges because such exchanges have special conditions which the corporations must fulfill before they become eligible to be listed. Smaller firms usually sell their securities through an over-the-counter market. (OTC has no exact location. Small brokerage offices located throughout the U.S. deal with such securities). For more information see Hirt & Block (1983, Chapter 2).

not meet the requirements of the established exchanges. The National Association of Securities Dealers trade on their automated quotation system known as NASDAQ (National Association of Securities Dealers Automated Quotation System) which links each other's operation through a system of computer networks. Firms that are eligible to be traded on NASDAQ must have at least 300 shareholders, with 100,000 shares outstanding and $1 million in assets.[2] The OTC market deals with smaller firms and the established stock exchanges deal with firms much larger than those required by NASDAQ.

Most of the Third World Countries, including the Muslim countries, do not have any significant secondary markets for securities. This is possibly because of the following: first, the development of an efficient secondary market requires frequent buying and selling of a large volume of securities in the open market; second, it requires well trained man-power and communication skills and equipment; and finally, it requires a thriving private enterprise system based on the participation of the general public, rather than that based on family or small enterprises. The primary market for securities also are at a nascent stage in most of the Third World Countries that allow private enterprise. More about this later in the paper.

B. *INVESTING IN STOCKS*

Stocks or share certificates can broadly be divided into two basic categories: *preferred stocks* and *common stocks*. Both provide ownership to the investor. However, the nature of ownership is different for the two. *Preferred stock* holders have claims on earnings and assets of the enterprise in which they invest, but, they cannot participate in the election of the board of directors of the enterprise and, hence, in the decision making process of the enterprise. Besides, the returns they receive on their investment is fixed per share[3] even though it is called a dividend. They have some advantage over the common stock holders. Dividends to preferred stockholders are given first. If after paying them any amount is left, then and only then can common stockholders receive dividends. If the enterprise fails in its operations and it needs to be liquidated claims of preferred stockholders' are met before those of the common stockholders.

Common stockholders have voting rights – i.e., they have the right to elect the board of directors, who in turn appoints the principal executives of the enterprise. Thus, through their voting rights, the common stockholders theoretically can control the operations of the enterprise and, in this sense,

---

[2] Ibid, page 34.

[3] . . .unless they own "participating preferred shares." In this case they receive the fixed rate of dividend plus they are entitled to share with the common stockholders the remaining dividend income to be distributed.

they are the real owners of the enterprise. After the fixed dividends whatever is left for distribution is shared among the shareholders.[4] Thus, at times of business prosperity the dividend income to common stockholders may be far larger than the fixed amounts received by the preferred shareholders. By the same token, in times of economic adversity the common shareholders may or may not receive much of any dividends. At this point, it should be remembered that when the enterprise has no after tax profit and, hence, nothing to give to the shareholders, it is not obliged to pay any dividend to either the preferred or the common stockholders. However, where a dividend is declared, the preferred shareholders are paid first.[5]

From the point of view of the investors common stock is more risky than the preferred stock. This is because the claims of the common stockholders on returns and assets come after those of the preferred stockholders. To the enterprise the least risky way of financing is through the issuance of common stock because it is not legally binding on the enterprise to pay dividends even when there is some net profit. More on these later when we talk about Islamic injunctions with regard to investment.

C. *INVESTING IN BONDS*

While stocks are an equity (ownership) instrument, bonds are a debt instrument. The corporations (companies, establishments, etc.) and the governmental agencies borrow funds by issuing bonds which are just I.O.U.'s. The bondholders have no ownership right but have the first claim on the assets of the borrowing enterprise, in case of business failures. In most countries creditors have the first payments in the form of interest income. They do not share in the enterprise's prosperity. All they get back at the maturity of the bond is the face value of the bond.

The returns from the investment in bonds is usually referred to as *yield*. *Yield* includes the periodic interest payments plus the amount saved at the time of the purchase of the bond. Bonds are usually sold at a discount–i.e., sold at a price which is lower than the face value which is the principal amount that is returned at the time of maturity.

