Shariah Principles for Islamic Capital Markets and the Regulation of Market Abuse in UK and the US: Common Grounds, Divergences and Proposal for Reform

A thesis submitted to the University of Manchester for the degree of

PhD

in the Faculty of Humanities

2012

Kabir Ahmed

School of Law

List of Contents

Abstract

Investor protection is the essence of Islamic banking and capital markets. Shariah aims to promote fairness in the exchange mechanism, prohibit abuse, exploitation and harm, protect investors and safeguard public interest. The purpose of this thesis is to explore and compare Shariah's principles for investor protection from market abuse with the rationales and theories of prohibition underpinning the UK and US legal market abuse framework in securities markets.

Shariah takes a completely different and a very comprehensive approach in combating market abuse. It takes a two pronged approach. *Firstly,* it propounds compliance and incorporation of ethical principles, Quranic proscription, and Prophetic commandments in the legal framework which prohibit market abuse before it occurs. *Secondly,* its unique contractual structures facilitate fair exchange. The product innovation incorporates ancient contractual structures as building blocks with inbuilt safety features to curb abusive speculation, manipulation and distortion in the price formation mechanisms. These principles and contractual structures successfully safeguarded the interest of participants in *one to one* transactions in barter based ancient markets in Mecca and Medina.

The thesis analyses the validity of the aforementioned approach in regulating market abuse in *impersonal* trading in the context of emerging technologically advanced Shariah compliant stock exchanges. It also explores how Shariah's approach facilitates the smooth interplay of market forces and uninterrupted natural equilibrium devoid of exploitation and harm. In the light of the antiquity of Shariah's ethical principles and contractual structures and the modern securities markets offering a sophisticated electronic trading platform, it presents a particularly challenging task to put together a coherent theoretical *Shariah based market abuse framework* for the smooth operation of advanced equity, debt and derivative products.

The thesis also comprehensively analyses the speculative nature of modern equity, debt and derivative products and illustrates how, in contrast, long standing Shariah compliant contractual structures provide inbuilt safety features to reduce the potential for volatility and distortion in the price formation mechanism. It further highlights non-Islamic features and practices in the conventional spot, forward and futures markets and illustrates their susceptibility to facilitate abusive and excessive speculation, distortion and manipulation.

Based on the comparative analysis of the rationales of UK and US market abuse regimes and Shariah principles, the thesis concludes by highlighting common ethical approaches, divergences and how Shariah based market abuse approach could be used to improve the integrity and stability of the UK and US securities Market.

Declaration

No portion of this work referred to in this thesis has been submitted in support of an application for another degree or qualification of this or any other university or institute of learning

Dedication

To the Eternal Memory of My Father

Acknowledgements

The writing of my thesis has been a long journey which would not have been possible without the support of family, friends and colleagues. I have owed many debts of gratitude during this time period.

Firstly, I want to thank my Lord who is *Merciful, Beneficent* and who created such peaceful circumstances for me to undertake this long course.

I am greatly indebted to my supervisor, Professor Emilios Avgouleas for his un-wavering support, his mentoring, learned advice and continuous engagement throughout this time period. His enthusiasm and commitment to excellence is truly amazing.

I specially thank my sweetheart mother and scholarly father for their life long commitments, their utmost energies spent in nurturing me, their continuous prayers and for meeting the expenses of my education. My sincere gratitude also goes to Touqeer Bhai and Allam sahib, who are no more in this world, but will always be remembered in my prayers for being so kind and supportive. They enabled me to take the first baby step towards achieving my educational goals.

None of this would have been possible without the support of my lovely wife. I am profoundly grateful to her for taking care of my daughter, compromising on all those missed opportunities to spend time together on vacations and to Amarah who had to endure an absent minded father at times. I also thank Aunty Amtul-hafiza for her lovingly cooked food, full of nutritious ingredients.

I would also like to thank my colleagues who made these years much more exciting specially Vincen, Timothy, Florkin, David, Herbert, Franklin and Craig as well as Shane, Cecelia, Meemy, Laula, Rachel, Waheed, Farheen, Faheem, Tanzhu, Hani, Fang Fang, Ouche, and all others who accompanied me in this journey. I hope all of you go on to have illustrious academic careers.

A special thanks to Jackie and Mary for being so kind throughout these years.

List of Statutes

UK

1697 Act to Restrain the Numbers and Practices of Brokers and Stockjobbers.

1734 Act to Prevent the Infamous Practices of Stock-Jobbing.

Prevention of Fraud (Investments) Act 1958
s. 13

Theft Act 1968

Companies Act 1980

Part V – s. 68, s. 69, s. 70, s. 71, s. 72, s. 73.

Insider Trading Sanctions Act (1984)

Companies Securities Act (Insider Dealing) Act 1985

Financial Services Act (1986)

s. 47 (1) and (b), s. 47 (2).

Criminal Justice Act 1993

Part V - s. 52 (1), (2)(a), s. 53, s. 54, s. 55, s. 56, s. 57, s. 58(2)(3) s. 59, s. 60, s. 61, s. 62, s. 63, s. 64.

Financial Services and Market Act 2000

s. 118 (1) (a) (i) & (ii), s.118A (1), s. 118 (2), s. 118 (2) (b), s.118 (3), s. 118 (4), s. 118 (5), s. 118 (6), s. 118 (7), s. 118(8), s. 118, s. 118C(2), s. 118C(3), s. 118C(4), s. 118C(5), s. 118C(6), s. 118(9), s.119, s. 397 (1), (3), (5), s. 123.
s. 397(1) and (3).

Financial Services and Market Act 2000 (Prescribed Markets and Qualifying Investments) Order 2001

Financial Services and Market Act 2000 (Market Abuse) Regulations 2005

USA

The Kansas Act 1911, Ch. 133

Commodity Exchange Act, 7 USCA SS 9, 13b (1970)

Securities Exchange Act 1934, Pub. L. No. 291, 48 Stat 881 (codified as amended at 15 USCA SS 78a-*78ll* (1998 & Supp. 1993).

s 10 (b).
s. 16(a), (b) and (c).
s 14 (e).

Securities Act 1933, Pub L No 22, 48 stat, 15 USCA SS 77a-77z (1988 & Supp. 1993)

Sarbanes-Oxley Act, Pub.L. 107-204 [1], 116 Stat. 745, enacted July 30, 2002

s. 403,

Regulation by Securities Commission

Rule 10(b) - (5), Rule 14 (e) -3.

List of Cases

UK CASES.

R v Ghosh (1982) QB 1053

R v Page (1996) CLR 821

R v De Beranger (1814), 3M &S (KB); 105 Eng Rep 536

Re Cady Roberts and Co, 40 S.E.C. 907, 911 (1961)

Goodwin v Aggassiz, 186 N.E. 659 (Mass. 1933)

New South Wales in North v Marra Developments Ltd, (1982) 56 AJLR 106

Whittaker v Whittaker Corporation, 639 F.2d 516 (9th Cir. 1981)

Smolowe v Delendo Corporation 136 F. 2d 231 (2d Cir. 1943).

USA CASES.

Blue Chips Stamps v Manor drugs Stores (1975) 421 U.S. 723, 737.

Central Bank of Denver v First Interstate Bank, (1994) 511 U.S. 164, 174

Dirks v United States, (1983) 463 U.S. 646

Chiarella v United States (1980) 445 U.S. 222

Inc v Curran, S.Ct. 1825, U.S. Mich (1982) at 1821-1831

Leist v Simplot, 638 F.2d 283 (1980)

Mulhern 938 F 2d 364 (2s Cir 1991).

Sante Fe Industries, Inc v Green, 4(1997) 30 US 462, 477

SEC v Texas Gulf Sulphur, 401 F. 2d (2nd Cir. 1968) (en banc), cert Denied, 394 U.S 976 (1969)

Speed v Transamerica 99 F. Supp. 808, 828-832 (D. Del.1951).

United States v Bryan, 58 F. 3d 933 (4th Cir. 1995)

United States v Carpenter, (1969) 791 F.2nd 1024, 1031 (2d Cir. 1986), aff'd 484 U.S. 19.

U.S. v Chestman, (1992) 947 F.d 551 (2d Cir. 1991) (en banc), Cert. denied, 112 S.Ct 1759.

U.S. v Newman, (1983) 664 F.2d 12 (2nd Circuit 1981) aff'd after remand, 722 F.2nd 729 (2d Cir 1983), Cert. denied, 464 U.S. 863.

United States v O'Hagen, (1997) 521 U.S. 642, 658

United States v O'Hagen, (1997) 117 Supreme Court at 2210

US v Milken, 759 F Supp. 109 (SDNY 1990)

List of Abbreviations

IF	Islamic Finance
ICM	Islamic Capital Markets
SCSM	Shariah Compliant Securities markets
MSCI	Morgan Stanley Capital Index
DJIMI	Dow Jones Islamic Market Indices
IDB	Islamic Development Bank
IRTI	Islamic Research and Training Institution
IOSCO	International Organisation for Securities Commissions
TGS	Texas Gulf Sulphur
EMH	Efficient Market Hypothesis
FSA	Financial Services Authority
SEC	Securities Exchange Commission
OTC	Over the Counter
SRO	Self Regulatory Organisation
NYSE	New York Stock Exchange
CJA	Criminal Justice Act 1993
FSMA	Financial Services and Market Act 2000
MAD	Market Abuse Directive 2003
Code	The Code of Market Conduct
EEA	European Economic area
OFEX	Off Exchange
RIE	Recognised Investment Exchange
LME	London Metal Exchange
CFMA	Commodities and Futures Modernisation Act 2000
CESR	Commission of European securities Regulators
CCP	Central Counter Party
CFTC	Commodities Futures Trading Commission
CDO	Collaterised Debt Obligation
GCC	Gulf Council Co-operation
BLME	Bank of London and Middle East
EIIB	European Islamic Investment Bank
SRI	Socially Responsible Investment
BRIC	Brazil, Russia, India and China
BFX	Bahrain Financial Exchange
SAC	Shariah Advisor Council
PLS	Profit and Loss Sharing
IFI	Islamic financial Institutions
BBA	Bai Bithaman-Ajil
AAOIFI	Accounting and Auditing Organisation for Islamic Financial Institutions
SPV	Special Purpose Vehicle
SSB	Shariah Supervisory Board
CESR	Commission of European securities Regulators
WDM	The World Development Movement

1- General Introduction

1.1- Introduction

Islamic Finance encompasses banking, insurance and securities markets. In the recent years, it has witnessed an unparalleled growth and continues to develop at a remarkable pace as the industry promotes itself in the mainstream international financial arena. Originating from humble beginnings in 1960, with the establishment of the Mit Ghamr savings project in Egypt, it currently boasts 614 Islamic financial institutions established in 75 countries across the globe. It has been estimated that the amount of assets under management has grown from $150 billion in the mid-1990s to around $1.5 trillion in 2010. With the presence of 1.6 billion (Muslims) potential customers, around the globe, Standard and Poor's has forecasted that the industry could potentially control up to $5 trillion of assets by 2015. The commercial significance and potential has not gone unnoticed and a number of western financial institutions have established Islamic windows to serve this growing market. This includes Citibank, Kleinwort Benon, Grindley's, Chase Manhattan bank and HSBC-Amanah etc.

The emergence of Shariah compliant securities markets is a natural progression as the Islamic banking industry becomes more sophisticated and assets transfer from the banking industry to securities markets. It is also regarded as indispensable for the *non-interest* based Islamic banking system which has its main reliance on equity based products or asset based sukuk (Islamic bonds) for mobilising funds for corporate and government financing. The overall popularity has also been facilitated by the recent financial crisis which has drawn attention to highly liquid Islamic capital markets, ideal for raising funds in the wake of the recent financial crisis. It is currently the fastest growing segment of the international financial markets.

Shariah compliant securities markets are an assertion of religious values in financial market transactions.[1] It performs exactly the same function of transferring savings and surplus liquidity into long-term productive investments through the *primary* markets. It mobilises funds for projects which are also socially responsible by adhering to

---

[1] This approach is similar to pre-classical economist who regarded ethics and finance inseparable. Rodney Wilson, *Economics, Ethics and Religion* (1997) New York University Press at p 3.

ethical criteria of Shariah.[2] It also incorporates moral, ethical and shariah principles in analysing the compliance of the firms listed or wanting to be listed on the Shariah compliant securities markets.[3]

The Islamic capital market has a wide array of products to meet the needs of those who want to invest in compliance with Shariah. These include Shariah compliant stocks, Islamic bonds (sukuk), Islamic funds and Islamic risk management products. The trading on *secondary* Shariah compliant securities markets in Malaysia, UAE, Bahrain and in other countries of Organisation of Islamic Countries (OIC) has already started. The ICM is also rapidly growing in sophistication by providing Shariah compliant product structuring and innovation, project financing, stock broking, asset management, and venture capital services.

The growth is also evident from the number of indices that track the performances of Islamic Financial markets such as Dow Jones Islamic Market Indices (DJIMI)[4], Standard and Poor's Shariah compliant indices, Morgan Stanley capital index (MSCI), FTSE global Islamic index series. The modern Shariah compliant securities markets are at a transitional stage of transforming from being domestic and regional players to becoming a global industry.[5]

As the market is becoming more complex and sophisticated, it needs supportive infrastructure to function more efficiently and effectively. An effective, legal and regulatory framework provides the essential foundation for the functioning of the modern capital market.[6] It also safeguards the investor from insider trading,

---

[2] Ali Adnan Ibrahim, The Rise of Customary Business in International Financial Market, An Introduction to Islamic Finance and Challenges of International Integration, (2007) Volume 23, *American University Law Review* at p 8

[3] Khatkhatay, Shariq Nisar, Shariah Compliant Equity Investment: An Assessment of Current Screening Norms (2007) Volume 15, Islamic Economic Studies at p 1.

[4] DJIMI measures performance of global investable equities that have been screened for shariah compliance. It has been estimated to be worth $20 trillion.

[5] A Policy Dialogue Paper No 1, Islamic Financial Services Industry Development: Ten Years Framework and Strategies (2007) Islamic Development Bank, Islamic Research and Training Institute, Islamic financial services Board at p 1.

[6] Rafael La Porta, FlorencioLopez-de-Silanes & Andrei Shleifer, What Works in Securities Law? (2004) Downloaded from http://mba.tuck.dartmouth.edu/pages/faculty/rafael.laporta/docs/WhatWorksInSecuritiesLaws/securities06112004complete.pdf. Accessed on 2nd May 2013.

manipulation, fraud and harm which is indispensable to create a liquid market. This thesis analyses the ethical and moral underpinning of the more established UK and US market abuse framework in order to draw comparison with the Shariah principles.

The absence of a robust Shariah based legal and regulatory market abuse framework signifies a potential gap in the protection of investors. Moreover, there is also a general trend in Middle Eastern countries to transpose a market abuse legal and regulatory framework from western regimes, without any further enquiry. This creates a visible risk that investors of the Islamic capital market may fall victims to abusive activities which may undermine the integrity of its secondary markets and jeopardise the survival of the entire industry reliant upon equity based financing. It is therefore argued that if Islamic capital markets are to progress, they must move from mere *Shariah compliance* to a *Shariah based approach*. Shariah compliance means the regulations are transposed from the western regimes after ensuring that they do not fall foul of Shariah principles whereas Shariah based means developed from Shariah's own ethical principles.[7] *The thesis is an exercise and an attempt in developing a Shariah based approach in regulating market abuse in comparison with UK and US legal and regulatory regime.* There is no prior literature which has analysed this area thoroughly although there have been some irregular and isolated attempts.[8]

In attempting to conceptualise a Shariah based legal framework for investor protection, its overall objectives of Falah, socio-economic justice, Maslahah, equitable distribution of wealth and alleviation of poverty formulate the foundation of its overall philosophy of market regulation. Shariah is all about fairness in trading, prohibition of abuse, exploitation, harm, protection of investor and safeguarding public interest. Ethics is the foundation of Shariah compliance. Shariah principles are richly endowed with ethical contents and rules of moral propriety. Shariah prohibits riba, gambling, gharar (excessive risk taking) and maisir (excessive and abusive

[7] A Shariah based product or legal framework is designed taking in account the precepts and spirit of Shariah. It may share some similarities with existing conventional products or infrastructure however does not necessarily orginate from it. On the other hand, a Shariah compliant product or legal framework is adopted from conventional finance by tweaking its feature so that it does not contravene any Shariah ruling.

