Comments of

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on

Reviewing the Concept of Shares: Towards a Dynamic Legal Perspective

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The author discussed several issues regarding shares trading in Islamic finance. The issues discussed include the permissibility of shares trading and whether shares are assets backed instruments or rather "a bundle of right". The author also touched on the possibility of trading shares based on the concept of sale of right in Islamic law. He is of the opinion that Sharīʿah scholars should consider the changes in the UK legal system and change the *fatwas* in Islamic law accordingly based on the assumption it is a valid ʿ*urf*. He has also elaborated on the evolution of the concept of shares in the English legal system.

Moreover, the author addressed the criteria for creating an Islamic share index whereas he outlined the criteria used by the FTSE Islamic index and the permissibility of investing in Western stock market and companies own by non-Muslim. He also addressed the cash and asset ratio in screening of companies, the debt equity ratio, and the non-permissible ratio.

In many of the issues raised, the Sharīʿah investigation seems to be shallow and some based on a misunderstanding of some basic Sharīʿah principles. Before, commenting on these issues, we would like to mention some general observations on this paper

General Observations

- We have to applaud the author courage in addressing this complicated issues and pointing out to some of the shortcomings of the Sharīʿah scholars' discussions on the concept of shares or the formulation of an Islamic index.
- In many instances, the author is referring to the opinion of some early scholars without proper references. (see for instance, p.3; p12; p.13, 18)
- Generally, reference to classical Muslim jurists' works is made through secondary sources. (see for instance, p.12; p14; p.15)

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- The author discussion in the area of developing Islamic index is largely limited to the criteria adopted by the FTSE Islamic Index which is only part of the reality and an omission of some other important experiences.
- The paper would have been more fruitful if the writer referred to the legal position of other countries than the UK especially the legal system of some Muslim countries in his discussion of the concept of shares.
- Despite the fact that the author defined the objective of his paper at analyzing the theoretical discussion regarding the conflicting views prevailing among Muslim jurists regarding the permissibility in shares(p.2), he referred only to a handful of researches that addressed the concept of share from an Islamic perceptive, many important works on the issue are left out.

After these general observations let us turn now to the particular issues discussed by the author in his paper.

Islamic law is not dependent on English Law

One the flagrant mistake of the author in the entire structure of the paper is the assumption that there is a change in the concept of share in the English system and therefore, Islamic law must follow these developments. The author advanced the following reasons to support his argument:

1. "What is very important to understand is that it is not easy to develop Islamic model outside the secular law" (p.3).
2. "The legal position in the UK is that shares represent an entitlement of a bundle of rights. Thus, there is a shift from ownership toward shouldering the liability risk of the companies… hence Muslim will have to reconsider how to implement Sharīʿah within a volatile legal system" (p.1).
3. "The British legal position should be understood in order to make any discourse analysis of the *fatāwas* issued regarding the status of shares in Sharīʿah " (p.8).
4. "This discussion should be analyzed in the light of British Law because the law of the land that prevail"
5. "Law can change any time but some Islamic principles are immutable. This dichotomy of secular and Islamic legal system needs further debate as there is more dependence of Islamic finance over secular law this an area that need further attention. If secular law is accepted as *ʿurf* (customs), then there must be *sharṭ* (condition) to make it strong *ʿurf* due to the dynamism in the commercial world." (25).

The above quotations are clear enough to demonstrate the shaky foundations of the paper and the assumptions analyzed. The author wants to tell us that it is not easy to develop an Islamic model outside the secular law. This is because the British Law is the law that prevails and Islamic finance is dependent over secular law. Therefore, we have to understand Islam in light of the British law and this the

only way to get rid of the dichotomy of secular and Islamic legal system. To implement these proposal while maintaining some Islamic flavour let us consider the British law as a strong '*ʿurf* that is applicable without any problem.

The above passages of the paper show the author lack misunderstanding of what is Islamic law. The Sharīʿah has never been dependent to secular law and will not be. Yet, Islamic law is open to other systems including the British law and accept whatever rational wise and beneficial provided that it does not contradict any Islamic principle. Therefore, the *fatwā* would not change in Islamic law just because there is a new concept of the limited liability company in the British law. Moreover, no Muslim scholar has considered the British as an *ʿurf* whether it is week or strong so that Islamic law should change accordingly. Indeed *ʿurf* is recognized as a secondary source of Islamic law. However, for a valid there are several conditions that shall be taken into consideration.[1]

Development of the concept of shares in UK legal system

The author acknowledged that the concept of share has gone through a long process and phases whereby the concept of legal persona of company was introduced the 17th century to boost the expansion of the British economy. Originally, according the author, "shares were considered as a pro rata ownership of the asset of the company" (p.4). It is only in 1897 that the House of Lord gave its seminal judgement in the *Solmon v/s Solmon Limited* decided that the shareholders are different persons from the company. Further evolution took place since and corporate law becomes one of the most amended laws due to the intricacies associated with the legal personality of company created by subscription of shares. However, the author did not elaborate on the reasons behind the change in this concept.

The author maintained that the concept of shares is no longer a *pro rata* ownership in the assets of listed companies as reflected in most *fatāwas*. The legal position in the UK legal system nowadays according the author is that shares represent an entitlement to a bundle of right. Thus the concept of shares has moved from real rights (a tangible asset) towards personal rights (an intangible asset).

However, this conclusion is unacceptable based on the following and from the paper itself:

> *British Law, as quoted by the author does consider share as a property of a sui generis nature. Section 107 of the insolvency Act 1986 provides: "Subject to the provision of this Act as to preferential payments, the company property in a voluntary winding up shall be applied in satisfaction of the company's liability pari passu and subject to that application, shall unless*

[1] See, Mohammed Hashim Kamali, *Principles of Islamic Jurisprudence* Ilmiah Publishers second revised Edition 2000, pp. 283-296.

the article otherwise provide) be distributed among the members according to their rights and interest in the company" (italic added) (p.15)

This a clear provision that the British law consider shares as asset based.