Bonds can be classified into various categories, but the ones that are most relevant for this study are the classifications of *mortgage bonds* and *debenture bonds*. Mortgage bonds are secured by specific real assets. If the issuer of the bond fails to repay the loan amounts, these properties then can be liquidated for satisfying their claims. Debenture bonds, on the other hand, are not backed by any specific collateral of the enterprise. In case of liquidation,

---

[4] The terms *stockholders* and *shareholders* are used interchangeably throughout this paper.

[5] If the security is "cumulative preferred stock," the shareholder receives the dividend for the current period as well as dividends for the prior periods that were missed.

the claims of debenture bondholders are entertained only after meeting the claims of mortgage bondholders. Then comes the claims of the preferred stockholders and finally, those of the common shareholders. Thus, in terms of security to an investor, the most attractive form of investment is mortgage bonds, followed by debenture bonds, preferred stocks and common stocks. In terms of security to the enterprise, the most risky way of financing is through mortgage bonds, and the least is through common stock.

It may be useful here to discuss briefly two other features of bond issues, namely *callable* bonds and *convertible* bonds. Callable bonds are those which can be retired by the bond issuer before their maturity. At the time of bond issue it is specified after what time period the issuer can ask the investors to return the bonds for repayment and at what *call premium*. Callable bonds are usually issued at times when interest rates are high and the issuer believes that interest rates would come down in the foreseeable future. Since the call feature is advantageous to the issuer in that it can reissue a new series of bond at a lower cost, the issuer has to pay a *premium* or a percentage of interest to the original investor for this privelege.

Convertible bonds are those bonds which can be converted to commonstocks at an agreed upon rate of conversion. For example, for every bond worth, let us say, $1,000, the bondholder can receive 100 shares, at an implied price of $10/share. It is the bondholder who decides when to convert his bond to stocks. In this example of a convertible bond, the bondholder may decide to convert his bond into common stocks when the market price of the stock is above $10.

D. *INVESTING IN OPTIONS, WARRANTS AND RIGHTS*

An *option* for common stocks is a right to buy or sell 100 shares of a common stock at a specified price (called the *exercise price*) within a specific time period (now standardized to three, six and nine months) for which the writer of the option receives an option price (called *premium*) which is a fraction of the cost of the stock. Options for common stocks can be divided into two broad categories: (1) call and (2) put option. A *call option* is the right to buy 100 shares while the *put option* is the right to sell that many shares. The writer of an option, usually a dealer initiates a *call* or *put* option and tries to find an investor, a hedger or a speculator to take the other side of the option. The writer of the option receives a premium which can be as low as ¼ – i.e, $.025/share (or, $25 for 100 shares) or $25 for an option, or as much as one-third the market price of a stock or higher. The buyer of the *call* option will exercise his option if the market price rises above the exercise price plus the premium cost. Until the buyer of the option exercises his right, the common stocks remain in the possession of the seller. The seller continues to receive the dividend income until the buyer has exercised his

option. The corporation which originally issued the stocks need not even know that its stocks are now traded in the options exhanges. The writer of a *put* option expects that the market price will not go above the exercise price so that the buyer would not exercise his option. If the option is not exercised, the premium is still for the writer to keep. As a matter of fact, roughly fifty percent of the options are never exercised, resulting in a hefty unearned income for their writers in the form of premiums collected.

Trading in *options* has become popular for a number of reasons. Buying an option requires a fraction of the money required to buy the underlying stocks. Thus, the investors who do not have enough funds to invest or who do not want to tie up large sums of money in the stock market without being sure about the future directions of the market, can still have control over a large number of stocks (for each option 100 common stocks). If the market price moves in the right direction, they can easily exercise their option and buy the stocks with their own funds or partly borrowed funds, and then sell them in the market and pick up the difference as gross profit. If the market price moves in unfavorable directions, they simply do not exercise the option and forefeit the premium money paid. The loss due to premium money is usually far less than if its investors actually owned the stocks and had to sell at a lower price than the purchase price.