[8] Most countries such as Dubai, Bahrain, Malaysia and Pakistan, where the Islamic Capital Markets are flourishing, had their legal framework transposed from western regimes and as such lack purely Shariah based legal framework.

speculation) because they negate its concept of justice. *The thesis will illustrate that these prohibitions have direct implications for investor protection from market abuse in Shariah compliant securities markets.*

Shariah also prescribes stipulations for contractual structure as a part of its investor protection philosophy. It prohibits the use of financial instruments and practices in trading that conflict with its ethical principles and contractual structures. It also believes that the contractual modes of the products play a key role in facilitating fair transaction and promote falah (social benefit) from the markets. Shariah realises this by designing balanced contractual structures integrating the notion *of fairness, balance of negotiation power for the protection of weaker parties*, which discourages *transaction laden with gharar* and *gambling proclivities* (betting with margin creating excessive volatility).[9] It aims to promote a level playing field in the markets. Shariah scholars in every financial institution supervise financial innovation to ensure the above.[10] The contractual structures also link any investment with the real economy making excessive and abusive speculation very difficult. *The thesis will explore whether transformation of the aforementioned ethical principles in the legal and regulatory framework and mechanics of Shariah compliant contractual structures has the potential to offer inbuilt safety mechanism to battle with market abuse in the context of the modern securities markets.*

The above religious principles and contractual structures were successfully practiced in the markets of Mecca and Medina, fourteen centuries ago, however the modern securities markets have been completely transformed with the technological advancements. The trading in the ancient markets took place on a barter based system whereas trading now takes place on impersonal electronic exchanges with complicated products. The modern electronic exchanges have enabled the relay of information across the globe leading to globalisation of trading. Moreover the

[9] Also see Mohammad Akbar Khan, Consumer Protection and Islamic Law of Contract (2011) *Islamabad Law Review* at p 1, Downloaded from http://ssrn.com/abstract=19619192.

[10] Every Islamic financial institution has its own set of Shariah scholars who approve of all financial transactions as well as all financial innovation to ensure compliance with the spirit of Shariah. In addition to this, the establishment of some key supervisory and self-regulatory organisations is also noteable. For further information please see age 99-100.

availability of highly efficient and leveraged financial instruments has enabled the unscrupulous to carry out paperless transaction at a split second.

This transformation has raised concerns for the safety of investors and has equipped the unscrupulous with increasingly new and potent techniques for the perpetration of fraud, insider trading and market manipulation in the burgeoning Shariah compliant securities markets.[11] It is also acknowledged that transforming or conceptualising the aforementioned ethical principles and ancient contractual structures into a coherent Shariah based market abuse framework to curb market misconduct in the advanced equity, debt and derivative products presents a serious scholarly challenge.

The potential for the occurrence of market abuse in the modern technological advanced Shariah compliant securities markets is not much different from the markets of ancient time. The unscrupulous participants desire to become rich overnight through fraud, manipulation and distortion is as old as the market itself. References of these malpractices were present in the most ancient Roman markets in the second century B.C.[12] The Roman governments had enacted offences of engrossing,[13] regrating[14] and forestalling[15] to curb manipulative practices to ensure the smooth price

---

[11] Internet has made manipulation easier by providing access to wider audience through the internet chat rooms, bulletins and newsfeeds posted to message boards.

[12] Mark Smith, *A History of Global stock Market: From Ancient Rome to Silicone Valley* (2004) University of Chicago Press at p 10-12.

[13] Engrossing was defined as:

That whatsoever person or persons …shall engross or get into his or their hands, by buying and contracting or promise taking, other than by demise, grant or lease of land or title any corn growing in the fields, or any other corn or grain, butter, cheese, fish of dead victuals whatsoever, with in the realm of England, to the intent to sell the same again, shall be accepted and reputed and taken on unlawful engrosser*;* (1551) 5 and 6 Edw.VI c. 14. Statutes of Realm (1363), (37 Edw III c 8.). Also see Wendell Herberk, Forestalling, Regrating and Engrossing (1929) *Michigan Law Review* at p 365-368.

[14] Regrating was defined as.

That whatsoever persons and persons…shall by any means regrate, obtain or get into his or their hands or possession, any corn, or other commodities, that shall be brought to any fair or market in his realm…to be brought to any fair or market with in this realm …to be sold, and do sell the same again in any fair or market holden or kept in the same place, or in any other fair or market within four miles thereof, shall be…taken as regrater.

[15] Forestalling was defined as:

That whatsoever person or persons… shall buy or cause to be brought, any merchandise victual, or any other thing whatsoever, coming by land or by water toward any market or fair, to be sold in the same …or make any bargain, contract or promise for the having or buying of the same, or any part thereof, so coming as is aforesaid, before the said merchandise, victual, or other things, shall be in the market, …ready to be sold; or shall be in the market, letter, message or otherwise, to any person or persons, for the enhancing of the price, or dearer selling of anything or things above mentioned, or else dissuade, move, or stir, any person or persons coming to the market… to abstain or forbear to bring, or convey to formation mechanism.[16] Engrossing was a practice similar to cornering of the supply of commodities. Forestalling was an old practice whereby a manipulator would purchase the commodities from the sellers on their way to the market to increase its price. Regrating was a practice of engineering an artificial shortage of commodities by buying up supplies sufficient to control their flow. Subsequently, these concepts were borrowed from Roman law and enacted to deal with market abuse in the reign of Edward VI in 1284 in UK.[17]

Similar forms of exploitation and abuses were also notorious in the 7th century in Islamic civilisation. They existed in the form of *devouring, ikrah, najsh, ghabn, ikhtiar, ghish, tadlees, collusion and hoarding.*[18] Shariah had taken whole host of measures to curb abuse, exploitation, distortion and manipulation in order to maintain natural equilibrium. The Quran dictated *mutual consent* as a pre-requisite for Shariah compliance to ensure *fair transactions*. It leads to fair price formation mechanisms and a natural equilibrium in the markets which is believed to be a fair method of *equitable distribution of wealth* in the society. This achieved its overall *objectives of socio-economic justice, falah, Maslahah, alleviation of poverty.* Shariah's overriding ethical principle of *sad-al-dhari* also prohibited any elements that may cause *exploitation, oppression, abuse and harm* to the market participants.

The grave nature of aforementioned risk from market abuse is also correspondingly apparent from the history of conventional securities markets. It caused dips and shocks wiping billions of pounds from the market value of the companies, leading to financial crises and throwing entire economies into turmoil. Some of the classic examples of the devastating role of market abuse on the economies are demonstrated

---

the market… to abstain or forbear to bring, or convey any of the things above rehearsed , to any market …shall be deemed …for a forestaller.

[16] The term that is connoted with the concept of free market economy in the modern world, which postulates that law of supply and demand predominates in the idealised free market, influencing prices toward an equilibrium that balances the demands against the supplies. The necessary component of the functioning of the ideal free market includes the complete absence of artificial price pressure, from taxes, subsidies, tariffs, government intervention and independent interaction of economic agents/factors.

[17] Vivien Goldwasser, Regulating Manipulation in Securities Markets: Historical Perspectives and Policy Rationales (1999) Volume 5, *Australian Journal of Legal History* at p 151.

[18] These terminologies are elaborately analysed in the sixth chapter.

by the South Sea bubble in 1720,[19] the Mississippi Scheme in France and the Wall Street crash of 1929[20] and 2008 crisis.

The 2008 crisis[21] distressed the UK and US economy whereas the Islamic finance came through unscathed.[22] This highlighted its conservative approach, inbuilt safety features and stronger ethical foundation which proved to be more potent in avoiding abusive speculation, debt-ridden greed in the build-up of bubbles exploding into financial crises. The resilience has been attributed to its unique principles of profit loss sharing schemes creating greater market discipline, asset based structures creating wealth by linking credit expansion to the growth in the real economy, curbing volatility and abusive speculation by avoidance of excessive uncertainty (gharar). *The thesis explores the role of inbuilt safety features of Shariah compliant financial instruments in equity, debt and derivative markets and analyse their effect in curbing abusive speculation, market abuse leading to financial crisis in the securities markets*.

Currently, the investor protection in Shariah compliant securities are regulated under three different types of regulatory structures across the globe; fully Shariah based legal system,[23] partially shariah based legal system[24] and secular Shariah based legal

---

[19] Historically, bubbles have been initiated by widespread manipulation. In UK, the evidences are "The Royal Commission Report on the Trade of England" (1696), which identified wide spread manipulation and "the pernicious trade of stock jobbing" for causing the crisis. Secondly, the Parliamentary Enquiry after the South Sea Bubble in 1720 also identified manipulation and falsification of the accounts for the formation of its bubble and its collapse. George Gilligan, Historical Touchstones in the Regulation of the Financial services Sector: the Evolution of Financial Services Regulations (1992) *The International Journal of Law and Regulatory Practice* at p 65. In US there have been numerous incidents of manipulative practices by pools creating bubbles and crashes such as steam engine railroad boom and technology bubble of the 1990s. Emilios Avgouleas, *The Mechanics and Regulation of Market Abuse: A Legal and Economic Analysis*, (2005) Oxford University Press at p 88-92

[20] In US, the Senate Banking and Currency Committee investigated the securities industry and identified manipulation as one of the main reasons for the crash. This proved to be a precursor to the enactment of Securities Act 1933 and Securities Exchange Act 1934, in order to alleviate public confidence. H.R.Report No73- 85, (1993) part 1, 2 at p 2.

[21] A financial bubble as defined by Kindleberger "is an upward stock price movement over an extended period of time that eventually and unexpectedly explodes." Charles Kindleberger, Manias, Panics and Crashes: A History of Financial Crisis (2000) John Wiley at p 16. The collapse of dot com bubble (1998-2000) and corporate debacle of Enron, Tyco, Qwest, Parmalt, World com, and Xerox is another example of harm from abusive practices.

[22] Islamic finance was also unaffected in the Asian Crisis of 97-98. It was another testament to its ethical superiority.

[23] This includes Saudi Arabia, Sudan, and Iran etc.

[24] This includes Malaysia, Indonesia, Bahrain, and the UAE etc.

system.[25] A policy paper by the Islamic Development Bank has identified two approaches for the future development of Islamic Finance.

Firstly, a policy frameworks approach that requires legislative reforms and establishment of institutional, legal and regulatory frameworks. Secondly a market orientated financial engineering approach which promotes Shariah compliant products within the existing legal and licensing regime. The later approach regards Shariah compliance a market discipline rather than a regulatory issue. [26] International Organisation for Securities Commissions report also regards the former as more appropriate and viable way to proceed.[27] However, both approaches necessitate evaluation of Shariah principles in reducing the risk of market abuse. *Based on a comparative analysis, the thesis aims to highlight the key features of a Shariah based market abuse framework in securities markets.*

In addition to the above, there are several other compelling reasons for the evaluation of Shariah based market abuse regime which are as follows.

Firstly, the companies obtaining the capital by listing on the stock market contribute significantly to economic growth and development. Historical evidence indicates that a sound legal and regulatory framework and access to finance and economic growth are interlinked.[28] Post financial crisis, the role of shariah compliant securities markets in mobilising resources and risk management has become increasingly important in the global capital markets. It therefore, warrants a clear, concrete and comprehensive

[25] This includes UK, the US and Singapore etc. Nik Thani, The Effectiveness of the Legal and Regulatory Framework for Islamic Financial Services, Published in Current Issues in Islamic Banking and Finance: Resilience and Stability in Islamic Banking (2010) World Scientific publishing Ltd at p 81

[26] A Policy Dialogue Paper No 1, Islamic Financial Services Industry Development: Ten Years Framework and Strategies (2007) Islamic Development Bank, Islamic Research and Training Institute, Islamic financial services Board at p 15, 38.

[27] International Organisation of Securities Commission (IOSCO), Islamic Capital Market Fact Finding Report: Report of the Islamic Capital Market Task Forces (July 2004) at p 1. IOSCO, Analysis of the Application of IOSCO Objective and Principles of Securities Regulation for Islamic Securities Products, September 2008. http://www.iosco.org/library/pubdocs/pdf/IOSCOPD154.pdf, Accessed on 20th March 2010.

[28] Rafael La Porta, FlorencioLopez-de-Silanes & Andrei Shleifer, What Works in Securities Law? (2004) Downloaded from http://mba.tuck.dartmouth.edu/pages/faculty/rafael.laporta/docs/WhatWorksInSecuritiesLaws/securities06112004complete.pdf. Accessed on 2nd May 2013.

Shariah based legal market abuse regime for investor protection, which takes into account its fundamental principles, concepts and also rationales behind its products in ensuring a transparent and level playing field for all investors.

It is also evident from the 2008 catastrophe that the regulators as well as the participants and the market failed to appreciate the risk posed by the complex structured products,[29] thus highlighting a corresponding need to devise a sound legal framework to stay ahead of the accelerated development of Shariah-compliant products with unique contractual structures in securities market.[30] It is therefore, important to design an appropriate Shariah based market abuse framework which will mitigate the risks originating from the unique contractual structures of Shariah compliant products.

Secondly, at present, Shariah compliant securities are operationalized in an environment not compatible with Shariah's principles and norms of morality. There is a risk that the Islamic Capital Markets may fall victim to the shortcomings or practices of the conventional (non-Shariah compliant) system.[31] Therefore, in order to ensure an orderly evolution into a well-functioning Shariah compliant securities markets, which could contribute to the socio-economic prosperity, it is imperative to devise a well-structured institutional, legal, regulatory and supervisory market abuse framework.

Thirdly, despite the growth, great demand and bright prospects, Shariah compliant securities are limited in variety, number and volume in comparison with the conventional securities. They are characterised by family control, fragmentation and concentration in a narrow range of sectors in different countries. This makes them a relatively easy target for insider trading, manipulation and distortion in price formation mechanism. It further highlights the significance of evaluation of shariah principles for investor protection from market abuse.

---

[29] Emilios Avgouleas, The Global Financial Crisis and the Disclosure paradigm in European Financial Regulation: The Case for Reform, Volume 6, *European Company and Financial Law Review* at p 1

[30] Abbas Mirakhor, Noureddine Krichene, Recent Crisis: Lessons for Islamic Finance (2009) Volume 5, Issue 1, *Journal of Islamic Economics, Banking and Finance*, at p 68.

[31] Abbas Mirakhor, The Islamic Financial System and Lessons of the Recent Crisis at p 2, Downloaded from http://www.islamonline.net/English/index.shtml. Accessed on 4rth April 2010.

Lastly, the conventional stock markets have become so disassociated from the real economy that a general trend is shifted to taking advantage of inflated prices through *excessive and abusive speculation* rather than receiving a dividend over a longer period of time. In the absence of robust legal and regulatory framework policing abusive speculation and manipulation, there is a real, actual and perceived risk of these practices in Shariah compliant securities markets as evidenced earlier in the corporate failures of Enron, WorldCom etc. Any such incident may ultimately result in the erosion of confidence and trust in the Islamic Capital Markets before it has had the chance to establish itself.

The thesis attempts to explore and evaluate ethical principles for investor protection in Shariah in comparison with rationales and theories of regulation of market abuse underpinning the UK and US legal and regulatory framework. It aims to define Shariah's approach for investor protection from market abuse and attempts to highlight harmonised theoretical interface and divergences between both the regimes.