The author admitted that most listed company does provide that share holders will be entitled to residual asset and this will confirm that share are asset backed. (p.16)

Confronted by the above clear provision the author argues that "Prima facie this provision seems to make a share asset –backed. But one has to look at reality and not only at the words of the law." (p.15)

It can be argued that if the author wants to tell us that the words of the British law are not in touch with reality, then let us change the British law first before advocating any change in the principles of Islamic law.

Ironically the author write toward the end of his paper (p.23) "

Moreover, the author admitted that"

- "It can be argued still that in case of voluntary liquidation there may an asset". (12)
- In another place he stated the following ″on an accounting point of view shares are considered as an asset for shareholders."
- Moreover, one of the rights the shareholders are entitled to, as listed by the author is that "on liquidation of the company or in reduction of a capital the right to receive assets distributed to shareholders of that class".

The Concept of Share

If the author has referred to the different studies on the issue of shares or at least the major papers specially those from Sharīʿah perspective, he would have done a great job. It not enough to refer to a handful of works and conclude that "there is no consensus on the permissibility of shares trading" or "there is still conflicting view" (p.3).

Even the few the papers he referred to, seem not to support his conclusion. Thus, if we refer to the writing of the scholars quoted by the author we may come across an apposite finding. For instance, Sheikh Taqi Usmani, one the scholars quoted by the author on the difference of opinion among Muslim scholars and the non-permissibility of shares trading Sheikh Taqi states the following: "the Contemporary Sharīʿah experts are almost unanimous that if all the transactions of a company are in full conformity with Sharīʿah, which include that the company neither borrows money on interest nor keeps its surplus in a interest bearing

account, its shares can be purchased, held and sold without any hindrance from Sharīʿah side".[2]

The author also referred to Sheikh Nizam Yaqubi discussion on the issue and concluded that "still one can see that conflicting views still persist" (p.3). However, Sheikh Nizam's paper and from its title is clearly confined to a very specific issue and it is not about permissibility of shares trading *per se:* the paper was entitled "Participation and Trading in Equities of Companies which Main Business is Primarily Lawful But Fraught with Some Prohibited Transactions"[3] therefore the differences of opinion here is due to the involvement of prohibited transaction and not because of a difference of opinion over the concept of share.

It is true that a limited objection to shares trading among contemporary Muslim scholars have been reported when the issue was for the first time discussed, decades ago. However, it is no longer a point of differences of opinion today as stated by Sheikh Taqi Usmani.

It is clear from the above that the author literature review on the issue suffers from several limitations.

To give the reader a better understanding about the discussion on the concept of shares and shares trading, from Sharīʿah perspective, in this short comment we will try to refer to the discussions at the Islamic Fiqh Academy of the Organization of Islamic Conference and its resolutions which are the most authoritative resolutions with regard to Islamic finance and the largely followed resolutions by Islamic financial institutions. We also refer to the Standard on Shares by the Accounting and Auditing Organization of Islamic Financial Institutions as these standards are reflecting the practical reality of Islamic finance.

The Islamic Fiqh Academy addressed the issue several times and in different sessions. We are specifically concerned in this comment with the concept of shares and that of limited liability and legal personality as these are the core issues raised by the author in his paper.

Thus, the Islamic Fiqh Academy in its fourth session while discussing the issue of *zakāh* in shares. Ten papers where presented and a resolution was adopted. Almost all papers concurred to the definition "a share is an undivided share in the assets of the company and the certificate is the instrument of the right to this share.

The resolution on this issue stated that "the company's management shall distribute *zakāh* on behalf of the shareholders as a legal or juristic personality considering the assets of the company as the asset of one person" in a tacit recognition of the juristic personality of the company.

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[2] Taqi Usmani, An Introduction to Islamic Finance, Idaratul Ma'arif, Karachi, Pakistan, 1998, pp. pp. 204-205.

[3] Paper presented at the Fourth Harvard Islamic Finance Forum Harvard University, September 30-1st October 2000.

Unfortunately, if we refer to the papers presented in this session there is little analysis about the juristic personality or limited liability concepts except the paper by Siddiq al-Darir which had addressed the concept form the legal perspective and rejected the legal approach to the effect that the company is the party that owns the shares and not the shareholders. Siddiq al-Darir emphasized that the shares will remain under the ownership of the shareholders and the company may distribute *zakāh* of their behalf as an agent and not as an owner.

Some scholars such as Mukhtar al-Salami, Ramadan al-Buti and Sami Hammood in their rejection of the legal approach that the company has a legal personality and it shall distribute the *zakāh*, maintained that the distribution of *zakāh* is a defining law (*ḥukm taklīfī*) which is addressed to the (*mukallaf*) a human being and nothing else. This is because it is human being who is looking for reward (*thawāb*) and avoiding punishment (*ʿiqāb*).[4] Therefore, *zakāh* is not directly compulsory to any entity other than human being.

The shortcoming of this session is that it did not address in details the main issue of limited liability and its Sharīʿah consequences and more importantly the contractual relationship between the shareholders and the company.