Options are increasingly being used by speculators as a hedging device against open positions in stocks or, in the futures markets. An example of hedging with options is that of a *short seller*[6] who must buy back the *stocks sold* short within a short period of time. Usually, the investor *sells* stocks *short* in anticipation of lower prices in the future. But there is no guarantee the price of the underlying stock will go down within the expected time period. If the stock price goes up at the time the owner of the stock, whose shares were shorted, demands his stocks, the speculator must deliver them, buying back from the market at a higher price and incurring a loss to himself. The *short seller* can go to the option market and buy options to cover the *short sell*. if the anticipated price changes do not take place, he can exercise the option and return the stocks to the broker. If the price moves in the right direc-

---

[6] "Selling short" means selling a stock that one does not own. An investor can borrow stocks from his brokers which may belong to a third party and sell them to another investor in anticipation that the price of the stock will come down soon and he will be able to buy back the number of stocks in the open market at a cheaper price. The difference between the selling price and the purchase price represents the *markup* (gross profit) which is then shared between the broker and the investor (i.e., the investor who borrowed the stock.). Short selling is done for a number of reasons, prominant among which is to save taxes during a given tax year. For a detailed explanation of *short-selling against the box* or *short selling as a means of hedging* see Fischer & Jordan 1979, ch.2).

tion, he simply does not exercise the option. The money lost through the option premium is more than made up by the decline in the price of the stock.[7] Whether or not *options* are a legitimate instrument of investment for the Muslims will be taken up for discussion later in the paper.

Like options, *warrants* also give the right to the *warrant* holders to buy a specific number of common stock at a specified price at any time during the life term of the warrant. The buyer of the warrant pays a *premium* (or *warrant price*) to the seller. The premium is a fraction of the market price of the underlying stock. Similarities between *options* and *warrant*, however, end right here. Unlike options, warrants are usually a longer term security instrument: with an usual life term of 2 years; but at times it can be of longer duration, including an indefinite period. Warrants are issued by the companies issuing the stocks, and not by any security dealers. When the warrants are exercised – i.e., the investors buy the underlying common stocks – the money goes directly to the companies issuing the stocks, thereby adding to its capital stock which can then be utilized in real economic assets.[8]

Warrants are generally issued by corporations as "sweeteners" for bond (or common stock) issues so that the investors have an added reason to buy the bonds (or the common stocks). Warrants are called "sweeteners" because they are of significant value when the bond prices rise, as expected, over time. The warrant holder then exercises his warrant at the exercise price and receives the number of bonds or stocks specified under the warrant *agreement*. Like an option, a warrant gives the investor a command over a number of stocks without requiring a substantial amount of initial investment. The warrant holder like the option buyer, has neither the voting rights nor does he receive any dividend or interest income. The warrants are attractive to the issuing companies because they not only help in marketing the underlying securities, but also to generate additional funds through *warrant premium* for which they do not have to incur any additional expenses in the form of interest or dividend.

There is another kind of option related to sale of common stocks, known as *rights* or *preemptive rights*. These instruments are very short term in nature with maturity dates for 30, 60, or 90 days. The *rights* are issued to the existing shareholders by the company issuing stocks, usually at a favorable price.[9] This is done to ensure that the existing shareholders are given the first opportunity to buy new issues to avoid further dilution of ownership of the enterprise. Only if the existing shareholders do not exercise their *preemptive rights*

---

[7] For a more detailed explanation of the use of options in the stock market the reader is advised to see L. Chavez (October 24, 1982, page F 17).

[8] For further details on this see R.K. Reilly, (1982, Ch. 17)

[9] For more information about *rights* or *preemptive rights* see J.B. Cohen, E.D. Zinbarg, et al., (1977, Ch 11).

in the enterprise in question then free to float the new stock issues in the market. Like warrants, there are no middlemen involved in *rights*. Unlike warrants and options, rights (or preemptive rights) do not have a secondary market and, as such, are not available to all investors.

II. ISLAM AND INVESTMENT

The Muslim jurists contend that all economic activities, except those prohibited by the *Shari'ah*, are permissible under Islam.[10] Muslims are encouraged to seek economic bounties which God has made available to them. They are encouraged to work for a living and have been told to cooperate with each other. God has not endowed every man with all the skill, knowledge and material resources needed to survive and excel in this world. Different individuals have been bestowed with different resources so that they cooperate with each other as a single body to achieve their economic goals.[11] It is because of the need for cooperation in economic activities that Ibn Qayyim urges that the act of *Fuduli* (i.e., when a person does something to foster the interest of another person without the latter's prior consent) be compensated and promoted.[12]) Iby Qayyim argues that if *Fuduli* is not compensated, many just and appropriate voluntary acts simply will not be performed and, as such, potential economic benefits to the society will be wasted.