1.2- Research Question

The thesis seeks to explore the following fundamental questions:

Firstly, does Shariah provide for principles, maxims, rationales and features of contractual structures, which can protect investors from abuse, exploitation and harm in securities markets? The thesis will attempt to trace these prohibitions and maxims from Quran and Sunnah and illustrate that they are capable of being transformed into a legal market abuse framework to protect investors in the context of modern securities markets.

Secondly, do Shariah principles and contractual structures have an inbuilt safety mechanism to diminish excessive and abusive speculation, which also reduces the occurrence of market abuse? It also outlines the non-Islamic features from the conventional equity, debt and derivative products and analyses their correlation with volatility, abusive speculation, market abuse and financial crisis.

Lastly, the thesis compares and contrasts the rationales and theories of prohibitions of market abuse underpinning UK and US legal framework with Shariah's approach of combating market abuse identified pursuant to the first research question. Based on this comparative analysis, the thesis concludes by highlighting the harmonised theoretical interface, common grounds and divergences between both the regimes.

1.3- Structure of the thesis

In addressing the aforementioned research questions, the thesis has been organised under nine chapters as follows.

Chapter One: General Introduction. This chapter traces the origin of Islamic Banking and evolution of Shariah compliant securities markets. It also briefly touches upon its fast growth, its scope, bright future prospect, potential for market abuse and resultant necessity for legal and regulatory market abuse framework. It addresses the gap in the current research and the general trend to transpose western market abuse legal and regulatory framework in burgeoning Shariah compliant stock exchanges in various Middle-Eastern countries. It highlights the compelling reasons for analysis of *Shariah based* approach as opposed to prevailing Shariah compliant approach. Finally, it sets out the precise research questions.

Chapter Two: Rationales of Prohibition of Market Abuse. This chapter analyses the legal and economic rationales, ethical and philosophical theories underpinning the prohibition of market abuse set out in section 10b(5) of Securities Exchanges Act 1934 in US and section 118 of Financial Services Market Act 2000 in UK. It analyses the on-going debate about deregulation of insider trading based on economic analysis and the opposing stance based on legal and ethical theories. It also analyses the *pros* and cons of regulating and deregulating market manipulation. This sets the scene for comparative analysis with the ethical principles of Shariah in prohibiting exploitation and abuse in the securities markets.

Chapter three: UK and US Law on Market Abuse. This chapter is divided in two parts. Part I analyses the development of US law on market abuse. It traces the US approach on prohibiting market abuse prior and post Great Depression. It analyses the origin of federal prohibition of insider trading and market manipulation. It discusses the Securities Exchange Commission and the Court’s approach to come up with a coherent and robust theoretical framework for prohibition of market abuse after the enactment of Securities Exchange Act 1934. It traces this approach through the development of case law. Part II analyses the current law in UK. It discusses the evolution of statutory law. It explores the current law set out in Criminal Justice Act 1993 and Financial Services Market Act 2000.

Chapter Four: Shariah Principles for Securities Markets. This chapter traces the origin of Islamic finance and Shariah compliant securities markets. It briefly explores and analyses the Islamic principles and prohibitions which aimed to safe guard from abuse, harm and exploitation in the barter based ancient markets. This sets the background analysis of Shariah's approach in dealing with market abuse. It is further developed in the sixth chapter to formulate a coherent theoretical underpinning in the context of modern securities markets.

Chapter Five: Contractual structures and Shariah Instruments in Securities Markets. This chapter analyse the equity, debt based and risk hedging contractual structures of Shariah in spot and forward markets. It deductively analyses these structures to ascertain its special inbuilt safety features which discourage the occurrence of market abuse in practice. The inbuilt safety features are further explored in comparison with the equity, debt and derivative products of conventional finance to illustrate their effectiveness in combating abusive speculation and manipulation in the seventh chapter.

Chapter Six: Shariah Perspective of Market Abuse. This chapter develops on the ethical principles elaborated in the fourth chapter to formulate a philosophical underpinning for investor protection in the context of modern securities markets. It also traces the Quranic prohibitions and Prophetic commandments for prohibition of artificial interference, abusive speculation, harm, exploitation, and insider trading and market manipulation in the context of modern securities markets.

Chapter Seven: Shariah Perspective of Market Abuse and Prohibition of Abusive Speculation: This chapter traces the Quranic prohibitions and Prophetic commandments for prohibition of artificial interference, abusive speculation, harm, exploitation, insider trading and market manipulation in the context of modern securities markets. It also develops on the ethical principles elaborated in the fourth and fifth chapters to formulate a philosophical underpinning for investor protection in the context of modern securities markets

It also analyses the effectiveness of aformentioned Shariah principles in minimising abusive speculation in equity, debt and derivative markets. It also highlights the role of inbuilt safety features of Shariah compliant contractual structures in curbing abusive speculation and manipulation from securities market.

Chapter Eighth: Critical Evaluation and Conclusion. This chapter critically compares and contrast the rationales of prohibition of market abuse in UK and US with the ethical and religious principles of Shariah. It highlights the important features of Shariah's market abuse framework. It also examines the common ethical approach divergences and whether Shariah based market abuse approach could be used to improve the integrity and stability of UK and US securities Market.

2- Rationales for Prohibition of Market

2.1-Introduction

The chapter examines moral and economic rationales articulated *for* and *against* the regulation of insider trading, market manipulation and distortion. These ethical theories, rationales and principle are of central importance and formulate the theoretical force underpinning legal and regulatory prohibition. It also examines various ethical theories evolved in Court's attempt to come up with a coherent theoretical framework under section 10b (5) of Securities Act 1933. It aims to eliminate harm, exploitation and promote investor confidence, transparency and a level playing field in secondary trading. The theoretical framework will serve as a bench mark for comparison with ancient Shariah principles in subsequent chapters, which aim to achieve the same objectives.

2.2- Prohibition of Market Abuse

Market abuse refers to insider trading, market manipulation and distortion of the price formation mechanism leading to adulteration of the integrity of the financial markets. The violation of the above offences can expose a person not only to civil and private litigation but also to criminal prosecution. It is therefore particularly important to ensure clarity and coherence in the theoretical underpinning of the prohibition.

2.3- Prohibition of Insider Trading

2.3.1- Introduction

The law against insider trading is enacted in most countries. However the underlying debate about *ethical versus economic rationales* is still on-going. Economists argued that the prohibition has been supported by legal, theoretical, ethical and doctrinal analysis carried out by lawyers, judges and law professors.[1] Professor Manne was the first economist to challenge the the underlying ethical theories and principles on the basis that it leads to incoherent policy prescriptions.[2] He argued that the adverse effects of insider trading upon public investors, corporations and stock markets were

---

[1] Roy Schotland, Unsafe at Any Price: A Reply to Manne, Insider Trading and the Stock Market, (1967) Volume 53, *Virginia Law Review* at p 1425.

[2] Laura Benny**,** Insider Trading Laws and the Stock Market around the World (2006) Paper No 35, *The John M Olin Centre for Law and Economics Working Paper Series* at p 1-3.

simply assumed without taking into account the economic rationales.[34] He advocated annulment of law prohibiting insider trading on the basis that[5]

1- Insider trading is a conduit for information disclosure. It benefits society and the particular corporation's stocks by moving the price closer to the true equilibrium level which leads to increased price accuracy and liquidity.

2- Insider trading acts as a managerial compensation for the production of useful information.[6]

3- The practice does not cause any harm and therefore the prohibition cannot be justified on the basis of "Fairness."

Scholars rejected his views as being both offensive to the moral standards of business and which if accepted, will undermine market integrity.[7] The subsequent headings consider the *economic rationales* against the regulation of insider trading and *key ethical and moral rationales* in favour of regulation.

2.4- Insider Trading and the Efficient Pricing of Securities

2.4.1- Information and the Stock Market

The Stock exchanges provide a platform to determine the monetary value on information about companies' stocks. The information originates from the conduct of

---

[3] He considered the economic rationales of regulating insider trading for the first time in his book in 1966. Henry Manne, *Insider Trading and the Stock Market* (1966) New York: The Free Press.

[4] He considered the economic rationales of regulating insider trading for the first time in his book in 1966. Henry Manne, *Insider Trading and the Stock Market* (1966) New York: The Free Press at p 5, 6-8, 9, 13, 51, 128, 230. The existing literature was based on Reports of the Special Study of Securities Markets of the SEC, *H.R.Doc. No 95, 88th Congress, Its Session* (1963), Hearings on Stock Exchange Practices before the Senate Committee On Banking and Currency, *72d Congress 2nd Session* (1923-1933), *73rd Congress Its & 2d Session* (1933-1934), Berle, Publicity of Accounts and Directors Purchases of Stocks (1927) Volume 25, *Michigan Law Review* at p 827, Cary, The Direction of Management Responsibility (1962) Volume 18, *Business Law* at p 29, Cary, Corporate Standards and Legal Rules (1962) Volume 50, *California Law Review* at p 408, Cary, Recent Developments in Securities Regulation, (1963) Volume 63, *Column Law Review* at p 856.

[5] Henry Manne, Insider Trading: Hayek, Virtual Markets and the Dog that did not bark (2005) Volume 31, *Journal of Corporation Law* at p 167-185.

[6] This rationale is mentioned for the sake of completeness and is not analysed any further. It discusses the justification for deregulation of insider trading from economic perspective and as such does not raise any ethical theories for the analysis in the subsequent chapters.

[7] Schotland and Bainbridge criticised Manne's approach. Other academics writers and economist such as Milton Friedman, Thomas Sowel, Dennis Carlton, Daniel Fischel, and Frank Easterbrook etc have approached Manne's views more sympathetically, providing further support and elaboration. John Schiller, *Financial Fraud* (2010) Create Space Publishing at p 17. Also see Larry Harris, *Trading and Exchanges* (2003) Oxford Press at p 591-597.

normal business activities and insiders may exploit this information to earn profit. Generally, investors evaluate financial information of firms, its equity to debt ratio, business plans, future profit forecast, reputation of management and other general economic conditions before trading. In this context, good accurate and reliable information plays a key role and can ultimately lead to the success or failure of an investor. There is a consensus that wider availability of market information results in better pricing of securities which leads to efficiency in the stock market.[8] The flow of sufficient and credible information to all investors is ensured by specific registration requirements and on-going mandatory disclosure obligations. It ensures level playing field for all investors and they are able to make well informed investment decisions.

2.4.2- The Impact of Insider Trading

Insider trading serves as a less costly substitute of disclosing information because it facilitates the incorporation of information into the market price of securities. It enhances efficiency because it refers to both the speed and accuracy with which the market integrates new information into the pricing of a security.[9] Thus accurate pricing of securities and the correct prospects of different issuers increase the informational,[10] allocational[11] and operational efficiency of the stock markets.

Manne theoretically demonstrated the effects of *insider* trading upon the *market* and its *participants* (outsiders).[12] He argued that if the new information relates to good news, insiders purchase causes a slight price rise.[13] Some outsiders, noticing upward

[8] Georgios Zeckos, Is the law effective in Protecting from Insider Trading (2006) *Hertfordshire Law Journal* at p 4-7 and p 16.

[9] Henry Manne, *Insider Trading and the Stock Market* (1966) New York: The Free Press at p 56.

[10] This leads to increasement in the amount of value added by firms as they use society's scarce resources for the production of goods and services.

[11] This leads the funds to those who can make the best use of them.

[12] He classified the outsiders into two categories; first are those whose decisions are *function of time* and the second who base their decisions *on price*. The time functioned investors trade for reasons unrelated to the price changes. These traders investment strategy is based on fundamental factors, such as the reputation of issuers' management, dividend history and earning potential, as well as by taking into account external event such as liquidity needs, economic and political events. On the contrary, price functioned traders speculate on the basis of changes in prices." Henry Manne, In Defense of Insider Trading (1966) Volume 44, *Harvard Business Review* at 114-115.

[13] He then examined the impact of prohibiting the insider trading (No Insider Trading Rule) and allowing it (Free Insider Trading Rule) upon each one of above mentioned categories. Under a free

price movements start to purchase a particular stock.[14] As the buyers side grows bigger in the market, the market price gradually rises to a level reflecting the value of new information, just as if this had been publicly disclosed. He thus argued that outside sellers are better off because they are able to sell shares at a better price.

On the other hand, the opposite would occur when the insider learns bad news because by selling securities, the demand will fall and so will the price. Therefore the market is more accurate and insider trading acts as a better conduit for the gradual and rapid dissemination of non-public information in the market.

The rationale behind Manne's theory is that prohibition of insider trading delays the fast reflection of new information in the markets and inaccurate reflection creates uncertainty in the markets. This makes beneficial trading more costly and less likely.[15] Carlton & Fischel supported him by arguing that accurate pricing decreases the volatility of security prices.[16] This dampening of price fluctuations increases the attractiveness of investing in securities for risk-averse investors.[17] This reduces investors' uncertainty and also benefits corporations through improved opportunities to raise more funds.

Givoly & Palmon[18] disagreed with the above assertion and argued that the insider trading effect on the price, supply and demand of a particular security has only a minimal impact. The correct measure for the supply of securities is not simply the total of firm's outstanding securities, but vastly large number of securities with a similar combination of risk and return on the stock exchanges. Therefore the supply

---

insider-trading rule, insiders are free to trade on private information before disclosure. Henry Manne, *Insider Trading and the Stock Market* (1966) New York: The Free Press at p 95.

[14] Ibid at p 80.

[15] Henry Manne, Insider Trading and the Law Professors, (1970) Volume 23, *Vanderbilt Law Review* at p 566.

[16] Dennis Carlton & Daniel Fischel, The Regulation of Insider Trading (1983) Volume 35, *Stanford Law Review* at p 857.

[17] Stephen Bainbridge, The Insider Trading Prohibition: A Legal and Economic Enigma (1986) citing Wang, Trading on Material Non-public Information of Impersonal Stock Markets (1986) Volume 54, *South California Law Review* at p 1226.

[18] Dan Givoly & Dan Palmon, Insider Trading and the Exploitation of inside Information: Some Empirical Evidence (1985) Volume 58, *Journal of Business Review* at p 69.

effect of a relative small number of insider trades cannot have a significant price effect.[19] Manne acknowledged that insider trading account for only a small portion of the total trading activity but maintained that small number of insiders with valuable information will have a determinable effect in a randomly fluctuating market. The *Texas Gulf Sulphur case* appears to provide support for his hypothesis where the prices raised gradually until they fully reflected the inside information.[20]

Professor Carlton and Fischel[21] also supported the contention that insider trading is more effective way of ensuring that market prices reflect information, a firm could not feasibly announce publicly. The information is of a non-disclose able nature or not fully developed. Announcement may destroy the value of the information, may compromise firm's competitive position and owing to the uncertainty of information may subject the firm to massive damage liability if it turns out incorrect or misleading at a later stage.[22] He quoted an example from the TGS case, if the company was obliged to disclose the ore strike immediately, landowners would have demanded a higher price for the mineral rights. Thus the argument holds strength that insider trading is an effective compromise between the need for immediate disclosure of information and the disclosure of information prematurely in securities markets.[23]

Schotland dismissed the above assertion as flawed and argued that the insiders may delay disclosure to give them more time to arrange financing to buy more shares. Moreover, allowing insider trading makes unlawful manipulation more likely. It also increases the potential risk that the employees would be distracted in their devotion to the corporation due to conflict of interest.[24] Haft argued that if the members of the organisation pursued individual profit, the cohesiveness of the unit will deteriorate

---

[19] Ronald Gilson & Reinier Kraakman, The Mechanisms of Market Efficiency (1984) Volume 70, *Virginia Law Review* at p 629.

[20] Henry Manne, *Insider Trading and the Stock Market* (1966) New York: The Free Press at p 98.

[21] Dennis Carlton & Daniel Fischel, The Regulation of Insider Trading (1983) 35 *Stanford Law Review* at p 866.

[22] Ibid at p 868.