The Sixth session of the Academy addressed the issue of share trading while discussing the theme "Islamic Financial market". Thirteen papers were presented. The definition of shares adopted in the previous session was reconfirmed by almost all the papers. Unfortunately, here again the issue of limited liability and its repercussion has not been discussed. This session has preferred to postpone the final resolution to the upcoming session.[5]

The seven session of the Islamic Fiqh Academy seems to be the most important with regard to the discussion on shares. Thirteen papers were presented under the theme "Islamic Financial Market". The final resolution maintained that a share is an undivided share in the capital of the *sharikah* and the share certificate is the proof of this right in the share.[6]

The issue of "Islamic financial market" has been again raised in the eight session of the Academy. Two papers on the issue were presented and both papers referred to the issue of shares but nothing new has emerged from the discussion with particular reference to the issue of concept of share or the concept of limited liability.[7]

The ninth session allocated three papers with particular focus on "investment in shares". The papers repeated existing facts regarding the concept of shares and no

[4] See Majallat Majmaʿ al-Fiqh al-Islami no.4 vol. 1, 1988, pp . 701-878.
[5] See Majallat Majmaʿ al-Fiqh al-Islami no.6 vol.2. 1990, pp.1269-1725.
[6] See Majallat Majmaʿ al-Fiqh al-Islami no.7 vol.1, pp.70-713.
[7] See Majallat Majmaʿ al-Fiqh al-Islami no.8 vol.3, pp.

substantial discussion on the concept of limited liability and modern companies has come out.[8]

The AAOIFI Sharīʿah Standard no.21 which becomes effective January 2005 addressed the issue of shares but reiterated the position of the Islamic Fiqh Academy with regard to the definition of shares without addressing the issue of relationship with the shareholders and the company.

The above discussion show that the Sharīʿah discussion at least at the level of the Islamic Fiqh Academy and despite the number of sessions and papers, the discussion suffers from the following shortcomings:

- There is no genuine discussion about limited liability and legal personality and their implications on shares trading.
- Although it is generally accepted that some aspects of the legal personality such as the company shall have a name, nationality limited liability can be accommodated in Islamic law, the legal or Sharīʿah relationship between the shareholders and the corporation is not discussed.
- The concern of some economists with regard to the nature of shares, though unacceptable in Islamic law and rejected by many scholars, it needs a detailed and documented response from the Academy.

Investing in Shares

The current accepted criteria and methodologies in shares trading are the result of continued discussions and consultation among Sharīʿah scholars. The OIC Islamic Fiqh Academy issued the resolution no. 65/1/7 in 1992 regarding stocks markets trading. The resolution maintained that:

1. Considering the fact that in principle, all commercial transactions are deemed to be permissible, establishing a company having permissible objectives and dealing in *ḥalāl* transaction is also permissible.
2. There is no difference of opinion among Muslim scholars that it is illegal to invest in a company which is originally based on *ḥarām* transactions such as dealing in *ribā* or trading unlawful products.
3. In principles, it is illegal to invest in companies dealing sometimes in non-permissible transactions such as *ribā* even if its main activities are based on permissible transactions".

The above resolution was not a clear-cut ruling with particular reference to investment in companies dealing sometimes in *ribā* and non-permissible investments although their main activities are permissible. It did not declare it categorically non-permissible to invest in these companies and at the same it did not allow normal trading stocks and shares of these companies. It is worth noting

[8] See Majallat Majmaʿ al-Fiqh al-Islami no.9vol.2, pp9-173.

that these types of companies represent the vast majority of existing companies whether within the Islamic world or abroad.

This has prompted the need for additional forums to discuss the issue. Thus, a seminar jointly organized by the Islamic Fiqh Academy and the Islamic Research and Training Institute IRTI-IDB was held.[9] The resolution adopted was not final once again. It has reiterated "in principles it is illegal to invest in companies dealing sometimes in non permissible transactions such a *ribā* although their main activities are permissible transactions. However, the resolution has added an important new ruling stating "it is permissible to invest in companies dealing sometime in *ribā*, if the investment in such companies is done with the intention of transforming these companies into fully Islamic companies, by those who are capable of doing so, and the transformation process shall be expedited".

By validating the investment in companies dealing sometime with *ribā*, if the intention is transforming such companies into fully Islamic is a step forward that paved the way for more concessions regarding investment in such companies.

The issue has been raised again in the eight and ninth sessions of the Islamic Fiqh Academy but once again no final resolution was taken except the call for more investigation and research on the issue.

Due to the crucial importance of the issue to the Islamic financial institutions another seminar, jointly organized by the Islamic Fiqh Academy and the Islamic Research and Training Institute was held to discuss the issue. The resolution reconfirmed the Academy position regarding the major points adopted in the previous sessions whereby it is permissible to invest in companies dealing sometime with *ribā* if the objective of investment is to transform these companies into fully Islamic. However, a new condition was added to the previous resolutions. It was added that it would be permissible to invest in such companies only if it is possible to transform such companies into fully Islamic companies, in the first general meeting of the company after being a shareholder. However, if one fails to achieve this target, after the first general meeting, he has to liquidate his shares in the company.

It is also maintained that it is permissible to invest in the large and important companies in the Muslim world, which provide the basic needs to society, whether they are public or private if they deal sometimes in *ribā* due to necessity and common need and in cases where there is no purely Islamic alternative avenue of investment. However, a time frame should be put forward in order to Islamize these companies.[10]

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Several other forums such Al-Barakah Seminars[11] and Kuwait Finance House Seminars[12] discussed the issue. The objective is not to review all these resolutions or to trace the whole historical development on the issue but to point out to an important fact in the development of modern Islamic finance to the effect that decision on controversial issues are not obtained following one or two sessions. To the contrary for an opinion to crystallize in a specific issue there is a need for a number of meetings and continuous addition, refinement and amendment of clauses and conditions.

Despite the numerous seminars and forums, the issue of participation in companies with permissible objectives and dealing but involved sometime in *ribā* and prohibited transactions remain a moot point.

The general stand of Muslim scholars in equity trading can be summarized as follow:

First: There is virtually no disagreement among Islamic scholars over the permissibility of owning the shares of companies that deal with permissible activities, which are free from anything prohibited.

Second: There is, moreover, no disagreement among scholars over the prohibition of owning the shares of companies which are established, in principle, for dealing with prohibited things, such as usurious dealings, or trading in things such as alcoholic beverages or pork.

Third: However with regards to companies whose scope of activity is permissible but in some cases, involve a certain measure of "*ḥarām*", owning shares in such companies or trading the share of such companies is permissible according to the contemporary Muslim jurists if all conditions and criteria are observed especially the condition that the shareholder should do his best to compute the "*ḥarām*" element involved in the returns of his shares, to put it aside and give it to charity, without deriving any benefit.