This particular aspect of cooperation (i.e., *Fuduli*) is important in the context of investment in stocks where the investor provides part of the capital to the business and elects the board of directors (in the case of investors in common stocks, who are the only ones with voting rights) who are entrusted to make policy decisions on behalf of the shareholders. The board of directors and their appointee – the management–together run the day to day business which can be termed as *Fuduli* for the investors.

As far as the corporate form of business is concerned, where a group of individuals contribute to the overall financial capital of the business, but where not all participate directly in running the business, it seems there are a number of precedents dating back to the time of the Prophet (PBUH) in which some forms of trade came close to that of a corporation. Here we refer to *Qirad*

---

[10] Ibn Taimiyah, Ibn Qayyim and the other great thinkers of Islam have profound discourses on this subject, For their works see references.

[11] The importance of cooperation in economic activities has been emphasized by Muslim thinkers among whom is Ibn Qayyim, whose contribution is significant. See Ibn Qayyim's *shifa Al Alid* (pp. 489-90).

[12] For a detailed discussion of the view of Ibn Qiyyim on this subject see the reference in footnote 11 and the discussion by Islahi, (1982, pp. 10-16).

(which, linguistically, is similar to *Mudarabah*). *Qirad* was widely practised during the pre-Islamic period and it seems it was also practised by many companions of the Prophet (PBUH). The Prophet (PBUH) approved the form of *Qirad* that was in vogue during his time. Subsequent Muslim jurists tried to differentiate between different types of *Qirad*, and argued about which ones were permissible and which ones were not. Modern Muslim thinkers seem to approve of *Qirad* as a legitimate form of economic cooperation for the Muslims.[13]

It may be worthwhile here to briefly outline the nature of cooperation between the investors, board of directors, management, and the workers of the enterprise on the one hand and the consumers of the products or services on the other, in an industrialized country like the United States. Here the ordinary workers, management personnel, the board of directors, and the consumers all may own stocks and/or bonds of the various corporations they come in contact with one way or the other. It is not unusual for the workers of a corporation to invest in the stocks and/or bonds of that corporation with their savings. Some workers receive bonuses from the corporation in the form of stocks. This is especially true for the upper level executives, who often own a sizeable amount of corporate stock the companies where they work. Similarly, the board of directors often own sizeable percentages of corporate stock in companies in which they are directors. Ordinary consumers, who are not directly related to the corporation in question but often buy its products for their use, invest in the stocks and/or bonds of such corporations. Thus, it is difficult, if not impossible to isolate each factor of production so that one can judge whether or not the cooperation between them can be categorized under the traditional categories of *Qirad* or *Shirakat*.[14] The modern economic institutions often are so different from the ones in existence in the earlier centureis of Islam that an attempt at comparison of the two is an exercise in futility.

Fairness and social justice in economic activities have been the principal criteria for judging whether or not a particular form of economic activity is acceptable to Islam. Muslim jurists quote a number of traditions of the Prophet (PBUH)[15] which indicate that the state should take an active role in main-

---

[13] Abu Saud (Saud, 1980, pp. 59-84) discusses in detail the various views of the jursits regarding Qirad or Mudarabah. The reader's attention is drawn to this excellent paper. For another treatise on *Mudarabah* see Afzal-ur-Rahman (1974, pages 212-223), Yusuf, (1971, pages 32-39), Hamilton, (1975, pages 217-231), and Siddiqi (1972, page 139),

[14] Some Muslim jurists classify cooperation under four broad categories: (1) *Shirkat-al-Mufawadha*, (2) *Shirkat-al-Anan*, (3) *Shirkat-al-Sanai*, and (4) *Shirkat-al-Wajooh* (see Afzal-ur-Rahman, 1974, pages 218-219).