[23] Henry Manne, Insider Trading: Hayek, Virtual Markets and the Dog that did not bark (2005) Volume 31, *Journal of Corporation Law* at p 4.

[24] Roy Schotland, Unsafe at Any Price: A Reply to Manne, Insider Trading and the Stock Market (1967) Volume 53, *Virginia Law Review* at p 1451.

leading to lower quality decision making. This may also give rise to conflict of interest which may destroy the team culture of the corporation.[25]

Manne argued that there will always be a time lag between the development of new information and its ultimate publication to outsiders, even if there is a perfect compliance with the rules of disclosure.[26] This makes insider trading a perfect conduit for the information to be absorbed. He argued that insiders will move very quickly with whatever resources they have[27] because they are aware that with every passing minute, hour, or day there is a probability of a new event or information that may cause a decline in the same stock price.[28]

Manne also asserted that insider trading makes the market less volatile as a result of smoothing effect. It improves stock market continuity. He stated that the prices would rise much sharper and abruptly upon public disclosure if insider trading was barred.[29] Schotland challenged this assertion on the grounds that *firstly,* the assumption that unregulated inside trading moves the market closer to the correct price. For this to happen, the volume of the trade has to be very large. *Secondly,* if it is accepted, than the questions is why gradual price movement is better than a sharp rise. *Thirdly,* gradual price movements may be desirable in comparison with a sharp price shifts. However if the market is characterized by equality of participants and fairness leading to informed transactions than it may be argued that it is perhaps better than at false market with smoother price movements. Therefore insider trading leading to smoothness is not worth its price and is not desirable.[30]

A more contemporary and significantly stronger case for deregulation of insider trading on the promotion of efficiency rationale has been built with the Efficient

---

[25] Robert Haft, The Effect of Insider Trading Rules on the Internal Efficiency of the Large Corporation (1981) Volume 80, *Michigan Law Review* at p 1058.

[26] Henry Manne, Insider Trading and the Law Professors (1970) Volume 23, *Vanderbilt Law Review* p 566.

[27] Ibid at p 568

[28] Henry Manne, Economic Mysteries in Insider Trading (1991) Discussion Paper, Saarbrucken: Europa-Institute at p 4.

[29] Henry Manne, *Insider Trading and the Stock Market* (1966) New York: The Free Press at p 86-90.

[30] Roy Schotland, Unsafe at Any Price: A Reply to Manne, Insider Trading and the Stock Market (1967) Volume 53, *Virginia Law Review* at p 1446.

Market Hypothesis (EMH).[31] In this context, Fama categorised the EMH into the weak form, the strong form and the semi-strong. The *weak form* assumes that prices fully reflect all information contained in the historical pattern of market prices. It implies that prices follow a random walk and an investor cannot predict future prices from looking at the past development. It therefore is irrelevant in the context of insider trading.

On the other hand, the *strong form* states that securities prices reflect both non-public and public information. Assuming the strong form applies, an investor derives no advantage from insider trading, since the information is already incorporated in the price of the stock. The *semi strong form* is the most widely accepted as prevalent in the world's securities markets. This assumes that stock prices do not incorporate information that is not publicly available. The main assertion is that insider trading would assist the market to surpass the level of semi-strong informational efficiency and rise to the level of strong informational efficiency. An increase in trading volume caused by insider trading also signals to the market that there is undisclosed information, which is not being reflected in the price. Thus prohibiting insider transactions has a negative impact on reflection of information in the stock prices.

Manne also asserted that insiders are more capable of estimating the true value of a security. Securities analyst may discover much of the information, but he will rarely in be in the same position as insiders to asses all the relevant factors. Furthermore information can be processed and acted upon much more quickly by an insider than by the public.[32] On the other hand, Professor Gilson and Kraakman[33] argued that market participants cannot glean non-public information unless the identity of the insider is disclosed.[34] Derivatively informed trading can affect price, however it functions slowly and sporadically. He suggested that outsiders cannot decode the

---

[31] Eugene Fama, Random Walks in the Stock market Prices (1965) Volume 21, *Financial Analysts Journal* at p 55.

[32] Henry Manne, Insider Trading and the Law Professors (1970) Volume 23, *Vanderbilt Law Review* at p 569

[33] The price effect of insider trading is an example of what they call the derivatively informed trading mechanism of market efficiency. Ronald Gilson & Reinier Kraakman, The Mechanisms of Market Efficiency (1984) Volume 70, *Virginia Law Review* at p 578.

[34] Ronald Gilson & Reinier Kraakman, The Mechanisms of Market Efficiency (1984) Volume 70, *Virginia Law Review* at p 632-634.

information effectively enough. Minor fluctuations in price and volume can be ambiguous or susceptible to noise. Fully effective price decoding is unattainable and remains a theoretical concept rather than a market reality. Therefore the suggestion that the outsiders can decode the information from the trading activities of insider is the product of limited understanding, if not a fundamental misconception of the mechanism of market efficiency.[35]

Manne propounded two other non-economic arguments against regulation. He asserted that the current regulatory regime has failed to significantly deter insider trading. According to him, perfect enforcement is not possible and therefore insiders will discover the subterfuges and devices to circumvent the prohibition. These devices to avoid compliance with the SEC rules will consume time and all other individuals who benefit from an efficient stock market are injured.[36] The proponents reject his logic and state that the enforcement can never be totally effective. Ineffective or inefficient enforcement should not impugn the criminal status of any action. If anything it should only stimulate a debate about a better form of policing methods. David Ferber[37] contended that although some insiders will get away as undoubtedly the public authorities would be unable to catch them. The fact that the Securities Exchange Commission is able to enforce the law against other violators will necessarily discourage potential future violators.

Academics, lawyers and economists concede that the resolution of this debate is very much an empirical question. However empirical studies remain very much inconclusive on this subject. Schotland criticised that although Manne deplored the lack of empirical research, he does not cite any published or unpublished reports in his book.[38] He argued that there were at least three published reports of empirical

---

[35] Roy Schotland, Unsafe at Any Price: A Reply to Manne, Insider Trading and the Stock Market (1967) Volume 53, *Virginia Law Review* at p 1446

[36] Henry Manne, Insider Trading and the Law Professors, (1970) Volume 23, *Vanderbilt Law Review* at p 567.

[37] David Ferber, The Case Against Insider Trading: A Response to the Professor Manne (1970) Volume 23, *Vanderbilt Law Review* at p 621.

[38] Although he repeatedly deplored the lack of empirical research and called upon the economist to bring their skills to the problem.

research on the market impact of insider trading, before the publication of his book, all strongly suggesting the absence of any substantial impact.[39]

Despite the aforementioned compelling economic arguments against the regulation of insider trading, the UK and US regimes have provided an active legal and regulatory framework prohibiting this practice. This is an attempt to bring norms of ethics in trading on secondary markets which endorse morality over efficiency.

2.5- Fairness as a Justification for Insider Trading Prohibition

One of the main policy justifications propounded for banning insider trading has been based on "unfairness." However, the proponents of this justification have failed to give any contents of unfairness and just contended that the practice was fundamentally corrupt and hence prohibited. Manne criticised this poorly articulated notions of fairness, which failed to push[40] beyond a "sense of moral outrage."[41] He

---

[39] Roy Schotland, Unsafe at Any Price: A Reply to Manne, Insider Trading and the Stock Market (1967) Volume 53, *Virginia Law Review* at p 1443. There are two unpublished thesis on the subject done under Professor Irwin Friend of Wharton School of Finance and Commerce, University of Pennsylvania. Wu, *Corporate Insider Trading Profits and the Ability to Forecast Stock Price*, H Wu & A Zakon, Elements of Investments 442, 443 (1965). See also the unpublished doctoral dissertation on the subject by Monroe Fischer, American University Department of Economics, 1965. The first empirical study of insider trading is by an economist named, Frank Percy Smith, Management Trading: Stock Market Prices and Profits (1941) Yale University Press. Sugato Chakarvarty and John McConnell, Does Insider trading really move Prices (1999) Volume 34, *Journal of Financial Quantative Analysis* at p 191. The author uses case study of Boesky's purchase of carnations stock show that the effect of insider trading and non-insider trading are statistically indistinguishable. Lisa Meulbroek, An Empirical Analysis of Illegal Insider Trading (1992) Volume 47, *Journal of Finance* at p 1661

[40] In addition to the footnotes below, I have consulted these articles. Joerg Hartmann, Insider Trading: An Economic and Legal Analysis (1997-1998) Volume 1, *Gonzaga Journal of International Law Review* at p 61. Ian Lee, Fairness and Insider Trading (2002) *Columbia Business Law Review* at p 141-160. Dennis Carlton & Daniel Fischel, The Regulation of Insider Trading (1983) Volume 35, *Stanford Law Review* at p 880. Alan Strudler & Eric Orts, Moral Principle in the Law of Insider Trading (1999) Volume 78, *Texas Law Review* at p 400. Victor Brudney. Insiders, Outsiders and Informational Advantages under the Federal Securities Law (1979) Volume 93, *Harvard Law Review* at p 355. Charles Cox, Kevin Fogarty, Bases of Insider Trading Law (1998) Volume 49, *Ohio State Law Journals* at p 358-360. Phillip Anthony O'Hara, Insider Trading in Financial Markets: Legality, Ethics and Efficiency (2001) *International Journal of Social Economic* at p 1053-1056. Panagiotis Staikours, Ensuring the Integrity of Price Formation Mechanism (2003) Unpublished thesis, London School of Economics at p 15-115. Peter-Jan Engelen, Luc Van Liedekerk, An Ethical Analysis of Regulating Insider Trading (2005) Discussion Paper Series, Volume 6, Tjalling Koopman Research Institute at p 11-14. Stephen Bainbridge, The Insider Trading Prohibition: Legal and Economic Enigma, Volume 38, *Florida Law Review* at p 55-61. Stephen Bainbridge, the Law and Economics of Insider Trading: A Comprehensive Primer (2001) at p 71. Downloaded from http://papers.ssrn.com/paper.taf?abstract_id=261277. Accessed on June 2008. Stephen Bainbridge, Insider Trading: An Overview (1998) at p 11-14 Downloaded from http://papers.ssrn.com/sol3/papers.cfm?abstract_id=132529. Accessed on June 2008.

argued that theoretical framework based on unfairness which underlies prohibition of insider trading would collapse when subjected to systematic analysis. He argued that fairness is a high sounding but essentially empty concept that lacks any standard of reference or intellectual coherence.[42] He conceded that moral and ethical business standards have an important role, however, when formulating a public policy, morals are either sham or refuge for intellectually bankrupt. Moreover, just because insider trading "raises a spectre of dishonesty, exploitation and fraud," this does not suffice for the practice to be banned without any systematic analysis.[43]

Scotland disregarded the above assertion and argued that legal and theoretical rationales of prohibition of insider trading are evaluated from an economic perspective in order to ensure "sounder legal or moral judgements."[44] He argued even if Manne's economic analysis is correct, it still has to be disregarded to secure a "*stock market with fairness, just reward and integrity*"[45] It is also in harmony with the policy behind the Securities Exchange Act 1934 which was to create a fair and honest market and preserve investors' confidence. The Act repetitively mentioned "*Fair dealing*"[46] and "*fair and orderly market.*"[47] Moreover, Congress declared insider trading and manipulation immoral by giving "fairness" an overriding status and the Supreme Court has endorsed this in *O'Hagan.* Furthermore it is also evident from global development of securities law that countries increasingly recognise that regulation of insider trading is a factor, which global institutional investors require as a pre-condition for investment.

---

[41] Henry Manne, *Insider Trading and the Stock Market*, (1966) New York: The Free Press at p (VI) – Preface.

[42] Stephen Bainbridge, *Securities Law: Insider Trading* (1999) Foundation Press at p 125.

[43] Ibid at p 126.

[44] Schotland, Unsafe at Any Price: A Reply to Manne, Insider Trading and the Stock Market (1967) Volume 53, *Virginia Law Review* at p 1438.

[45] Ibid at p 1439.

[46] Fair dealing is mentioned in no fewer than six sections in Securities Exchange Act 1932. 15 U.S.C. 78f(d), l (b) (2), l (b) (3), m(a), 0-3 (k)(1), s(b) (1964), See SPECIAL STUDY, pl.2, ch V, at 13-14, Also see Stephen Bainbridge, *Securities Law: Insider Trading (1999) Foundation Press* at p 149-150. Schotland, Unsafe at Any Price: A Reply to Manne, Insider Trading and the Stock Market (1967) Volume 53, *Virginia Law Review* at p 1438.

[47] 15 U.S.C. 78 k (a), (b) (1964). Ibid at p 1438.

Academics and jurists have attempted to present a reasoned argument in favour of the theoretical foundation of fairness doctrine. In this context, three key themes appear to emerge which define fairness as follows:

1- Fairness requires symmetrical information to all investors.
2- Fairness dictates no breach of fiduciary duty by insiders.
3- Fairness dictates no harm to the contemporaneous trader and preservation of investors' confidence.

2.5.1- Fairness Requires Symmetrical Information to all Investors

The doctrine of fairness posits that nobody should be able to take advantage of superior, non-public information in the impersonal securities market. It aims to promote a sportsman theory which advocates that all investors should be subject to the same risk. Insider trading is regarded as unfair because insiders enjoy an informational advantage in comparison to outsiders and therefore the parties are not in equal positions. This state of affairs discourages ordinary investors, destroys competition and undermines the efficient and proper functioning of the free market. In the context of *provision of information* in securities markets, fairness may be subdivided as follows:

1- The Absolute Equality of Information
2- The Equal Access View.

The subsequent headings consider the rationales, justifications and approaches under the above two versions of fairness.

2.5.1.1- The Absolute Equality of Information

The underlying theme of this notion was originally mentioned in the classical writings of Cicero over two thousand years ago.[48] Cicero illustrated his disapproval of insider trading by hypothetical examples. The example related to grain merchant who withheld the information about oncoming supply in ships in order to sell his

[48] Cicero (3, 106 BC – December 7, 43 BC) was a Roman philosopher, statesman, lawyer, political theorist and Roman constitutionalist. He is widely considered as one of Rome's greatest orator and prose stylists.

commodity at a favourable price.[49] He presented his argument in the form of an imaginary dialogue between him and another philosopher and concluded a person who fails to disclose is "no candid or sincere or straightforward or upright or honest man but rather one who is shifty, sly, artful, shrewd, underhand, cunning and one grown in fraud and subtlety."[50] He based his argument on the rationales of *interest of community and fellowmen*.[51] Shariah also regard transactions as void where the information is withheld based on a similar rational of *social interest*. It is referred to as *ghish* and is further elaborated in the subsequent chapters in the context of trading on impersonal stock exchanges.

The modern concept of "absolute equality of information" between the investing public took shape from Judge Leahy's decision in the interpretation of Rule 10b (5) in the case of *Speed v Transamerica*.[52] He regarded the Rule to be instrumental in providing some "degree of equalization of bargaining position"[53] on the impersonal securities market. In other words, the rule was thought to be maximising fairness and fairness was equated with equality of information among all the investors. The principle of equality of information was developed further in the case of *Re Cady Roberts and Co.*[54] SEC decided all traders who have access to inside corporate information must disclose the information before trading because they owe this duty to the market and other traders. It was a very strict notion of fairness.[55] The principle has also been cited as an underlying rationale in the legislative history of Insider Trading Sanctions Act 1984.

---

[49] See M. Cicero, DE OFFICUS Bk, III (W. Miller Trans. 1968) at Bk. III, ch.xii; Mentioned in Garry Lawson, The Ethics of Insider Trading (1988) *Harvard Journal of Law and Public Policy II* at p 737-740.

[50]Ibid at p 740.

[51] Ibid at p 740. Between thirteenth and the seventeenth century three of the major continental lawyers (Aquinas, Grotius and Pufendorf) had a consensus that there is a moral duty to disclose facts in relation to the subject matter of contract such as the defects in the building but no duty to disclose circumstances surrounding the subject matter of the contract such as the arrival of ships laden with grain.