However, scholars differ in the implementation and details of these criteria. Some adopted the stand that investment in such companies will be allowed only in cases of intention to transform such companies into fully Islamic companies in the first general meeting of the company. Others preferred the opinion that the process of transformation can continue up to the third general meeting of the company.

On the other hand, some have fixed a specific percentage for the non-permissible asset of the company others prefer to leave it general without specifying it but just mentioning that it should be minimal.

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[11] See, Majmuat Dallah al-Barkah, Fatawa Nadawat al-Barakah, 5ft edition p.88; p.126-127.

[12] See, Bait al-Tamwil al-Kuwaiti, Amal al-Nadwa al-Fiqhiyyah al-Khamisah 2-4 November 1998, pp.9-172.

At the same time while some restricted the application of this permissibility to companies operating outside the Muslim world while others did not see any difference on this ground. Finally a group of Muslim scholars allow trading the share of such companies for capital gain but not to be a shareholder and getting dividends.

It should be noted that another factor that have complicated the issue of shares trading more is that the development of Islamic equity market has been taking mainly in Western market especially in its early days of development. This is partly due to the fact that Islamic countries own markets lack depth and breadth. In addition, Islamic fund managers are also going global for diversifications opportunities, attractive tax environments, bullish trends in developed markets and political stability.

However, floating new transactions in western markets mean facing regulatory frameworks that may or may not be compatible to Islamic principles. This is clearly reflected on the probability of larger number of companies completely avoid dealing in interest.

Coupled to the issue of Sharīʿah compatibility is the need for a benchmark. Initially, Islamic equity fund tended to be benchmarked against conventional indices such as Morgan Stanley Capital index (MSC) with certain weighting adjustments that were necessitated by the exclusion of prohibited stocks.

However, there has been always inspiration among players for a common standard so that Islamic investors around the world have a reference point that can be used to judge the relative performance of their global or regional portfolio of equities. Consequently, the idea of Islamic index became a reality in 1999.

The screening and purification process is undertaken sometimes by a centralized body as it is the case with the Sharīʿah Advisory Council of the Securities Commission Malaysia. In other countries, it is done through the private sector. Thus, IBF. Net launched India's first Islamic equity index. Sometimes as it is in the Gulf region companies produce their own lists of Sharīʿah compliant stocks.

The Creation of Islamic Indices

An equity index is based on a representative group of equities. It is selected to serve as a benchmark, or index, of a specific market sector. These indices consist of a bundle of top securities by performance, representing an intelligent indicator of the general sentiment of the business prevailing within the stock markets. Usually these securities represent the highest portfolio ratio. By following the aggregate performance of the constituents of that index, an accurate, continuing record is build up reflecting the performance of the overall market or sector. It

provides a useful and unbiased benchmark against which to compare the performance of actively managed investments made in the same sector.[13]

The indices tell us either today the market is bullish or bearish and provide us information on the general sentiment or condition of the business. On the basis of these indices the investors make their decisions to invest or disinvest from the stocks. In short, these market indices are the reflection of the mood of business.

The first Islamic equity index was introduced in Malaysia by RHB Unit Trust Management Bhd in May 1996. This was followed by the Dow Jones Islamic Index in February 1999, the Kuala Lumpur Sharīʿah index in April 1999 and the FTSE Islamic Index in October 1999. The establishment of these indices represents a wise initiative for measuring stock market performance for Islamic investors in the competitive and globalized market. Thus Islamic investors can follow both Dow Jones and FTSE well-established index methodology and the Islamic investment guidelines based on Islamic principles. It is also a triumph of ethical virtues in the market place and a way for a whole new financial sector. An Islamic Index represents a yardstick against which investors can measure the performance of existing Islamic funds and a step forward in the maturity of Islamic financial market. It is also a step towards integrating Islamic investors into the world of global equity funds, a way in bringing financial transparency and accountability[14] and a reflection on the growing interest in Islamic investment.

Market players applauded the performance of the Islamic Indices and the 2002 corporate scandal in the United States confirmed the usefulness of the Islamic indices. These practical events have really put the Dow Jones Islamic index, in particular, and Islamic finance in general, in the global scene. During the recent accounting scandal in the United States the Dow Jones Islamic index managed to detect signs of corporate trouble even before Wall Street woke up to it. The DJIM rejected some the big companies such as World Com, Tyco and Enron before the scandal. WorldCom for instance, a giant US telecom company, was valued at 185 billion, at its peak in early 2000. It collapsed in June 2002, due to a combination of outright fraud and bad accounting practices leading to losses of billion of dollars for investors worldwide. Islamic fund mangers around the world have been able to save their investors from this disaster. The Dow Jones Islamic Market Index decided to remove WorldCom from its indices before its collapse and Islamic fund managers sold off its shares, at a time when the share prices were respectable. Similar scenario happened with other companies such as Tyco and Enron. The removal of these companies shows that Islamic finance is a safe bet for risk-averse investors.[15]

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[13]James Hume, "Tracking The Performance of Islamic equities – A Welcome Service to Islamic Investors World-Wide" New Horizon, February, 1999, pp. 15-16.
[14] See, New Horizon, March 1999, pp.3-6.
[15]Peter J. Cooper, "Dividends For Islamic Finance", AME Info, Wednesday, July 23-2003.

The Islamic stock screening and the methodology of debt avoidance has also worked well for Islamic investors insulating them from being affected by the technology bubble as a lot of dot.coms companies did not meet the Dow Jones Islamic Index.[16]

However, the divergence of screening methodologies and the different parameters used nowadays by Islamic indices providers are affecting the industry aim to take its right place in the international scene as a competitive, well-regulated and harmonized industry. It is time to standardize and harmonize the screening methodology.