[15] Ibn Taimiyah, Ibn Qayyim, Ibn Khaldun and the other Muslim scholars devoted significant passages to the question of the role of the state in ensuring fairness of price and distribution of income in a Muslim state. See A.A. Islahi (1980 & 1982) and M.N. Siddiqi (1982).

taining prices for products and services and in ensuring equitable distribution of the economic resources. Thus, we find that the permissible forms of *Qirad* or *Mudarabah* or *Shirakat* are those where each contributor to the enterprise receives shares of gains and losses in direct proportion to his/her contribution. To ensure fairness and to prevent impropriety the state monitors and regulates practically every aspect of dealings in securities in the United States. The Securities and Exchange Commission (SEC), a government regulatory agency, is responsible for ensuring that securities' prices are not manipulated by those who work for the corporations issuing them or the brokers and the dealers who may work on their behalf or on behalf of other parties with vested interests. Corporations and agencies issuing securities have to comply with various "disclosure" requirements, so that pertinent information regarding the operation of the business are not hidden from the purview of the potential investors. Corporate executives, who receive stocks as bonuses, are not free to sell their stocks in the open market at any time – specific laws prevent them from taking advantage over others; the securities dealers are required to intervene, at times, to stabilize the market in particular securities.[16] The result is that the securities markets not only operate efficiently, but also are relatively free of large scale schemes of fraud and irregularities[17] unlike in some of the Third World Countries. The recent debacle of the Kuwaiti stock market [18] should serve as an example of an economy where the government failed to create proper institutions to safeguard the interests of all parties engaged in a large scale cooperative venture.

Properly and adequately regulated markets for securities, combined with the general participation of the investors, workers, management, policy makers, (the board of directors) and the consumers, seem to make investment in the stocks of U.S. corporations a permissible form of busienss (i.e., trade) from the Islamic point of view. Let us now elaborate on this statement.

In section I we tried to explain the differences between *preferred* and *common* stocks. Preferred stockholders receive a fixed rate of dividends on their

---

16 *Specialists* in the stock exchanges act as market makers. Each *specialist* deals only with a few stocks of which they maintain large inventories. They intervene by selling from their inventories or by buying (and then adding to their inventories) particular stocks, if the market conditions demand so. For further details on this see Fischer & Jordan (1979, Ch. 2).

17 It is true that one hears from time to time of individual cases of fraud and irregularities in dealings with securities in the U.S. These are isolated cases. Those who engage in such activities often end up paying heavy penalties in the form of court imposed sentences and a permanent loss of customers' trust.

18 See Peter Truell's article entitled "The Party's All Over for Kuwaiti Traders. . ." in *The Wall Street Journal* (December 2, 1982, page 1 & 18) and "Souk the Lot" in *The Economist* (December 4, 1982, page 86).

holdings. There is no qualitative difference between a fixed rate for a dividend and an interest payment. Both are fixed percentages of the amounts invested. Since Muslim jurists, in general, consider interest as usurous (*al-Riba*), dealing with *preferred* stocks is tantamount to dealing with interest. It is true that there is some difference between the dividend of a *preferred* stock and interest received on loan. The former is not guaranteed—i.e., the corporations are not required to pay dividends when they do not have net profits to pay dividends—while interest payments are a fixed obligation and must be paid whether or not there is any net profits. In case of a business liquidation, preferred stocks may or may not receive back their investment money because the first claim on the assets of the business are by the lenders (i.e., those who invested in *debt* securities like bonds and notes). Despite the possibility that the *preferred* stock, holders may share in both profits and losses of the enterprise, the fixed nature of the dividends, make their investment income akin to usury. Given the Quranic injunctions against usury, it is desirable to avoid investing in *preferred* stocks. To quote the Holy Quran:

> "Those who swallow usury cannot rise up save as he riseth whom the devil hath prostrated by (his) touch. That is because they say: Trade is just like usury; whereas God permitteth trading and forbiddeth usury. He unto whom an admonition from his Lord cometh, and (he) refraineth (in obedience thereto), he shall keep (the profits of) that which is past, and his affair (henceforth) is with God. As for him who returneth (to usury)—such are rightful owners of the Fire. They will abide therein."
>
> (The Quran, Chapter II, *Al-Baqara*, verse 275).

also,

> "O ye who believe! Observe your duty to God, and give up what remaineth (due to you) from usury, if ye are (in truth) believers. And if ye do not, then be warned of war (against you) from God and His messenger. And if ye repent, then ye have your principal. Wrong not, and ye shall not be wronged.
>
> (The Quran, Chapter II, Al-Baqara, verses 278 and 279).