[52] 99 F. Supp. 808, 828-832 (D. Del.1951)

[53] 99 F. Supp. at 829.

[54] 40 S.E.C. 907, 911 (1961).

[55] SEC held that the duty to disclose material non-public information or refrain from trading rests on two principle elements; 1- the existence of relationship giving access, directly or indirectly, to information intended to be available only for a corporate purpose and not for the personal benefit of

Professor Levmore supported the above approach and proposed an analogous definition of fairness. He argued that fairness is only achieved when all the investing community, insiders and outsiders are in equal position.[56] This can only be achieved if we can devise such a system that would not make any party envy the other in relation to the information relevant in any transaction. In this context, Jennifer also argued that fairness reflects the golden rule of impersonal behaviour, "treating others as we would ourselves."[57] Her arguments also echo the essence of Cicero's commentary. It is argued that prima facie this sounds overly broad and would render most of the economic activities involving disparity of information as unfair and unethical.

Jonathan Macey[58] argued that although the above reasoning may sound persuasive and equitable at first impression, however it does not lead to rational and productive results, if taken to its logical conclusion. *Firstly*, if the "equal information rational" is applied all across the board, it may lead to a total ban on all trading activities.[59] This reasoning would justify disclosing information even where it is undesirable such as TGS disclosing the requisite information to the landowners. *Secondly* and most importantly, the securities market is inherently in-egalitarian. It "rewards its participant precisely"[60] because it exercises an advantage over the other party due to their effort, skills, knowledge, intelligence, capitalisation or even luck. In real life the investors are barely ever equal even if the enforcement of insider trading proves to be a hundred per cent successful. They differ in their ability, diligence and sophistication to draw inferences from the available information and make the right investment.[61]

---

anyone and 2- the inherent unfairness where a party takes advantage of such information knowing it is unavailable to those with whom he is dealing. 401 F.2d at 848.

[56] Saul Levmore, Securities and Secrets: Insider Trading and the Law of Contract (1982) Volume 68, *Virginia Law Review* at p 122.

[57] Jennifer Moore, What Is Really Unethical about Insider Trading (1990) Volume 9, *Journal of Business Ethics* at p171-182.

[58] Jonathan Macey From Fairness to Contract: The New Direction of the Rules against Insider Trading (1984) Volume 13, *Hofstra Law Review* at p 9-64.

[59] Ibid at p 16

[60] Kimberly Krawiece, Fairness, Efficiency, and Insider Trading: Deconstructing the Coin of the Realm in the Information Age (2001) Volume 95, *North-western University Law Review* at p 502

[61] Frank Easterbrook. Insider Trading, Secret Agents, Evidentiary Privileges and the Production of Information (1981) *Supreme Court Review* at p 330.

Thirdly, fairness equated with parity of information would prove to be a rigid principle in practice and would result in conviction of not only insiders[62] but also others who possess inside information due to their genuine efforts, intelligence, greater trading skills and superior investigative expertise. Strudler also argued one might have legitimately worked hard to produce or discover information and therefore morally deserve the right to use the information to his bargaining advantage.[63] Thus regulatory system should allow market professionals and analysts to trade on the basis of their superior skills, knowledge and understanding and should only penalise obtaining and possession of information by illegal means.

Fourthly, to require stock traders to disclose any informational advantage would encourage competitors to free ride on someone else discovery. This would discourage information traders to specialise or expend resources to uncover and interpret undisclosed price sensitive information and would diminish efficiency when the information does not reach to the market via these experts. These concern have lead Jonathan Macey, Kim Lane Scheppele, Victor Brudney to reject the parity of information as a “utopian position”[64] Thus free disclosure or parity of information is described as a recipe for the collapse of the entire information market.

Machan analysed the moral, legal or natural obligation to share the non-public information to others.[65] He argued that transactions involving informational asymmetry take place on a daily basis between lawyers/doctors with theirs clients, tutors with their students and plumbers with homeowners. Since information is always asymmetric in the business world, evidently there is no apparent reason as to why trading in stocks is different than other commodities or real estate. The law of contract also permits trading on the basis of superior information without any requirement for disclosure unless there is duty owed to the other party or a relationship of trust

[62] Justice Powel articulated the same approach in the case of Chiarella. Kim Lane Scheppele. It’s Just Not Right: The Ethics of Insider Trading Law (1993) Volume 56, *Law and Contemporary Problems* at p 128.

[63] Alan Strudler & Eric Orts, Moral Principle in the Law of Insider Trading (1999) Volume 78, *Texas Law Review* at p 402

[64] Victor Brudney. Insiders, Outsiders and Informational Advantages under the Federal Securities Law (1979) Volume 93, *Harvard Law Review* at p 339-340.

[65] Tibor Machan, What is Morally Right with Insider trading (2007) Volume 10, *Public Affairs Quarterly* at p 137.

generating such expectations. Thus legally there is no such requirement to disclose everything to the purchasers, as long as the contracting parties do not lie or misrepresent to each other in relation to the subject matter of contract.[66] Machan concluded that without a definitive moral theory, which describes when there is an obligation to disclose to the other party, equality of information rational is too broad and fails.

Strudler has applied *deontological theory of ethics* to clarify the concept of fairness that underlies the insider trading prohibition. It posits that rightness or wrongness of an action should be assessed independently of the consequences and economic arguments. Moral principles take precedence over economic results regardless of how effective they are for the society. He argued insider trading is morally wrong on its own account and the insider trading prohibition protects the autonomy of the investors from unfair and wrongful deception. Since the information is regarded as central to rational decision-making, non-disclosure of material information is a breach of an individual's autonomy. It vitiates the consensual nature of the transaction and amounts to fraud.[67] Shariah took a similar stance in one to one transactions in the ancient markets and this is analysed in the sixth chapter.

The above theory is better understood in contrast to the consequentialist theory. Scheppele[68] compared the doctrine of Utilitarianism (a form of consequentialist theory)[69] with Contractarian theory[70] in evaluating theoretical foundation of insider

[66] Lying and misrepresentation is a form of deception and deception is subtle form of coercion, which undermines the deceived party's exercise of rational choice with respect to the transaction. Jennifer Moore, What Is Really Unethical about Insider Trading, (1990) Volume 9, Journal of Business Ethics at p 172.

[67] Alan Strudler & Eric Orts, Moral Principle in the Law of Insider Trading (1999) Volume 78, *Texas Law Review* at p 409.

[68] Generally two broad classes of ethical theory – consequentialist and deontological, have shaped most people's understanding of ethics. Kim Lane Scheppele, It's Just Not right: The Ethics of Insider Trading (1993) Volume 56, *Law and Contemporary Problems* at p 150-155.

[69] The doctrine of Utilitarianism is the most widely advocated form of consequentialist theory of philosophy. The doctrine propagates that when, facing a moral decision, one should consider available alternative actions and traces the likely moral consequences of each and then selects the option that maximises the greatest happiness of the greatest numbers.

[70] It originates from the works of the American philosopher John Rawls (1921-2002) commonly known as "Rawls theory of justice." He sees justice as fairness, and its intuitive idea is that the well being of society depends on cooperation. It is based on the traditional theories of social contract as represented by English philosopher John Locke (1632-1704), Swiss philosopher Jean-Jacques Rousseau (1712-

trading regulations. Law and economics, generally, invoke consequentialist theory of philosophy, which compares the economic data from different legal rules in order to assess the desirability of any of the particular rule. Utilitarianism focuses on the greatest aggregate good. It is argued the utilitarianism gives no intrinsic value to choice of legal rules without measuring gains and losses. Since the stock market is regarded as a mechanism for distribution of wealth, it is important to ascertain whether insider trading fairly enhances the benefits distributed. It is argued that the answer lies in empirical research which is unsubstantiated on this issue.

On the other hand Scheppele claimed that contractarian theory provides fairer and better results.[71] The theory holds prior consent[72] of free and equal individuals and conformity with the correct procedure[73] is of central importance to assess the legitimacy and moral uprightness of any law, contract or any government.[74] He further argued contractarian theory complies with the fairness requirement by consulting with the people ahead of time, who are worse off by the very rules and who will be bound by them.[75] It could be argued that despite the passage of insider trading law through the Congress, which in essence represent the consent of the majority of people, it has failed to build a consensus of opinion among academics as to providing a valid rational, moral and theoretical foundation.

Avgouleas proposed a novel solution to this dilemma by suggesting a survey of participating investors' choices in relation to the desirability of insider trading

---

1778) and the German philosopher Immanuel Kant (1724-1804).Downloaded from http://www.Economyprofessor.com/theorists ?johnrawls.php

71 Kim Lane Scheppele, It's Just Not right: The Ethics of Insider Trading (1993) Volume 56, *Law and Contemporary Problems* at p 151.

72 Contractarian theorists differ over whether the consent to legal rules must be actual consent of the real people, hypothetical consent of the abstracted people, and plausible consent of the familiar type of people or something else.

73 If laws are enacted through proper institutions, their legitimacy and consent is passed through representative institutions to the statute themselves such as the constitution of America.

74 The legitimacy of any government arises out of consent of the governed, just as in any contract the legitimacy arises out the consenting contracting parties.

75 Kim Lane Scheppele, It's Just Not right: The Ethics of Insider Trading (1993) Volume 56, *Law and Contemporary Problems* at p 154.

prohibition.[76] This would identify investor's preferences[77] and incorporate the prevailing social norms in the prohibition, and replace the current most criticised abstract notion of morality. He further argued that norms carry great influence in individuals' lives and since law cannot ignore social norms, the aforementioned input will provide certainty and moral authority and form a valid theoretical foundation for the prohibition.

2.5.1.2- The Equal Access View

A narrower and more concrete moral concept of fairness based on equal access was devised in *SEC v Texas Gulf Sulphur*[78] to support prohibition of insider trading. The Second Circuit Court of Appeal restricted rather strict interpretation of fairness - equality of information and waived the requirement of disclosure in *every* transaction where there is asymmetry of information. In interpreting the Rule 10b (5) Court devised the "disclose or abstain rule"[79] which was based on a policy foundation of "*equal access to Information.*" After TGS the requirement for fairness in any transaction would be considered satisfied as long as both parties *could* have acquired the material information. The Court justified it on the basis that "the Rule is based in policy on the justifiable expectation of securities market place that all investors trading on impersonal exchanges have relatively equal access to material information."[80] The brief life of equal access theory ended with the Supreme Court's decision in *Chiarella.* It is argued that Courts *subsequently* resurrected at least some portion of equal access theory in *O'Hagen.*

Brudney argued the prohibition can be justified because the information has been accessed by virtue of their insider's position. The access to information has been

---

[76] Emilios Avgouleas, *The Mechanics and Regulation of Market Abuse; A Legal and Economic Analysis* (2005) Oxford University Press at p 204-309.

[77] Avgouleas argued that "the body of society whose opinions may be surveyed comprises the entirety of individuals who because of their direct involvement as professional, speculators or savers or indirect involvement through a pension fund or collective investment scheme in financial markets, understand themselves to be affected by the workings of the financials market and regards themselves as conscious investors. The survey can be carried out using Internet or tools of social sciences." Ibid at p 208.

[78] 401 F. 2d 833 (2nd Cir. 1968) (en banc), cert. Denied, 394 U.S 976 (1969)

[79] The Rule originated from the case of Re Cady Roberts.

[80] The Second Circuit Court endorsed the above principle on the grounds that congress intended "all members of investing public to be subject to identical risk."

withheld systematically in such a away that it cannot be competed away until the disclosure. It places the general investors at an inherently disadvantaged position, which cannot be overcome regardless of their amount of sophistication, experience and diligence.[81] This generates a sense of unfairness and inequality.

Easterbrook contended that obtaining information is a function of cost. An officer, director or manager who is working in any industry would always have more information than an ordinary investor. Private organisations and shrewd investors invest resources to develop human capital that can assimilate and process information to ensure speedy and superior access. Thus outsiders may be able to access superior information by paying the slightly higher cost associated with it.[82] He argued that there may be some differences in search cost, but only big differences create level playing field issue.

It is argued that the major drawback of the equal access theory is that it raises doubts about the role of analysts, market professionals and other specialised organisations. They invest resources to develop advanced technological software's and employ individuals specialised in processing and analysis of information and data. The essence of their profession is that they analyse, assess and monitor the market in order to have reliable information as fast as possible. Some analysts and professionals tend to visit companies' headquarters and monitor the outcome of courtroom trials to ascertain valuable information. Thus it can be argued that by employing sophistication, superior expertise and due to power, wealth and advanced technology, some players in the market is always going to have better and early access to information than the general public. This is also acknowledged by the Circuit Court in *United States v Carpenter*[83] which stated that disadvantages in access to information transpire into disadvantages in the distribution of other resources. It is further argued that since professionals are main beneficiaries of the prohibition and lobby political support for it, the theory could not exist in mutual tolerance with their perceived roles.

[81] Victor Brudney, Insiders, Outsiders and Informational Advantages under the Federal Securities Law (1979) Volume 93, *Harvard Law Review* at p 346, 355, 360.

[82] Frank Easterbrook. Insider Trading, Secret Agents, Evidentiary Privileges and the Production of Information (1981) *Supreme Court Review* at p 330

[83] 791 F.2d 1024, 1031 (2d Cir. 1986), *aff'd* 484 U.S.19 (1969)

Krawiece contended the public mandates of equal access to information through legal prohibition cannot really guarantee symmetry of information, as it is the private sphere that controls the information market. Although the theory appears to promote consistency and uniformity of information in comparisons with the misappropriation and classical theories, however in reality, the effect is hardly deep rooted and significant.

2.5.2- Fairness Requires No Breach of Fiduciary Duty

American Courts further constricted the equal access rationale in order to put forward a more concrete legal and theoretical foundation of the principle of fairness for insider trading prohibition. In the cases of *Chiarella*[84] and *Dirks,*[85] the Supreme Court stated that the corporate insider has been given position of trust and confidence with the objective to serve the corporation and the shareholders. He occupies a position of fiduciary or resposnsibility and therefore "owes a duty to disclose or refrain" from trading. This theory has been criticised as flawed for various reasons.

Firstly, fiduciary duty only applied to insiders such as employees, directors and officers of the firm. This limited the scope of insiders and left a gap in the protection from outsiders such as suppliers, contractors and counsel who may have enough information to trade but still escape from conviction due to there being no fiduciary duty.[86] Secondly, it is argued that theory did not cater for the insider trading against the first time purchasers of stock in any company. Since the perspective purchaser is a total stranger to the corporation, he is therefore is not owed any fiduciary duty.[87]

Thirdly, the major shortcoming of the fiduciary model was that the insider's duty was owed to the corporation and the harm being caused to the shareholders.

[84] 445 U.S 222(1980)

[85] 463 U.S 646(1983)

[86] Carpenter v United States and O' Hagen is quoted as the examples. Thus the traditional theory cannot explain the wrongness of Winnan's and James o' Hagen action.

[87] Alan Strudler & Eric Orts, Moral Principle in the Law of Insider Trading (1999) Volume 78, *Texas Law Review* at p 390.

Traditionally,[88] any private party with a sufficiently vested interest, who a particular statute is devised to protect, could bring suit for damages. This created confusion by going against the established rules because Court rejected the existence of any general fiduciary duty owed to the market or the sellers of the shares. Thus applying the normal rules of jurisprudence would mean that only the selling shareholders would have the standing to sue.

Fourthly, the requirement of breach of pre-existing fiduciary duty threatens the job security of the potential target company's management in the context of hostile takeovers. It enables the arbitrageurs to accumulate enough shares in order to facilitate a hostile takeover action, without breaching the rules of insider trading. Since the arbitrageurs do not owe any fiduciary duty to the potential target, they clearly avoid any liability and this makes the hostile takeover more likely.[89]

2.5.3- Fairness Dictates No Harm and Preservation of Investors' Confidence.

