Seif el-Din Ibrahim Tag el-Din

Characterizing the Stock-Exchange from an Islamic Perspective

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Comments:

MOHAMMED AKACEM

Professor of Economics, Department of Economics, Metropolitan State College, Boulder, Colorado, U.S.A.

Mr. El-Din's article looks at an Islamic alternative to what he calls the Contemporary Stock Exchange and argues for regulatory measures to make sure that the stock market operates "efficiently". He argues that there is not enough information for people to make the right decisions, which is contrary to "Islamic rules".

However, the author does not offer solid evidence to substantiate his claim that the Contemporary Stock Exchange (CSE) is somehow inefficient. In fact, the author's two Shari'ah restraints are already met in the CSE. The average investor has access to all kinds of information – most of which is free – via the World Wide Web, financial news networks, newspapers and other sources. In fact, with the vast choices available to the average investor particularly with mutual funds, there is little-if any- need to do any research on the companies involved. Moreover, an investor can "park" his money in an indexed fund and never have to look up financial information on any company. The investor's portfolio is well diversified and as long as the companies represented in the fund are not engaged in non-Islamic economic activities, such funds could offer an avenue for safe investing.

Contrary to the author's claim (page 32) that "modern stock markets are mainly dominated by corporate shares and bonds to a lesser extent", it is in fact just the opposite. Bond trading and volume are by far much larger than that of stocks (by a significant multiple). Moreover, the stock market is not always used to finance "ambitiously large projects". In fact many start up companies (particularly in the high tech industry) do not require large amounts of capital to begin with.
It is not clear that the second part of the paper is needed to make the author's point that the Islamic alternative is superior to the CSE market. However, in it he makes a few points that do not support his case. First, while buying a share is not like buying a commodity, it is still close. The investor is buying an equity stake in a company that produces goods that do satisfy someone's consumption motive. If the author's argument is true (page 35) then it can be used against his Islamic alternative.

Second, the author goes on to propose a "pre-emptive right" option for existing shareholders. I respectfully disagree with both the author and Khayat's view that such rights are needed to make stock market consistent with Sharia. Furthermore, why should an existing shareholder that buys the same stock (which is different from the preferred vs common stocks) have more rights over a future stockholder? They both are buying claims on the same company. Not only would this add confusion to the buying and selling of shares, it would certainly curtail the growth of the market as the author correctly points out.

Third, the issue of Gharar is not applied appropriately to the trading of shares. The author relies on the assumption that the buyer does not know what he is buying or what the share stands for. All evidence points to the opposite. Individual investors do have enough information on the shares that they buy and the stock market can hardly be compared to gambling. A well-known host of a weekly PBS program on the stock market in the United States, Mr. Louis Rukeyser, once stated that "what the small investor has going for him is the stupidity of the large investor" (1).

Given that it is more likely that large (educated) investors are more likely to over-react since they have larger positions to protect, the theory that lays blame on the "naive" masses does not hold. Again, using the author's second Shari'ah restraint, large investors make mistakes just as many times as-if not more than-the small investor despite the fact that they-according to the author-should have access to more information. An excellent example is the failure and subsequent bailout (to the tune of $3.5 billion) of Long Term Capital of Connecticut. The firm had two Nobel laureates and a hand-full of experts and yet accumulated huge losses by misjudging the market. The use of the word "naive" is unfortunate. People from all walks of life; educated and uneducated make money in the stock market. Blaming the "naive" masses for the "unexplained ups and downs of share prices" is inaccurate. The author offers no evidence to support this claim and moreover fundamentals, new information or some other factors can explain the ups and downs of share prices.

It is not clear that "naive" investors often times react to irrelevant information. What is "irrelevant" information? Any information that affects the market is by definition relevant. Moreover, the best in Wall Street who undertake sophisticated fundamental analysis to determine if a stock is over or under priced, sometimes get it

(1) The quote is as close as I can recall it but it essentially underlines the fact that small investors do know what they are doing and even better than the large investor that may react to "rumors" and other information.
wrong. How does one know or regulate what is deemed relevant information. Do we really want to do this? I do not think so. The goal is not to protect investors from themselves. That is not the role of markets even in an Islamic economy. Stock market investors – educated or not – know the risk when they enter such markets.

To conclude, the Shari’ah restraints are not needed to guard against Gharar. Not only are the two conditions already met by the CSE market, it is not clear why the author assumes that somehow investors do not have accurate information. If they don’t, then they should not be in the market. However, no rational investor enters the market to lose money. Every investor enters the market to make money and thus we can conclude that he will have enough information that will enable him to execute his trades.

Too much emphasis is placed on speculative transactions as if all of the market participants are speculators. The controls that the author proposes will not work and are based on his assertion that the present market does not work well. It would be a nightmare to try to administer and enforce the different rules. The most extreme is the one that relates to the "behavioral norms" that would govern shareholders. This would have investors hold longer positions. This assumes that every shareholder is of the same age, has the same risk tolerance and has the same outlook in terms of the future performance of a given stock. We know that this is not the case.

In conclusion, the present CSE market has all the safeguards that one needs. These safeguards, however, are not intended to protect investors from losing money. Instead, they simply ensure that companies disclose ALL of the information available to them before they issue a stock or a security. The Securities and Exchange Commission in the United States does this. All an Islamic alternative needs is an agency similar to the SEC to ensure that market participants have the information they need and to prevent anyone from profiting from inside information (which is illegal). The rest is up to investors.