The Muslim thinkers like Ibn Qayyim, argue that both open (*jali*) and disguised (*khafi*) usury are prohibited in Islam.[19] Dividend income from *preferred* stocks is more of an open (*jali*) form of usury (*riba*) and, as such, investment in this form of security should be avoided by the Muslims.

Investment in *common* stocks appears to be free from the above objection that was raised about *preferred* stocks. The return on *common* stocks (the *divi-*

---

[19] For details on this topic see Islahi (1982, pp. 27-29).

dend) is neither fixed nor guaranteed. In case of business failure the *common* stockholders are the last ones in the list of claimants on its assets. Their dividend income rises with prosperity and declines with economic adversity, the prices of their stocks fluctuate in the market, depending on how the business performs in the market.[20] Moreover, the investors of the *common* stocks have some say in how the corporation is run through their voting power, even if they are not in it's employ. They come close to fulfilling the principles of permissible *Qirad*, which we discussed earlier.

Returns from an investment in a bond generally come from two sources: (1) the size of the discount at the time of the purchase of the bond (bonds are usually sold at a price lower than the face value – i.e., the value of the bond at maturity) and (2) the periodic interest payment based on the coupon rate (i.e., the fixed percentage of the face value of the bond). The first source of earning depends on various factors not completely controlled by either of the two parties – i.e., the issuer of the bond and the buyer of the bond. The price is determined by the market forces as in normal trade. This source, therefore, is a legitimate source of earning according to basic principles of trade in Islam. The second source of earning – i.e., the interest income – however, is fixed and predetermined and, as such, cannot be acceptable to practising Muslims. Moreover, bond is a debt instrument to the issuer and, thus, a fixed obligation. The bondholder, (not being a shareholder) does not share the losses of the debtor, the corporation. The bondholder can force the liquidation of the corporation to recover his investment according to the laws of the land. Because of these features, investment in bonds does not seem to be appropriate for Muslims.[21]

Investment in options is purely speculative. Whether or not the writers or the buyers of the options gain or lose is of little consequence to the issuer of the underlying stocks. The buyers and the sellers of the options are not necessarily part of the shareholders of the corporation[22] and, as such, may not be participating in any way in the running of the underlying corporation. They are essentially betting on the expected performance of the corporation in very much the same way gamblers bet on horses in horse racing. There is a difference between the two, however. In the *option* case, the gainer and

---

[20] This is true for an efficient but regulated market for securities. The case of the Kuwaiti stock market was the opposite.

[21] It is possible to design a debt instrument in such a way that there are no fixed returns and that the creditor as well as the debtor shares the gains and losses from the operation of the business.

[22] The writer of the *put option* (i.e., the seller of the option) may not necessarily own the underlying stocks for which he/she is writing the option(s). He/she can make some sort of standby arrangement with dealer to deliver the option(s) in case the buyer of the *option(s)* exercises his/her option(s).

the loser are the investors themselves, not the corporation. Because of striking similarities between options and gambling, it appears that the Muslim investors should refrain from investing in *options*.

Unlike options, *warrants* and *rights* are directly issued by the corporations to their shareholders. The *premiums* paid by investors on *warrants*[23] go to the corporation issuing them. Again when they are exercised, the payments made for the underlying stocks go directly to the corporate coffer. There is a secondary market for warrants like that of *options*. When the warrants are exercised, the stocks come from the corporation issuing them; when an option is exercised the *stocks* come from another investor, and *not* from the corporation. Because of some linkage between the warrant holder and the corporation, one can possibly argue that investment in *warrants* is perhaps permissible for the Muslims. If, however, the only way to invest in *warrants* is through the purchase of *bonds* from the corporation, then they should also be avoided by the concerned Muslims.

III. SUMMARY AND CONCLUSION

This paper summarized the nature and the operation of the *primary* and the *secondary* markets for securities, in the U.S. It explained the nature of returns from such investments as *preferred stocks, common stocks, bonds, options, warrants,* and *rights*, and the extent of involvement and cooperation between the investors and the issuers in the decision making process of the enterprises concerned. It then outlined the nature of *Mudarabah*, or *Qirad* (or *Shirakat*) in Islam and tried to show why the cooperation between the various factors of production, including financial capital, in a modern corporate form of business is not qualitatively much different from the types of *Qirad* permitted under Islam.