A third possible concept of fairness argues that one should not cause any harm to others in the market. The controversy lies in whether insider trading is really a source of benefit or harm to contemporaneous traders and whether its deregulation will proceed to undermine investors' confidence in general. Manne argued that insider trading is a victimless crime[90] rather it helps the investors in obtaining a better price in the market. If no one is harmed then the argument that it is unfair cannot be developed any further as no actionable offence has taken place.

Manne developed his argument upon his hypothetical illustrations that the stock market is divided into long term investors and short term traders, with the earlier incurring no loss due to insider trading and the latter deserving no protection[91] due to their tendencies to gamble. The transactions take place on the impersonal securities

---

[88] Haddock and Macey, A Coasian Model of Insider Trading (1980) Volume 80, *North-western University Law Review* at p 58.

[89] Jonathan Macey, *Insider Trading: Economics, Politics and Policy* (1991) The AEI Press at p 19. SEC launched 14e-3 immediately after the Chiarella decision, in order to curb insider trading in the context of tender offer.

[90] Henry Manne, *Insider Trading and the Stock Market* (1966) New York: The Free Press at p 93.

[91] Manne divided the stock market into "know it all" and "know nothing" types of investors and furthermore divided "know nothing" into long term investors and "short term traders." Ibid at p 104

market between consensual buyers and sellers who would carry out their transaction regardless of knowing each other or the presence of insiders. In this regards, the long-term investors are *not* induced to trade by price rise due to insider trading, as they take in account factors completely different than price.[92] The prohibition is therefore unjustified in protecting short term traders because they are so small as to be "unworthy of serious concern."[93] The harm occurs to a very small number of people who use the stock market as a casino and therefore cannot be considered as an overall economic loss to the community.[94]

The economic argument and analysis attracted government agencies and academics attention. The regulators also had to sharpen their arguments and shift their emphasis from *fairness* to *economic cost of trading on material information* in response. The proponents dismiss the no harm theory and argue that insider trading affect outsiders which makes them loose their confidence in the market. They disregarded the simplistic division of stock market into "*know it all*" and "*know nothing*" traders and subsequently into *long-term investors* or *short-term traders as* flawed. The economic analysis is purely theoretical and amounts to an approximation, not an accurate reflection of the operation of the real stock market. This is also apparent in the absence of empirical or statistical data, which could illustrate how insider trading influences the outsiders' behaviour.

It is further argued that a liquid market is described as the one that enable investors to dispose of his shares without unreasonable loss and undue delay. Manne's disapproval of short-term trading and their protection due to their gambling tendencies is unjustified. If this approach is taken a step further and if investors trade only on long-term basis, it will grossly affect daily rates of transactions. It is also argued that short-term traders are actually small investors. Lack of a level playing field may deter them from trading and cause a decline in the liquidity of the exchange. It is also a zero sum

---

[92] Henry Manne, In defense of Insider Trading (1966) Volume 44, *Harvard Business Review* at p115. He argued that "the long term investors tend to select stocks based on so called fundamental factors such as earning potential, divided history, growth prospects or the reputation of the management. They tend to sell either because of their estimate of the fundamental factors proved wrong or because of some change in their personal circumstances or needs."

[93] Ibid at p 115.

[94] Henry Manne, *Insider Trading and the Stock Market* (1966) New York: The Free Press at p 104.

game and the insiders profit actually comes from the equivalent losses incurred by short term traders.

There is also widespread acceptance of the notion that when insiders trade with market makers or intermediaries, they also consistently loose. In order to recover their losses, they increase their bid-ask spread and pass it on to the outsiders as a transaction cost or insider tax.[95] In this context, Avgouleas categorised the stock market as interaction of four key players, insiders, information trader, liquidity traders and noise traders.[96] He argued that in the absence of true identities of insiders, when insider trading is mixed with the noise traders, information traders cannot decipher information from the volume and price data available and therefore consistently loose to the insiders. This could also lead to a serious reduction in the number of analysts employed by information traders which may impede the flow of information and thus efficiency. [97]

The common denominator of the above argument is that it decreases public confidence in the market. Public confidence and trust is an essential and indispensable component of the markets, without which markets cannot operate.[98] Even the Supreme Court has related harm in terms of loss of integrity of the market rather than individuals or groups incurring losses.[99] The insider trading either cause the investors to simply discount their securities in order to compensate for the relevant risk or deters investors from trading in securities of issuers with the reputation of insider trading or in the worst-case scenario entirely depart in search of safer havens. Therefore the lack of regulation will unavoidably increase the cost of obtaining capital for the firms and reducing its liquidity in the whole process.

---

[95] Even Manne acknowledged the validity of this argument in his later article. Henry Manne, Insider Trading: Hayek, Virtual Markets and the Dog that did not Bark (2005) Volume 31, *Journal of Corporation Law* at p 2. Also see Walter Bagehot, *The Only Game in the Town* (1971) *Financial Analyst Journal* at p 12.

[96] Emilios Avgouleas, *The Mechanics and Regulations of Market Abuse; A Legal and Economic Analysis,* (2005) Oxford University Press at p 83

[97] Ibid at p 83.

[98] “The stock markets are an essential part of our commercial and financial structure and their health can only be sustained if the public feels that they are not a jungle but rather safe place for investment.” Roy Schotland, Unsafe at Any Price: A Reply to Manne, Insider Trading and the Stock Market (1967) Volume 53, *Virginia Law Review* at p 1440.

[99] United States v O’ Hagen 521 U.S. 642, 658 (1997)

2.6- Prohibition of Market Manipulation

Market Manipulation is a general term encompassing different practices harmful to the market participants.[100] It is also a term used to denote the illegal practice of artificially raising or lowering a security's price by creating the appearance of active trading.[101] There are number of ways of perpetrating these practices which leads to transfer of money[102] however, there is no consensus as to its definition,[103] scope and the necessity to regulate in today's globalised securities markets. This leads to the criticism that the theoretical and philosophical framework of legal prohibition is not devoid of ambiguity and confusion. It is therefore necessary to analyse and set out a clear and unambiguous theoretical framework as to why the law should seek to coercively control particular activities.

2.6.1- The Ethical Rationales for Prohibition of Market Manipulation

The primary purpose of the securities market is to facilitate the transfer of savings into investment by providing the companies with the necessary capital. This is materialised in the primary market where stocks and bonds are created with the help of investment and merchant bankers. Investors who purchase these securities can sell and recover their money in the secondary market. These transactions take place at a prices determined by forces of demand and supply. This regular trading activity provides an efficient means of determining the market price of stocks reflecting the fundamentals of the issuers. At the same time the prices provide valuable information about the money raised in the primary market and also how receptive the investor

---

[100] Santa Fe Industries, Inc. v Green 430 US 462, 477 (1977).

[101] In the case of *Santa Fe* the Supreme Court held that the contours of manipulation have been intentionally kept undefined in order to effectively cover the ingenious practices that may be used to manipulate securities practices.

[102]Manipulative practices have been divided in three different groups; (a) Information based manipulation, (b) - Artificial transaction based manipulation, (c) - Price manipulation. Information based manipulation is further divided into (i)- Broker misrepresentation and Investment analyst reports, (ii)-Market rigging and Internet manipulation. Manipulation based on artificial transactions disseminates false and misleading information is the product of specific transaction. Lastly, price manipulation is further divided into (i)- trade based manipulation, (ii)- contract based manipulation and (ii)- market power manipulation. Emilios Avgouleas, *The Mechanics and Regulation of Market Abuse*, (2005) Oxford University Press at p 154.

[103] All attempts to define the concept follows four different approaches (i) – The artificial price and effect based approach, (ii)- the intent based approach, (iii)- combinations of both (i) and (ii), (iv) market power manipulation. Ibid at p 108.

would be if the corporation's wants to raise more money by new offerings.[104] The scarce capital is thus made accessible in a less expensive way to companies that show potential and in a more expensive way to the failing companies.[105] Thus *fair* trading leads to a price formation mechanism which facilitates optimal resource allocation. The occurrences of manipulative practices lead to price anomalies. This, in turn, distorts the price formation mechanism and unduly interferes in optimal resource allocation through the market mechanism.

Congress also emphasized the significance *of fair market prices* as a rationale for the prohibition of manipulation before the enactment of New Deal. Section 2 of the Securities Exchange Act 1934 emphasized the role of the market as an appraiser of the value and highlighted its importance for the investors, creditors, public treasury and national banking system. Manipulation of prices leads to excessive and abusive speculation and cause sudden fluctuation.[106] This may cause unreasonable "contraction of the volume of the credit available for trade, transportation and industry and prevent fair calculation of the taxes."[107] This also makes it difficult for the fair valuation of collateral for bank loans.[108] Furthermore, the excessive speculation and manipulation may lead to financial crisis causing wide spread unemployment and dislocation of trade, transportation and industry.[109]

One of the main rational stated for prohibition of '*information based manipulation*' and '*artificial transaction based manipulation*' is that it's species *of fraud and*

---

[104] Frank Fabozzi and Franco Modigliani, *Capitals Market: institutions and Instruments* (1992) Prentice Hall at p 144.

[105] If the price of equity increases than the cost of raising capital through new offerings is reduced by the issuer. Similarly if the issuers decide to raise money by issuance of bonds, it has to pay lower interest to issue new debts thus lowering the cost of raising capital. Marshal Blume and Jermy Siegel, The theory of Security Pricing and Market Structure (1992) Volume 1, *Financial Markets, Institution and Instruments* at p 3; Eugene Fama, Efficient Capital Markets: A Review of Theory and Empirical work (1970) Volume 25, *Journal of Finance* at p 383, Simon Keane, *Stock Market efficiency: Theory, Evidence , Implications* (1983) Phillip Allan Publishers at p 3-5. John Barry III, The Economics of outside information and Rule 10b-5 (1981) Volume 129, *University of Pennsylvania Law Review* at p 1307. Panagiotis Staikours, Ensuring the Integrity of Price Formation Mechanism (2003) Unpublished thesis, London School of Economics at p 64-70.

[106] Section 2(1) of Security Exchange Act (SEA) 1934

[107] Section 2(2) of SEA1934

[108] Section 2(3) of SEA 1934

[109] Section 2(4) of SEA 1934

deception.[110] In the first case, deception consists of misrepresentation by dissemination of false information, circulation of false rumours and concealment of material information, whereas in the latter case, dissemination of false and misleading information is the side-effect of artificial or structured trades such as fictitious devices, washed sales or matched orders creating a misleading impression to the investor about the state of supply and demand. In 1990s, Failure of analysts to scrutinise the economic fundamentals and to issue fair reports and misleading statements facilitated the creation of the bubble.[111] Manipulation in the stocks by the insiders further prolonged[112] and concealed the bubble, which lead to the demise of Enron and WorldCom.[113] It is evident that manipulative practices camoflauged the perpetration and early detection of fraud.

In this context, fraud is a zero sum game as it transfers funds from the defrauded party to the manipulators.[114] The participants of the securities market also incur research costs in taking safety precautions and uncovering fraud. The legal and regulatory market abuse framework prohibiting fraud and manipulative practices enhances efficiency, increases fairness, attracts more investors and increases liquidity and therefore makes a crystal clear case.

---

[110] Frank Easterbrook, Monopoly, Manipulation and the Regulations of Futures Markets (1986*)* Volume 59*, Journal of Business* at p 106. Daniel Fischel and David Ross, Should the Law Prohibit Manipulation in Financial Markets (1991*)* Volume 105*, Harvard law Review* at p 510- 511.

[111] In October 2001, just before Enron bankruptcy filings, sixteen out of seventeen Wall Street Analysts covering Enron maintained their recommendations to either ‘buy’ or ‘strong buy. John Coffee Junior, Understanding Enron, It’s about the Gatekeeper, Stupid, *Columbia Law and Working Paper No 207* (2007) http://ssrn.com/abstract_id=325240. Testimony of Frank Torres on the Collapse of Enron: The Role Analysts Played and The Conflict they had. http://hsgac.senate.gov/022702torres.htm February 2002.

[112] R v De Beranger (1814) is one of the earliest examples of manipulation. In addition to that there are number of examples of corporations where manipulators within the firm created bubbles with their fraudulent practices. Apart from that ZZZZ Best Inc. in (1986), E.F Hutton & Co in 1988, Centennial Technologies Inc. in 1996, Bre-X Minerals in 1997, Enron in 2001, WorldCom in 2002, Tyco International in 2002, Adelphia in 2002, Health South in 2003 were significant examples of stock manipulation to hype up the share prices. Krueger, Enron and Bernard Madoff’s Ponzi schemes are also complicated example of manipulation and accounting frauds.

[113] Some of the worst bubbles in the history of the financial services were initiated by manipulation such as South Sea bubble and Great Crash of 1929.

[114] Emilios Avgouleas, *The Mechanics and Regulation of Market Abuse* (2005) Oxford University Press at p 213.

It is also argued that the trading takes place on an anonymous market exchange and market participants see trades as carriers of information. They use trade size and price data to infer correct pricing of the stock.[115] Thus prices communicate information about the demand and supply conditions in the market founded upon the aggregate investors' belief about the future prospects of the issuers. This is based on each investor's subjective appraisal of the information at hand and their investment strategy.[116] Trade based manipulations[117] can induce the market participants to trade in order to push the prices to the desired level by giving a false impression through trades that a particular security is overpriced or under priced. This makes it very difficult for the investors to deduce useful information and leads to a drop in investors' confidence in the credibility of the market. It distorts the mechanism of "Information hypothesis"[118] whereby the traders adjust their position depending on the reliable source of information.[119] This in turn undermines the investors' confidence in the *fairness and integrity* of the market. They flee the market in search of alternative safer investment thus affecting liquidity.

---

[115] The trade and price decoding is referred to as 'Information hypothesis'. Like any other information interpretation mechanism, it can be manipulated to mislead the markets rather than inform. Manipulators can employ variety of ways to do this such as trading at the end of the day, dealer's collusions, acquisition or sale of large supplies of trading. Franklin Allen and Douglas Gale, Stock Price Manipulation (1992) Volume 5, *Review of Financial studies,* at p 503 ,505

[116] Stephen Figlewski, Market Efficiency in a Market with Heterogeneous Information (1978) Volume 86, *Journal of Political Economy* at p 581. Stephen Figlewski, Information Diversity and Price Behaviour (1982) *37 Journal of Finance* at p 88. Steve Thel, Regulation of Manipulation under Section 10(b): Security Prices and the text of Security Exchange Act of 1934 (1998) *Columbia Business law Review* at p 367-368.

[117] A common example of trade-based manipulation includes structured trades or bogus transactions, matched orders painting the tape, pumping and dumping scheme and ramping.

[118] Portfolio theory provides powerful reasons to believe that demand and supply are elastic. Information hypothesis states that investors' decisions are influenced by trade size and price. This information affects the price. This is referred to as "Information Hypothesis." On the other hand, it is argued that the supply of near similar substitutes is likely to be much larger than the supply of the security itself and therefore trading does not affect the price. This is referred to as "substitution hypothesis." Empirical evidence favours the information hypothesis. It states that all securities possess characteristics peculiar only to them and therefore due to inherent limitation of supply and demand, the information carrying trade volume and price does affect price. Avgouleas, *The Mechanics and Regulation of Market Abuse* (2005) Oxford University Press Avgouleas at 133-135. Daniel Fischel and David Ross, Should the Law Prohibit Manipulation in Financial Markets (1991*)* Volume 105, *Harvard law Review* at p 513-514.

[119] Purchase based manipulation and sale based manipulation can be used to mislead the market. Structured trades or large trades may either give the market signal that an insider is the source is the source of such trades and may trigger herding mechanism to move the prices to desired level for the perpetrator of such scheme. Emilios Avgouleas, *The Mechanics and Regulations of Market Abuse; A Legal and Economic Analysis* (2005) Oxford University Press Avgouleas at 140- 143.