Harmonization of Screening Methodology

All Islamic indexes, whether international or domestic, agree on the exclusion of companies with unacceptable primary business activities. Thus, stocks of companies whose core activities are or related to conventional banking and insurance or any interest related activities are excluded. The list also includes for instance, company dealing in alcohol, tobacco, gaming, insurance, pork production or any activity that contradicting Islamic principles.

However, the differences of methodology in screening arise on the percentage of debt to equity in a company assets, the level of its dealing in interest or other prohibited activities and the implication of all these in the screening process.

A harmonization of screening process will definitely help in strengthening the international position of Islamic equity investment but also help in attracting to the Muslim countries hundreds of billion of Muslim funds invested in the West.

The overseas assets of the 200, 000 richest families in Saudi Arabia and the Gulf are worth US$1, 200 billion according to Saudi American Bank estimates, most of which are invested in equities, bonds and property in North America and Europe there is considerable scope to attract some of this funding into Islamic funds that will focus on Muslim markets as these have proved successful vehicles for investment, and their Islamic characteristic are additional marketing asset.[17]

The need for harmonization is obvious if we take a close analysis at the divergent screening methodologies currently used by Islamic indices. For instance, The Dow Jones Islamic Index at the beginning excluded companies whose total debt divided by total asset is equal to or greater than 33%. Companies whose account receivable if divided by total assets is equal or greater than 45%. Companies in which non-operating interest income plus other impure income divided by revenue is equal to or greater than 5%.

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17 See Rodney Wilson, Islamic Mutual Fund as a facilitator of the Integration of Capital Markets in Muslim Countries, Proceeding of the International Conference on Practical Measures to Establish A Common Market Between Muslim Countries, University of Qatar May 13-15, 2002.

However, the Dow Jones Islamic Market Index revised the above screening system in 2001. Two broad changes affected the Dow Jones Islamic Market Index. The first screening change is regarding the maximum corporate debt restricts borrowing to 33% of a company's market capitalization (market price of outstanding shares) while the previous rules capped debt was at 33% of assets. The new screen for receiving interest limits "cash plus interest bearing securities is revised to less than one third of market capitalization. Previously, companies with non-operating interest income equal to 5% or more of annual revenue were excluded from the Dow Jones Islamic Market Index.

One of the arguments behind this move is that there are cases of good companies that could pass all the screens except the condition of percentage of non-permissible elements especially companies that are not generating large operating income, as they are a new venture. Even a small amount of interest earnings will constitute a higher percentage of total earnings for such companies. [18] Furthermore, the issue is based on the concept minimal versus large in Islamic law whereas the percentage of what is considered to be minimal is generally 33%. Therefore, there is room of benefiting from this flexibility on the concept.

On the other hand, the screening methodologies of the Dow Jones Islamic Index either the previous or the reformed screening, in its turn, differ to some extent from the FTSE Islamic Index screening. The FTSE Global Islamic Index also excludes stocks whose core activities are or are related to interest, alcohol and tobacco, pork and all prohibited items. Besides this agreed upon criteria, the FTSE Islamic Index adds another parameter that is the exclusion of companies with interest bearing debt ratio divided by Assets is equal to or greater than 33.33%.

This need for harmonization of screening methodology is also reflected by the launching of the Almal US Sharīʿah-compatible Index (USSCI) on December 2003 by Kuwait based Almal investment Company. It was the result of lack of satisfaction with the existing screening methodology by some conservative investors. They are a concerned over the Sharīʿah screening criteria that the Dow Jones Islamic Index for instance is using. For instance, Almal US Sharīʿah-compatible Index (USSCI) use debt to asset financial ratio screen of not more than 33.33 per cent whereas Dow Jones uses Debt to Market Capitalization[19].

USSCI comprise 250 of the actively traded companies on US exchanges whose activities and financial ratio relating to debt and interest are compatible with the criteria established by Almal Sharīʿah scholars.[20]

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[18] Mohamed El-Gari, "Islamic Equity Investment" in *Islamic Finance Innovation and Growth*, Edited by Simon Archer and Rifaat Abdel Karim Published by Euromoney Books and AAOIFI, pp.151-160.

[19] Islamic Banker November/ December 2003, no. 94-95, p.19.

[20] Ibid.

The divergence of screening methodology is not limited to the international indexes. Domestic screening methodology may have its own criteria. Let us take the Malaysian Sharīʿah Index which is a local index. The Malaysian Sharīʿah Index is not following the Dow Jones Islamic index or the FTSE Islamic Index screening methodology. It applies broad standard criteria in its screening methodology focusing on the core activities of the companies listed on the KLSE and MESDAQ. Hence, companies whose activities are not contrary to the Sharīʿah principles will be classified as approved securities. The Sharīʿah Advisory Council (SAC) broad rules is also excluding *ribā*, gambling and all forbidden based companies such pork, liquor etc. As for companies whose activities comprise both permissible and non-permissible elements, the SAC applies broad criteria stipulating that the prohibited element must be very small compared to the core activities without any specifically determined percentage. Other criteria used by Malaysian Sharīʿah Index is that the public perception or the image of the company must be good; and the core activities of the company must have importance and *maṣlaḥah* (benefit in general) to the Muslim *Ummah* (nation) and the country, and the *ḥarām* element is very small and involves matters such as *ʿumum balwa* (common plight), *ʿuruf* (custom) and the rights of the non-Muslim community which are accepted by Islam.

Furthermore, the difference in screening methodology is not only limited to the differences between the international and domestic methodologies. A single company might have its own methodology and parameters in screening. Let us look at the example of a single company and how its screening methodology differs or resemble the international or local methodologies. For instance, the Sharīʿah Board of al-Barakah in general and Al-Sukoor Equity Fund in particular fix debt to total assets value ratio of 30%, total receivable plus cash of the invitee company should not exceed 49% of the book value of the total assets and net interest income to total income ratio of 5%. Although this screening parameter is closer to that of the previous screening methodology of the Dow Jones Islamic index although it has a slight difference.