The remaining portion of the paper explained why investment in certain forms of securities of modern corporations may not be permissible under Islam. It showed that investments in *preferred* stocks, *bonds*, and *options* may not be allowed by Islam because the returns from them are either fixed, and hence, very much like *riba*, or akin to that of gambling, which is also prohibited under Islam. Further, the paper showed that investment in *common stocks* is permissible, and that in the case of warrants it may also be permissible provided *warrants* are not part of *bond* issues.

In the light of the discussion of this paper, the Muslim governments may

---

[23] The rights are issued to the corporate employees and the existing shareholders at no cost to them. In fact, most rights allow the employees or the shareholders to buy the company's stock at a favorable price (often, lower than the market price of the stock).

consider some changes with respect to issuance of bonds, and preferred stocks. The returns from these should be made variable and ways must be found to share the gains as well as the losses between the borrowers and the lenders (i.e., the investors). *Options* should be banned altogether. This sort of investment activity Muslims can do without.

REFERENCES

Abu-Sulayman, A.A., 1976. "The Theory of the Economics of Islam," in *Contemporary Aspects of Economic Thinking in Islam*, Indianapolis: American Trust Publications, pp. 9-54.

Afzal-ur-Rahman, 1974. *Economic Doctrines of Islam*, Vol. I, Lahore, Pakistan: Islamic Publications Ltd.

Chavez, L., " Balancing Risk and Reward in Options," in *The New York Times*, Sunday, October 24, 1982, page F 17.

Cohen, J.B., E.D. Zinbarg, and A. Zeikel, 1977. *Investment Analysis and Porfolio Management* (Third Edition), Homewood, Illinois: Richard D. Irwin, Inc.

Fischer, D.E., and R.J. Jordan, 1979. *Security Analysis and Portfolio Management* (Second Edition). Englewood Cliffs, New Jersey: Prentice-Hall, Inc.

Ghanameh, A., 1976. "The Interestless Economy," in *Contemporary Aspects of Economic Thinking in Islam*, Indianapolis: American Trust Publications, pp. 61-71.

Hamilton, Charles, 1975. *The Hedaya*: or Guide—A Commentary on the Mussalman Laws, Lahore, Pakistan: Premier Book House.

Hirt, G.A., and S.B. Block, 1983. *Fundamentals of Investment Management and Strategy*. Homeward, Illinois: Richard D. Irwin, Inc.

Islahi, A.A., 1982. Economic Thoughts of Ibn Qayyim. A research paper, The International Centre for Researach on Islamic Economics, King Abdulaziz University, Jeffah, Saudi Arabia.

Islahi, A.A., 1980. *Economic Views of Ibn Taimiyah*, A Ph.D. thesis submitted to the Department of Economics, Aligarh Muslim University.

Qayyim, Ibn, 1975. *Shifa 'Al 'Alil*, Cairo: Maktabah Dar al Turath.

Reilly, F.K., 1982. *Investments*, Chicago: The Dryden Press.

Saud, M.A., 1980. "Money, Interest and Qirad," in *Studies in Islamic Economics*, edited by K. Ahmad, Jeddah: International Centre for Research in Islamic Economics, King Abdulaziz University, and London, U.K., The Islamic Foundation, Chapter Four, pp. 59-84.

Siddiqi, M.N., 1982. *Recent Works on History of Economic Thought in Islam—A Review*, a memeographed research paper of The International Centre for Research in Islamic Economics, King Abdulaziz University, Jeddah. Saudi Arabia.

Siddiqi, M.N., 1972. *The Economic Enterprise in Islam*, Lahore, Pakistan: Islamic Publications, Ltd.

The Economist, "Kuwait Stock Markets: Souk the Lot," December 4, 1982, page 86.

Truell, P., "The Party's All Over for Kuwaiti Traders; Country Still Reels," in *The Wall Street Journal*, Thursday, December 2, 1982, pages 1 and 18.

Yusuf, S.M. 1971. *Economic Justice in Islam*, Lahore, Pakistan: Sh. Muhammad Ashraf.