Thel has also justified the regulation from a perspective of policing the flow of information in contributing to the price formation mechanism.[120] He examined that artificial transaction based manipulation such as pumping and dumping schemes,[121] advancing the bids,[122] marking the close[123] and carrying on large trades are objectionable precisely because they move market prices even though they do not disclose information.[124] Although these activities are not deceitful, they make the prices react and change even though there is no underlying information to incorporate. The prices are artificially made to move due to an artificial imbalance of incoming orders and counterbalance interest and not as result of new information or real trades carrying information.[125] Thus new prices do not really communicate any real information and are less accurate making the market less efficient. This ultimately impairs the *fair* price formation mechanism as communicator of information.

In addition to the above, contractual rights and associated contracts such as rights of conversion, payments of dividends, future contracts and corporate employees' bonuses are often connected with the stock prices. This becomes a tempting target to engage in price manipulation. This provides an increased incentive to engage in manipulative practices. The cases of *Milken*[126] and *Mulhern*[127] are examples of successful contract-based manipulations. The manipulator earned profits from investment banking fees and offloading of large block of shares at a higher price was far more than the losses from the trading. IOSCO Report further confirmed the increased possibility of contract-based manipulation in the current integrated global

---

[120] Steve Thel, Regulation of Manipulation under Section 10(b): Security Prices and the Text of Security Exchange Act of 1934 (1988) *Columbia Business Law Review* at 415.

[121] Pumping and dumping is a scheme whereby manipulators engage into intense purchase activity, pushing prices increasingly higher and then massively disposing off the stock on the market.

[122] Advancing the bid is a manipulative tactics when manipulator increases the bid for a particular stock thus pushing its price up.

[123] Marking the close or ramping is a manipulative practice by which manipulator engage into actual intense trading at the close of the market thus effecting closing prices.

[124] Steve Thel, Regulation of Manipulation under Section 10(b): Security Prices and the text of Security Exchange Act of 1934 (1988) *Columbia Business Law Review* at p 429

[125] Ibid at 416- 418.

[126] US v Milken 759 F Supp. 109 (SDNY 1990)

[127] 938 F 2d 364 (2d Cir 1991).

securities and derivative market.[128] It is argued that manipulators may target pension funds, government bodies, public companies and banks where the majority of the public keep their savings, thus having the potential to affect the welfare of a large portion of the general public. It is therefore important to deter price-based manipulation by regulations.

The development of advanced derivative products has also increased the potential for *price manipulation* in the integrated global market place.[129] It has provided all the more ammunition for regulators to prohibit this activity. Derivative products may be used for common manipulative practices[130] of corners[131] and squeezes[132] in the commodity market. They distort the pattern of consumption and necessitate the excessive cost.[133] Thus prohibition of these practices appears to be justified on the

---

128 Technical Committee of the International Organisation of Securities Commissions, Investigating and Prosecuting Market Manipulation, May 2000 at p 2-3.

129 There are three major classes of derivatives: futures, options, and swaps. Derivative market can be used to hedge the risk and speculate. A futures contract is generally made on the trading floor of futures exchange to buy or sell a particular commodity or financial instrument at a predetermined price in the future. For an overview of an operation of futures market, See Leist v. Simplot, 638 F.2d 283, (1980) at 268-288; Merrill Lunch, pierce, Fenner & Smith, Inc v. Curran, S.Ct. 1825, U.S.Mich, (1982) at 1821-1831.

130 An attempt to corner the futures market has been made in several high profile cases, for example in 1950s traders complained that onions market was cornered in the Chicago Mercantile Exchange. Their complaints resulted in the passage of Onions Futures Act, which banned trading onions futures in the US and remain in effect as of 2009. In 1970s, the Hunt Brothers cornered the silver market. At one point, they were holding to more than half of the world's deliverable supplies. During 1979 and 1980, the price rose from $11 ounce to $55 ounce. It then collapsed to under $11. In 1990s, Yasuo Hamanaka attempted to corner the international copper market over a ten years period up to 1996. At one point he was controlling 5% of the world copper market. When his scheme collapsed, he was left with the losses of US £6.2 billion. In 1997, he pleaded guilty to criminal charges and was sentenced to 8 years imprisonment.

131 A corner is a situation where traders or group of traders acquires dominance and control in underlying asset by simply buying up large quantity in the spot market and hoarding up and at the same time taking dominance in the long position in the futures market. The underlying asset or item can be currencies, securities, or financial instruments and intangible assets or reference items such as stock indexes and interest rate. They use this position to manipulate the prices of underlying asset and reduce the quantity of deliverable stock available to short traders in the futures market. This leaves short sellers with only three options; they can either default or buy underlying asset from the manipulator or discharge their delivery obligations by selling it to another buyer. In view of the fact that penalties for defaults are very heavy and manipulator will sell at an extortionate value, the short seller is only left with the option of offsetting future contract at a very high price to the benefit of manipulator.

132 Squeeze entails holding a dominant position in the futures market only and may exploit shortages in the quantity of immediate deliverable supplies.

133 Short sellers incur significant costs to buy and transfer additional quantities of the underlying commodity to the delivery point, while consumption increases in the delivery market and decreases in the non-delivery markets, thus raising the price of commodity in the formers.

basis of abuse of excessive market dominance and necessity to maintain a fair mechanism.

It is also argued that domination with manipulative practices undermines the indispensable role, futures markets play in predicting prices based on today and tomorrow's estimated amount of supply and demand. Its successful operation depends on a continuous flow of information around the world and thus requires a high amount of transparency. Occurrences of manipulation disrupt the flow of information and impair the efficient operations of the future supply and demand in the spot market.[134] Non-regulation of manipulative practices place some participants above the forces of market and in a position where they do not loose in any eventuality. Thus the underlying rationale for regulation of manipulation in futures market lies in creating a level playing field so that all participants are subject to the interplay of market forces.

Future markets are also regarded as a place for manufacturers, producers, farmers, importers and exporters to hedge risks. Risks are reduced because the price is pre-set, therefore letting manufacturers know how much exactly they will need to buy or sell. This helps the businesses prosper as they can pre-plan their budgets and reduce their ultimate cost. Lack of control of manipulative practices deprives the market of its inherent purpose of hedging the risk by creating excessive risk in dealing with oligopolist, monopolist and manipulators who make every attempt to obtain extortionate profit by distorting the prices to their advantage. In this context the speculators play a key role in providing essential liquidity by assuming the risk that hedgers wants to shift.[135] The presence of manipulator drives away the speculators and other participants, which in turn reduces the liquidity in the futures market. This also

[134] Futures do not perform the function as an efficient and accurate aggregator and communicator of traders' information and expectation about the value of underlying asset thus distorting production decision. Frank Easterbrook, Monopoly, Manipulation, and the Regulation of Futures Market (1986*)* Volume 59, *Journal of Business* at p. Wendy Purdue, Manipulation of Futures Market: Redefining the offence (1987) Volume 56, *Fordham Law Review* at p 345. Craig Pirrong, Commodity Market Manipulation Law: A Critical Analysis and Proposed Alternatives (1994) Volume 51, *Washington and Lee Law Review* at p 949. Craig Pirrong, The Self-Regulation of Commodity Exchanges: The Case of Market Manipulation (1995) Volume 38, *Journal of Law and Economics* at p 141-142.

[135] Speculators have no interest in the underlying asset and purely trade in order to profit by price fluctuations, by contrast the hedgers only operate in order to cover them against the adverse price change of the underlying asset. This has been judicially recognised in Leist v. Simplot, 638 F.2d 283, (1980) at 268-288; Merrill Lynch, Pierce, Fenner & Smith, Inc v. Curran, S.Ct. 1825, U.S.Mich, (1982) at 1821-1831.

makes trading even more difficult in the already extremely risky and complex nature of the market making it impossible for the speculators to hedge the risk. In the absence of a centralised clearing house, lack of intermediaries who can maintain liquidity by increasing the spread and lack of transparency of the transactions, the case for regulation against manipulation becomes even stronger.[136]

Manipulation also causes the contemporaneous traders to consistently loose out and thus intermediaries increase the bid-ask spread in order to recoup their losses. This increases the cost of transactions, shifts the burden to the participants and further lowers liquidity.[137] There appears to be widespread acceptance of prohibition of manipulation as compare to insider trading. Manipulators also contravene the principle of the free, open and fair market competition and consequently drive the investors away in search of safer investments resulting in loss of confidence in the market.[138]

Based on the above rationales, it is therefore argued that the main aim behind regulation of manipulation is to create fair and honest market in order to promote investor's confidence in the integrity of the securities industry. The thrust of the regulation is to create a *level playing field* with the same opportunities and risks for all investors participating in the markets. Moreover, investors should have access to information leading to confidence in the price setting mechanism and be protected from fraud and manipulation. Thus creating confidence in the integrity of the securities market, safeguarding price formation mechanism and protection of investors constitute the theoretical underpinning of the legal framework of prohibition of manipulation.

---

[136] Emilios Avgouleas, The Thorny and Multi-Faceted Issue of OTC Derivatives Regulation and the Obama Administration Proposal, 2009. Also see Emilios Avgouleas, Financial Innovation versus Systemic Stability: The unresolved Dilemma of Derivative Regulations (2009) Downloaded from http://www.finreg21.com/home. Arkedov Chatterjee, Joseph Cherian, Robert Jarrow, Market Manipulation and Corporate Governance: A Perspective (1993) Volume 1, *Financial Management* at p 200-209.

[137] Emilios Avgouleas, The *Mechanics and Regulation of Market Abuse* (2005) Oxford University Press at p 213.

[138] It is of the essence of the economic function of the securities exchange that it be a free market – free of artificiality of manipulation. Louise Loss and Joe Seligman, Fundamental of Securities Regulation (1995) Aspen Publishers at p 1120.

2.6.2- The Economic Rationales against Prohibition of Market Manipulation

The opponents to regulation of market manipulation argue that different manipulative practices facilitate natural equilibrium faster than otherwise. They define a pool as a group of smart investors who are able to gauge the potential of any particular stock at a certain price. The colluding parties accelerate the change in the price of the securities. It helps the market to realise the true potential of the stock and create efficiency in a shorter time.

Criticism has also been levied against the prohibition of manipulation based on difficulties in defining,[139] detecting manipulative conduct and in enforcing the so-called regulations. Academics have argued that "the law governing manipulation is embarrassing, confusing, contradictory, complex and unsophisticated."[140] Various attempts in defining manipulation have been resulted in the following:

1- Interference with the free play of supply and demand
2- Induce people to trade, or
3- Force a security price to an artificial level.[141]

Fischel and Ross argued the aforementioned formulations are vague and imprecise and therefore proposed the abolition of a self-standing criminal and regulatory offence. The term "interference" is undefined and therefore does not offer much help. The term "induce" in the second formulation is too extensive and may cover transactions that parties enter for value maximizing purposes in day-to-day normal trading.[142] In the third formulation, the term "artificial" is difficult for the purpose of incorporation into legal terminology. It is also difficult to measure and differentiate the artificial from natural-equilibrium prices after free interplay of demand and supply. In determining the artificial price from the actual price, the Courts may engage in unreasonably complex analysis of the economic data and the related

[139] Ibid at p 1120.

[140] Daniel Fischel and David Ross, Should the Law Prohibit Manipulation in Financial Markets (1991) Volume 105, *Harvard law Review* at p 506 quoting Edward T McDermott, Defining Manipulation in

Commodities Future Trading: The Future Squeeze (1979) Volume 74, *North-Western University Law Review* at p 202.

[141] Daniel Fischel and David Ross, Should the Law Prohibit Manipulation in Financial Markets (1991) Volume 105, *Harvard law Review* at p 507

[142] Ibid at p 508

circumstances. Based on the above analysis, they argued that there is no objective definition of manipulation and made recommendations in favour of a subjective definition based on intent.[143]

Fischel and Ross also rejected the attractiveness of prohibition by analysing the probability of its occurrences in the absence of regulation. They argued that *information based* and *artificial transaction based manipulation* exhibiting characteristics of fraud must be regulated, however price based manipulation should be deregulated. This is because it is overall “self-deterring and self-defeating” and prohibition harms the market well-being and places undue restrictions on the trader’s economic liberty. Trade based manipulation can only be profitable if the manipulators purchase increases the price of the security and thereafter is sold at a price higher then purchased. They further argued that overall there is low likelihood that trade based manipulation[144] can ever succeed due to transaction costs, bid ask spread and liquidity cost.[145]

The same argument is advanced in relation to market power manipulation, which requires large capital in order to successfully corner or squeeze the market.[146] However, this is not the only requirement as it is very difficult to control the resultant price collapse in the spot market and the futures market after the completion of corner. This is referred to as “burying the corpse effect” and makes it very difficult for the manipulator to escape from the detection from the regulatory authorities due to offloading the large quantity involved.[147] In this context, Hunts corner of the silver market in 1970s and Yasua’s corner of the copper market in 1990s resulted in billions

---

143 Ibid at p 510

144 Trade based manipulation includes trading at the end of the day, by way of dealers collusion, purchase based manipulation, sales based manipulation.

145 Ibid at p 517-519.

146 Hunt Brothers had purchased silver worth US$4.5billion by 17th January 1980, at this time silver was trading at $50/oz. By 27th March 1980, silver market had dropped and the silver market opened at $15.80/oz. and closed at $10/oz. The Hunt's bullion purchases were all averaged around $10/oz. but their futures contracts were purchased at or about $35/oz. When it was all over they owed $1.5 billion dollars. After their bankruptcy in 1989, they were left with owing $90 million Inland Revenue Services. Similarly Hamanaka – Sumitomo acquired 5% of the world copper supply in order to corner the copper market.

147 Emilios Avgouleas, *Mechanics and Regulation of Market Abuse* (2005) Oxford University Press at p 154

of dollars' worth of losses and detection. Their subsequent prosecution by the authorities attested to the impracticality and obvious failures of such manipulative practices.[148] Thus there is no way of circumventing the authorities taking notice of the excessive market dominance of manipulators.

The contrary view is that potential manipulators can bring the losses and variation in price under control by placing the right hedging schemes. This can be achieved by taking a short position in the futures market maturing months ahead of the end of the corner.[149] In addition to this, the profits from large corners may outweigh the cost associated with detection and prosecution. The examples of Hunt and Yasuo also indicate that they successfully cornered the market for a long period of time[150] however their greed rather than failure of manipulative practices brought about their financial downfall. Professor Thel has also argued against the above argument and Avgouleas concurred with him, by stating that a manipulator can make profit by distorting the prices and triggering the contractual rights or benefits in derivative position and therefore state law must proscribe price manipulation.[151]

Judge Easterbrook has considered the monopolisation of the futures market and the underlying asset market from a very different perspective. He argued that if the counter party transacting with the dominant trader was disclosed information about the latter's real position in the futures and the spot market, he would not enter into long position contract with someone who already holds most of the supplies. This unreservedly amounts to misrepresentation of the material facts due to non-disclosure or concealment of the dominant traders position in the futures and spots market in conjunction with their unwillingness to liquidate their position in the latter. His view is criticised on the basis that non-disclosure of position is essential in order to allow

[148] Losses amounted to US$1.8 billion for Sumitomo Corporation - the employers of Yashuo Hamanaka. In the case of Hunt Brothers who were the richest men in the world, were bankrupt by 1990 owing $90 million to Inland Revenue Services.

[149] Emilios Avgouleas, *Mechanics and Regulation of Market Abuse* (2005) Oxford University Press at p 220.

[150] Yasuo Hamanaka cornered the copper market for a period of 10 years. It later transpired that J P Morgan, Merrill Lynch and UBS loaned money to Hamanaka to maintain artificially high price and later settled lawsuits out of Court with accepting liability. Similarly, Hunt brothers cornered the silver market from 1970 to 1979.