A clear effect of this divergent screening methodology is that stocks considered in a specific market, as Sharīʿah compliant may not be so if the screening methodology of another market index are applied. Thus, the Kuala Lumpur Stock Exchange for instance has over 800 counters of which 81% are deemed to be Sharīʿah compliant. However, when the Dow Jones Islamic Index's screening methodology was applied to these counters it has been realized that only about 150 companies can be considered to be blue chips, liquid and Sharīʿah compliant and in line with DJIM screening methodology.

Thus, although the Dow Jones Islamic Index screening methodology could be considered as conservative compared to the Malaysian screening methodology which has too broad methodology, the Dow Jones Islamic Index is also considered to be too liberal by investors preferring Almal US Sharīʿah-compatible Index. Such

wide difference may not help creating confidence in the market especially for those who are willing to avoid interest as much as they can.

Sharīʿah Basis for Divergence in Screening Methodologies

The roots of divergence in screening methodology reside with the jurisprudential basis of the issue. There is no explicit text from the Qur'ān or the *Sunnah* dealing with the situation. Scholars have to resort to the general principles of the Sharīʿah its objectives, the overall environment under which the Islamic finance industry is forging its way and the assessment of the *maṣlaḥah* or public interest involved in order to give a judgment.

Muslim scholars relied on several maxim and principles to justify the assets–debt ratio or the percentage of involvement by a company in non-permissible activities. The principles of *maṣlaḥah*, common need and necessity play an important role in the development of these parameters.

Several maxims are also used to develop the screening methodology such us the maxim that the majority deserves to be treated as the whole of a thing; What is not permitted independently may be permitted subordinately; the case of general need is like that of specific necessity; what could not be avoided is tolerated and the principles of removing hardship and bringing easiness.

Although resort to these principles and others to justify the temporary parameters of screening devised by Muslim scholars is acceptable under the prevailing circumstances, it is also necessary that this concession is not abused and at the same time a way out of this state of necessity is developed. This could be achieved by refining the present screening process methodology.

Refining the Screening Process

The present screening process helped in achieving many of the objectives of Islamic equities market. However, it should be clear that this screening process and in particular the concession to investment in companies indulging sometimes in non permissible activities is rejected by many influential contemporary Muslim scholars. Among others we may mention Ali al-Salus[21] Ali Al-Shaibani[22] Salih Al-Marzuqi [23]Ahmad Muyiddin[24], Darwish Jastanah.[25] They relied on the following to prohibit investment in these companies:

- The general texts prohibiting *ribā* and which did not make any difference between large amount of *ribā* or less and all shareholders in the company indulged in *ḥarām* are committing sins and not only the management.

[21] See Majallat Majmaʿ al-Fiqh Al-Islami, no 7 vol.1 p.705.
[22] Majallat Majmaʿ al-Fiqh Al-Islami, no 7 vol.1 p.695.
[23] Majallat Majmaʿ al-Fiqh Al-Islami,. no.9, vol. 3 p.164.
[24] Amal Sharikat al-Istihmar Fi al-Aswaq al-Alamiyyah, p.175.
[25] Majallat Majmaʿ al-Fiqh Al-Islami, no 7 vol.1 p.692.

- Non-participation by Muslims in these companies will force these companies and banks to avoid *ribā* and look for other means of investment.
- The issue of investment in companies indulging sometimes in prohibited activities although contains some benefits, it also contains some peril and it is a well accepted principle in Islamic Jurisprudence that in cases where good and bad are being mixed in one issue, avoiding the bad shall prevail. Therefore, although there are some benefits in the investment of such companies but the avoidance of *ribā* shall prevail.

The whole argument for the permissibility of investment in companies indulging some times in *ḥarām* is based on necessity and need. Different maxims are invoked to support this argument.

Let us see the grounds for these maxims and the opponent to this argument response. What is not permitted independently may be permitted subordinately; the majority deserves to be treated as the whole of a thing; the case of general need is like that of specific necessity; what could not be avoided is tolerated and the principles of removing hardship and bringing easiness.

The principle of need in this issue is based on the maxim that general need shall be treated as like necessity to individual/ the main ground is based on the *Ḥadīth* to the effect that when the prophet prohibited to people to cut down three at Makkah. He has been informed that people need a specific tree called *izkhir* for their housing then the prophet allowed the cutting of this specific three. It has deduced from this *Ḥadīth* that basic need shall be considered.

However, it is a common jurisprudential principle that the principle of common need and necessity will not transform the issue into a normal case. The issue will remain an exceptional case that should be monitored and updated accordingly. Lack of emphasis on the differences between the exceptional and the normal case may send the wrong signal to the market.

This confusion has prompted some observers to note, “The art of stock screening has not created a clear black and white universe of stocks. Instead, it has highlighted the grayness of the stock selection. The clear need to invest in Sharīʿah compliant has not been clearly addressed.”[26]

Another reason for the need for refinement in the screening process is that Islamic funds do not invest in Islamic companies although there are some in the market. They invest in companies listed on major stock markets screened according to Sharīʿah guidelines. Although fund managers make efforts to purify the

[26] Failaka International, "Islamic Equity Funds: Analysis and Observations on the Current State of the Industry", March 2002, pp.1-12.

prohibited elements from these portfolios, some observers see these funds as just Islamically *acceptable* funds but not *truly* Islamic fund[27]

To fully abide by the Islamic principles of investment is to move from the exceptional situation to the permanent and to devise strategic plans for investment in truly Islamic companies one day and not be satisfied with investment in acceptable.

To address these concerns the present screening system needs to be refined. For instance it did not address cases such as the following:

1. Is it permissible for Muslim investors to continue investing in a company with higher percentage ratio where there is a company with less percentage of non-permissible elements than the officially adopted in the present screening methodology are also traded?
2. Are we violating the principles of common need and necessity by continuing investing in the company with higher ratio?
3. What is the guarantee that a company currently having less than the 5% or more of prohibited element in the present screening system would not try to increase its capital through prohibited means without exceeding the limits in the current screening system?
4. On the other hand what is the guarantee that this state of necessity will end one day?
5. Does higher return in a company with higher ratio of non-permissible element although within the existing parameters justify ignoring investment in a company with lower return but also lower percentage of non-permissible elements?
6. What are the incentives in the present screening system to expedite the process of having sooner enough counter with 100% Sharīʿah compliant or truly Islamic?

It is possible to answer these questions in different ways. However, taking into consideration the need for refining the screening system and applying the principles of common need and necessity with more precision new criteria need to add to the present screening methodology. This could also be perhaps a step toward convincing scholars and financial institutions that still reluctant to accept the present screening system due to the presence of *ḥarām* elements,

Thus, besides the existing criteria it would be necessary that the following clauses are taken into consideration.

1. It is not permissible to invest in a company with non-permissible elements as long as there is a truly Islamic stock in the market even if the return is lower.

[27] Ibid.

2. It is not permissible for company having non-permissible element which is still below the maximum of publicly recommended parameters to borrow with interest in order to increase the volume of its capital even if the newly borrowed capital will not affect for instance the 5% indicated in the parameters.
3. In case of conflict between higher return coupled with higher non-permissible element and a case of lower return and lower non-permissible, a Muslim investor must opt for the later.
4. In case where two companies have the same investment grade and similar screening criteria it would be advisable for a Muslim investor to invest in the Islamic company.

It should be noted that although the use of the different parameters of stock screening the issue is not the point of consensus among contemporary Muslim scholars despite the fact the issue has been raised in numerous forums.

It is unfortunate that a significant number of managed Islamic equity funds function without Sharīʿah supervision of any sort.

Examples of Companies fulfilling the Criteria

	Industry Group	Total Debt/Total Asset 33%	Total Receivable 45%	Interest income Net Profit 5%
Name of company	Consumer	12.0	31.1	None
Name of company	Food	26.8	34.6	None
Name of company	Oil	12.0	17.4	None
Name of company	Chemical	15.8	29.6	None

Examples of Stocks not fulfilling the Criteria

	Industry Group	Total Debt/Total Asset 33%	Total Receivable 45%	Interest income Net Profit 5%
Name of company	Pharmaceuticals	34.2	40.7	5.0
Name of company	Electronics	11.7	60.2	8.8
Name of company	Automobiles	29.1	31.8	31.7
Name of company	Breweries, Hotels, Casino	Ineligible industry	Ineligible industry	Ineligible industry

Rating and Reporting Islamic Listed Stocks

An important aspect of accountability in Islamic equity investment is the rating and reporting of Islamic publicly listed stocks. American Islamic Financial (AIF) Investor services, a licensee of DJIM comes up with a pioneering initiative to fill this gap.

The service is well established in the conventional market companies such as Morningstar, Lipper and other brokerage firms provide ratings and report regularly

on a large number of popular stocks for both institutional and retail investors. A large number of small independent research firms ad to this by providing research on many additional stocks including mid-cup and small-cup equities. Because these rating and reports provide in-depth information in each company, they complement the market- comprehensive, stable benchmarking that Dow Jones Index provide.

AIF Sharīʿah issues are handled by Monzerr Kahf and Najaullah Siddiqi. The AIF rating service and reports are available both in printed form and on-line.

AIF rating is akin to that of Moody's or Standards & Poor's credit ratings. The company is using letters and numbers as rating classifications. The fist part of each rating is assigned a capital letters A through F rating the company's involvement in prohibited business such as alcohol, gambling, or interest based transaction.

The second part of the rating assigns a number from 1 through to 5 rating the amount of *ribā* in the company's finance and investment activities. Companies with a lot of cash earning interest in the bank or with large loan outstanding get a lower score in this respect.

Finally AIF, assigns a small letter from (a to c) rating the company avoidance of excessive *gharar* (uncertainty and deception), and conformity with the law of land. For example involvement in short selling, legal dispute with government agencies give the company a grade in this category.[28]

Despite the flexibility adopted by the large majority of Muslim scholars in order to allow the trading of shares in the main companies including the shares of Islamic banks, many of these companies could not pass the investment criteria developed by the scholars due to the percentage of *ribā* and in particular the debt ratio in these companies.

This situation has prompted some scholars to look for a solution by adopting the concept of share prevailing in the conventional legal system based on the concept of legal personality and limited liability and whereby the shares of a company are not the ownership of the shareholders but the company itself. Thus, if we consider the shares to be owned by the company and not by the shareholders, the shareholders would be having ownership rights in the company and not shares in its asset. Hence the sale of shares will not be having any relationship with the composition of the assets in the company whether they are debt, cash or physical assets.

The idea was initially advocated by Mohammed El-Gari.[29] His main argument is that Muslim scholars in their definition of the concept of shares have relied on

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[28] See, Rushdi Siddiqi "Possibility of Peer Review Beckons" *Islamic Banker*, no.110/111, March /April 2005.

[29] Mohamed Ali El-Gari,"Al-Shakhsiyyah al-Iitibariyyah Dhat al-Masuliyyah al-Mahdudah" Dirasah Fiqhiyyah Iqtisadiyyah, " *Dirasat Iqtisadiyyah Islamiyyah* vol.5 no.2 1419H, pp.9.60.

the analogy between the modern companies based on limited liability and the different companies in the classical literature and they have neglected the important part in the equation which is the issue of limited liability. El-Gari main argument resides in the analogy between the concept of limited liability and the liability of a master of a slave.

It should be noted here that "although the institution of slavery with reference to our age is something past and closed, yet the legal principles laid down by our jurist while dealing with various question to the trade of slaves are still beneficial to the student of Islamic jurisprudence, and we can avail of those principles while seeking solutions to our modern problems."[30]

El-Gari analogy is that the ownership of the master to the slave is a form of a limited liability. The master owns a capital that has a market value; however, his liability is limited to his own value and would not extend to the liability of his master. Therefore, if the slave in the course of trade incurred debts, the same would be set off by the cash and the stock present in the hand of the slave. But if the amount of such cash and stock would not be sufficient to set off the debts, the creditors had a right to sell the slave and settle their claims out of his price. However, if their claims would not be satisfied even after selling the slave they could not approach his master for the rest of their claims. These rules are applicable whether the slave is permitted by his master to enter into commercial transaction or not. Thus, the liability of the master is limited to the capital he owns, namely the slave. Thus, this concept, according to El-Gari is similar to the concept of limited liability and legal personality.[31]

El-Gari added that the buyer of a share in a particular company is not in a position to take the share away from the company but he has no option other than living it with the company whether it is cash or debt or physical asset. His objective from buying the shares is not the cash, nor the debt but the company itself and its performance in future. In the same line the sale of slaves is not covered by the rules of currencies exchange even if the cash and debt owned by the slave are more than the value of the slave. This is exactly the case of Limited Liability Company.[32]

However, El-Gari proposition has been criticized by Sharīʿah scholars Siddiq al-Darir maintained that

- A shareholder has the right to sell his share and this is a sign of ownership as a person could not sell what he does not own. At the same time is not possible to say that the shareholder is selling the certificate itself as a certificate has no value by itself.

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[30] Muhammad Tqi Usmani, An Introduction to Islamic Finance, Idaratul Ma'arif, Karachi, Pakistan, 1998, pp.229-230.
[31] Mohamed Ali El-Gari, Al-Shakhsiyyah al-Iitibariyyah Dhat al-Masuliyyah al-Mahdudah Dirasah Fiqhiyyah Iqtisadiyyah, *Dirasat Iqtisadiyyah Islamiyyah*, vol. 5 no.2, 1419H p.26.
[32] Ibid. p.41.

- The shareholders have a right in the asset of the company after liquidation and this is another fact that the shareholders own the assets of the company. This point and the above show that a shareholder has a share in the asset of the company.
- With regard to the El-Gari analogy with the rules of slaves, it is maintained that the difference of opinion among Sharīʿah scholars on whether the own or not does not impact the fundamental Sharīʿah fact that the slave and what he owns are the properties of his master. Therefore, based on El-Gari proposal the shareholders shall own the company and its assets and this will make the ground of El-Gari analogy to collapse.
- El-Gari conclusion that the liability of the slave is limited and could affect the personal asset of his master is also defective as many classical Sharīʿah scholars have stated that if the master has permitted his slave to trade, he will be responsible for all the debt he incurred and this undermine El-Gari analogy.[33]
- Moreover Sharīʿah scholars in their discussion of the concept *sharikāt* recognized the creation of new entity but this entity would not take away from the share holders the right of ownership in the asset of the company.
- Ownership in Islamic law is exclusive to natural human being and it could not be attributed to anything other than human being. This should not be confused by the case of *bayt al-māl*, mosque or waqf whereby a kind of legal personality has been recognized to these entities by Muslim scholars. It is a contractive ownership. In fact, the real ownership in *bayt al-māl* or the mosque is the whole Muslim community while the case of waqf the ultimate owner of the assets is Almighty Allah according to the prevailing opinion of Muslim scholars. Even if consider the opinion of the minority is this issue, the assets given as a waqf or to the mosque will be transferred totally to these entity without any relation with the original owner which is not the case with the case of shares, shareholders and company relationship .
- One of the important consequences of relying on the legal approach in defining the concept of shares and the relation between shareholders and the company is how do we define the relationship under which the ownership of the asset has been transferred from the shareholders to the company. If the shareholders would no be the owner of the asset but at the same time they will receive dividend from the company, the only possible relationship between

[33] For more detail see Siddiq al-Darir, Comment on El-Gari al-Shakhsyyah Al-ItiBariyyah Dhat al-Masuliyyah Al-Mahdudah, Dirasah Fiqhiyyah Iqtisadiyyah, " *Dirasat Iqtisadiyyah Islamiyyah* vol.5 no.2 1419H, pp.9.61-74.

the company and the shareholders is that of debtor- creditor. Hence, the transaction will be akin to *ribā* as it is giving loan and waiting for benefit.[34]

It worth noting that if the concept of limited liability is confined to some administrative and regulatory issues such as legal personality to the company, name, address, nationality, or the limited liability of shareholders there would not be objection from Sharīʿah point of view. The main objection by Sharīʿah scholars to the conventional legal concept of limited liability and legal personality is regarding the transfer of the ownership of the assets from the shareholders to the company without clear Sharīʿah basis. Therefore, what is needed is to think of a modified limited liability capable of bringing about the economic benefits of the conventional limited liability company without transferring the ownership of the assets from the shareholders to the company?

El-Gari attempt to adopt the legal definition of shares seems to avoid the controversy regarding the prevailing screening criteria which in many instances exclude even the shares of Islamic financial institutions due to their over reliance on *murābaḥah* and debt related instruments.

The AAOIFI Sharīʿah Standard no. 21 which becomes effective January 2005 adopted very flexible screening criteria and may serve the objective of El-Gari theory but in another way. The new AAOIFI criteria limit the interest based loan to 30%, debt equity ratio 30%; non-permissible component 5%.

These flexible criteria will have tremendous consequences that need to be discussed in future in more details.

[34] for more arguments against the adoption of the conventional legal concept of Limited Liability and legal personality, See, Husein Kamal Fahmi, Al-Sharikat Al-Hadithah Wa la-Shrikat al-Qabidah" *Majallat Majma' al-Fiqh al Islami.* no.14 vo.2 , 2004 pp. 426-546,; See also Abdul Sattar Abu Ghuddah al Sharikat la-Hadithah al- Sharikat al-Qabidah WaAhkamuha, *Majallat Majma' al-Fiqh al-Islami*, no.14, vol.2, 2004, pp.567-568.