[151] Emilios Avgouleas, *Mechanics and Regulation of Market Abuse* (2005) Oxford University Press at p 219**.**

the traders to take advantage of their information acquisition or research efforts and if revealed before time, markets may turn against them. The contrary view is that the concealment or non-disclosure amounts to fraud and allows the manipulators to create a false impression about the state of demand and supply and the real market conditions.[152]

The proponents of deregulation also argued that some of the practices such as trading at the end of the day, short selling and successive bids at higher prices are very difficult to differentiate from contemporaneous non-manipulative trades. The problem is also complicated in inferring manipulative intent from two objectively indistinguishable and identical transactions.[153] The author argues that the above difficulties may be there in detecting manipulative trades and inferring intention from the circumstantial evidence, however they are not insurmountable. In the modern financial markets, regulators operate with a highly sophisticated monitoring IT system, which has the ability to identify the smallest anomalies in the price formation mechanism and helps carry out systematic analysis. At the very least this creates credible deterrence and can provide leads to the regulators for further investigation. The alternative of deregulation would give a free ride to the manipulators and turn the market into a jungle.

Fischel and Ross also argued that contract based manipulation can be reduced by carefully drafted onerous terms of the contracts rather than enactment of legal prohibition. The cost or difficulty of such adaptation is another option that can perhaps be considered bearing in mind the high cost of legal prohibition and its implementation. They further argued that all such arguments, which conclude that private parties are unable to monitor contract-based manipulation and that there may be some trivial benefit in legal prohibition, are poor and weak.

On the other hand, legal prohibition is criticised in failing to identify and distinguish between the intentions, behind the transactions motivated by the conviction that

---

[152] Jeffery William, *Manipulation on Trial – Economic Analysis and Hunt Silver Case* (1995) Cambridge University Press at p 161 – 189.

[153] As it is argued that in practice, it would be quite difficult to distinguish between transaction, which have commercial rationale and are executed in a proper way and artificial transactions.

shares are undervalued and the transactions driven by the desire to move the prices in the wrong direction. Avgouleas has countered this argument by asserting that the global nature of current financial market has made contract based manipulation much easier now. Thus the exposure of multinational organisation in the cross-border nature of transactions has the potential to affect a large number of people. Therefore it further emphasizes the need to control such practices through state prohibition rather than cautiously drawn up agreement.

2.7- Conclusion

This chapter analysed the ethical and economic rationales underlyingthe legal and regulatory market abuse framework in UK and US securities markets. Despite the compelling aforementioned economic rationales, most countries maintain prohibition in the endorsement of ethical rationales, across the globe.

The analysis highlights ethical rationales of *freedom from coercion*, *freedom from misrepresentation, freedom from exploitation, right to equal access to information, respect for the autonomy of the individual investors, unjust enrichment, breach of fiduciary duty, level playing field, harm to the contemporaneous traders, undermining investor confidence and the integrity* of the markets. These rationales attempt to incorporate norms of ethics to protect investors in regulating transactions on secondary markets. Shariah also have similar ethical principles which safeguard against abuse and exploitation which are analysed in the next chapter.

3- US and UK Law on Market Abuse

Part I – US Law on Market Abuse

3.1- Introduction

The previous chapter analysed the rationales, ethical principles and legal theories as the theoretical underpinning of US and UK law on market abuse. This chapter analyses historical evolution of regulation of market abuse in US and UK. Part I analyses the US Court's endorsement of underlying *ethical theories of fairness* at various stages of historical development of case law on market abuse. Part II analyses the historical measures taken by UK and EU to promote the fair markets. The concepts and notions highlighted and practices prohibited are then comparatively analysed as a standard point of reference with Shariah principles in subsequent chapters.

The jurisprudence of US law on market abuse comprises of Statutes, SEC ruling and interpretation by the Courts. Its primary objective is to eliminate the exploitation, harm and market abuse by providing accurate and timely financial information to the investors and creation of level playing field in transactions on the securities markets. The SEC and Courts have taken different theoretical approaches in applying the law in practice. As a result the law is in a constant state of flux and is subject to degree of uncertainty.

3.2- The Evolution of law on Market Abuse[1]

The Bank of United States was created in 1791 and issued scrips and equity shares worth $10 million.[2] Trading in these shares marked the emergence of an active

---

[1]The main sources consulted for the analysis of this chapter are: Michael Parrish, *Securities Regulation and the New Deal* (1970) Yale University Press. Stephen Bainbridge, *Securities Law- Insider Trading* (1999) Foundation Press. Stephen Bainbridge, The Insider Trading Prohibition: Legal and Economic Enigma, Volume 38, *Florida Law Review*. Stephen Bainbridge, the Law and Economics of Insider Trading: A Comprehensive Primer (2001) Downloaded from http://papers.ssrn.com/paper.taf?abstract_id=261277. Accessed on June 2008. Stephen Bainbridge, Insider Trading: An Overview (1999) Downloaded from http://papers.ssrn.com/sol3/papers.cfm?abstract_id=132529.

[2] The federal US debt was then estimated to be $ 54 million. It was incurred in gaining independence after the revolution of 1775-1781. The Federal Government assumed States debt and funded it with $70 million worth of long term United States bonds. See Richard Sylla, The Rise of Securities Market:

securities market especially on Wall Street.[3] The development of the securities exchange was further fuelled by the growth of railroads and the large enterprises of the industrial revolution which required capital from greater segments of the general population than just the big city investment and merchant bankers.[4] This led to unregulated growth of securities market by the turn of twentieth century.

Prior to the financial crisis of 1929, the securities market was regulated partly by *self-governance* and by *State Laws*. Self-Regulatory Organisation (SRO) such as the New York Stock Exchange, the Investment Bankers Association (IBA) and the New York Curb Exchange policed the trading practices. They set out the corporate requirements for stock listing and compliance and pre-requisites for membership of the exchange.[5] *State regulation* effectively began in Kansas in 1911.[6] It set out a system of registration of securities and securities sales persons.[7] The Kansas Act was commonly known as the "merit regulations." It authorised a state securities administrator to supervise investment companies and deny them permission to sell securities if the issuers plan of business or proposed contracts were "*unfair, unjust, inequitable or oppressive*."[8] Twenty two other states enacted similar laws by 1913.

Over the next two decades, State legal framework on investor protection and SRO's regulatory infrastructure failed to prevent fraudulent and deceptive practices in the

---

What Can Government do? (1995) Presented at the World Bank Conference on Financial History: Lessons From History for the Reformers of Present.

[3] Wall Street is the financial centre of America. Dutch settlers built a 12 foot Wall in 1685 to protect themselves from British and the Native Americans. It was not intended to be a centre of commerce until British laid a down a street in its place called Wall Street in 1685.

[4] Arthur Levitt Remarks at the Commission Common Wealth Club San Francisco (May 1996). He discusses how capital market helped finance the construction of the railroads that tied the East to the

West. Downloaded from http://www.sec.gov/news/speech/speecharchive/1996/spch101.txt. Accessed on January 2008.

[5] Ann Khadmein, *The SEC and the Capital Market Regulations,* (1992) University of Pittsburgh Press at p 24-26.

[6] Jonathan Macey, The Origin of Blue Sky Law (1991) Faculty Scholarship Paper Series No 1641 at p 348-350. Downloaded from http//digitalcommon.law.yale.edu.fss_paper/1641. Also see Clarence Dykstra, Blue Sky Legislation (1913) Volume 7, *The American Political Science Review* at p 230-234.

[7] Kansas Law 1911 Ch. 133.

[8] Louis Lose, Joel Seligman, *Fundamental of Securities Regulation* (1999) Aspen Publishers at p 36-40. Also see Joel Saligman, The United States Federal- States Model for Securities Regulations (2003) Research Study Prepared for Wise Person Committee at p 81-83.

securities markets. The legislation was different from state to state which weakened its effectiveness in self-regulation. Another cogent reason for SRO's failure was that State Regulators and SROs were less willing to take strong measures to curb fraudulent practices for fear of losing revenue from corporations listed on the securities markets. Moreover, there was ineffective intra-state enforcement. Ultimately, in 1929, the stock market crashed, wiping millions of dollars and creating chaotic economic conditions.

The Senate Banking and Currency Committee investigated the causes of the crash and concluded that almost $ 25 billion out of $50 billion of new securities issued were valueless.[9] The committee identified five factors causing the crash:

1- Lack of periodic disclosure by companies whose stock is publicly traded.

2- Rampant Insider trading

3- Manipulation – False appearances of trading activities by brokers.

4- False or misleading statements by issuers.

5- Speculation fuelled by uncontrolled availability of credit.

3.3- The Origins of the Federal Prohibition of Market Abuse

The Great crash caused a massive decline in the investor's confidence in the integrity of the securities market. The public demanded for Wall Street to be held accountable in order to restore public confidence in the capital markets and the economy. Roosevelt advocated regulation of the securities industry in the form of New Deal for all Americans.[10] He facilitated the passage of the Securities Act of 1933, and the Securities Exchange Act 1934 through Congress.[11] The 1933 Act was to protect investors during the initial public offerings of securities.[12] On the other hand, the 1934

---

[9] Harold Bierman, The Stcok Market Crash of 1929 (2010) Volume 51, *Florida Law Review* (1999) at p 271 at p 271. Downloaded from http://eh.net/encyclopedia/article/bierman.crash. (Citing H. R. Rep. No 73 through 85, Pt.1,2 at 2 (1993))

[10] Arthur Laby, Models of Securities Regulations in the United States (1999) Volume 23, *Fordham International Law Journal* at p 24-26

[11] FDR theme for the enactment of 1933 and 1934 Act was that "sunshine is said to be the best disinfectants; electric light the most efficient policeman and disclosure to be the best regulations on securities market" Louise Brandies, *Other People's Money and How the Bankers Use It* (1914) Downloaded from http://library.louisville.edu/law/brandeis/opm-toc.html.

[12] The rationale behind the Act was to ensure the disclosure of sufficient, timely and material information about the securities offered for sale. It shifted the burden on the dealers and underwriters, replacing the philosophy of full disclosure for the philosophy of caveat emptor. The Act was aimed

Act was enacted to regulate the trading of securities on the secondary markets.[13] Among other things, it governed the transactions in previously issued securities and covered speculation, margin requirements, insider trading, fraud, manipulation and distortion.

The 1934 Act avoided definition of insider trading in favour of open-ended standards. Rule 10b (5) of the section 10b (5) of 1934 Act does not even mention insider trading. It has evolved through a series of judicial decisions rather than straight forward statutory interpretation.[14] It has been often described as a catch-all provision intended to prohibit fraudulent or manipulative practices in connection with transactions in securities. These anti-fraud provisions applied to corporate insiders who secretly traded when in possession of insider information because it was regarded as a specie of fraud. The Courts employed various theories in order to apply the law to insider trading cases.

3.4- The Current Law on Market Abuse

The Securities Exchange Act 1934 sets out the law on insider trading in three provisions that prohibited insider trading.

1- Section 10-(b)
2- Section 14-(e) and
3- Section 16

The 1934 Act also created the Securities Exchange Commission (SEC) to address the enforcement of interstate claims and improve co-ordination among state regulators. Both the 1933 and 1934 statutes empowered the SEC to make such rules and give those rules the force of law.

---

preventing exploitation by prosecuting issuers for any misstatements or fraudulent activities in issuance on the primary activities.

[13] Mark Dallas, United States v O Hagan: A Failed Attempt to Protect Public Policies underlying the Securities Laws (1999) Volume 32, *University of California Davis Law Review* at p 1107.

[14] US Supreme Court Chief Justice Rehnquist famously observed, “US inside trading law is a judicial oak which has grown from very little more than a legislative acorn” Blue Chips Stamps v Manor drugs Stores, 421 U.S 723, 737 (1975).

3.4.1- Prohibition under Section 10(b)

The core of the modern federal insider trading prohibition derives its statutory authority from Section 10 (b) of the Exchange Act, which provides that:[15]

> (a) It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange-
>
> (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commissioner may prescribe as necessary or appropriate in the public interest or the protection of the investors.[16]

The section is not self-executing and gives the SEC authority to prohibit "anti-manipulative or deceptive devices or contrivances." Pursuant to this section, SEC adopted Rule 10b-5 in 1942. The Rule provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national security exchange,
>
> (a)- To employ any device, scheme or artifice to defraud,
>
> (b)- To make an untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (c)- To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.[17]

Fraud is specifically referred to in sections (a) and (c). The Rule is often described as a *catch-all provision* intended to prohibit fraud in the purchase and sale transactions

---

[15] Joerg Hartmann, Insider Trading: An Economic and Legal Analysis (1997-1998) Volume 1, *Gonzaga Journal of International Law Review* at p 65-70. Stephen Bainbridge, An Overview of US Insider Trading Law: Lesson for EU, University of California, Research Paper No 05-5 at p 2-5. Stephen Bainbridge, the Law and Economics of Insider Trading: A Comprehensive Primer (2001) at p 9-19. Downloaded from http://papers.ssrn.com/paper.taf?abstract_id=261277. Accessed on June 2008.

[16] Section 10b (5) of the Securities Exchange Act 1934. 15 U.S.C.

[17] 17 CFR Section 240.10b-5

of any security. The Courts have attempted to define the applicability of the rule and the statue underlying in series of cases.

3.5- The Jurisprudence of Rule 10b-(5) [18]

The Rule 10b-(5) was first applied in the case of re Cady Roberts & Co in 1961. The Supreme Court has further developed it in several cases. The SEC and the Courts have employed three *theories of fairness* in order to premise liability in insider trading cases. These are the *Equal Access theory of fairness,* the *Classical theory of fairness* and the *Misappropriation theory of fairness.*

3.5.1- Equal Access Theory of Fairness

The theory states that all traders owe a duty to the market and other contemporaneous traders to disclose price sensitive information or refrain from profiting from it. SEC first applied this theory in an administrative decision in *Cady Roberts and Co*[19] when construing *the disclose or abstain mandate of Rule 10b-5.*

3.5.1.1- Cady, Roberts & Co

The board of directors of Curtiss-Wright decided to reduce the company's quarterly dividend. One of the directors J Cheever Cowdin was also a partner in Cady Roberts & company, a stock brokerage firm. Cowden informed one of his partners, Robert Gintel, before the news was announced. Gintel held discretionary trading authority over accounts and sold several thousand shares of Curtis Wright stock. Subsequently, their stocks fell several dollars per share upon announcement. Gintel, however, managed to avoid substantial losses for his customers.

The SEC held that Gintel had violated Rule 10b-(5) for tipping the inside information. In interpreting the Rule, the SEC held that there was an affirmative duty on corporate

---

[18] I have consulted several articles and books for this section. The details are: Stephen Bainbridge, *Securities Law- Insider Trading* (1999) Foundation Press at p 41-45. Stephen Bainbridge, An Overview of US Insider Trading Law: Lesson for EU, University of California Law Research Paper No 05-5 at p 2-5. Stephen Bainbridge, The Iconic Insider Trading Cases (2008) University of California, law & Economics Research Paper No 08-05 at p 2-9 and 13-20 Downloaded from http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1097744. Accessed on May 2013. Thomas Kirk, Speech by SEC Staff: Insider Trading –A U.S Perspective (1998) at p 4-7. Downloaded from http://www.sec.gov/news/speech/speecharchive/1998/spch221.htm. Accessed on June 2008.

[19] S.E.C 907 (1961)

insiders, particularly, officers, directors or controlling shareholders, to disclose material facts known to them by virtue of their position which would affect the judgement of an investor. This approach was based on two elements:

Firstly, the existence of a relationship giving access, directly or indirectly, to information intended to be available only for a corporate purpose and not for the personal benefit of anyone and *Secondly* the inherent unfairness involved where party takes advantage of such information knowing it is unavailable to those with whom he is dealing with. SEC argued that intimacy demands restraint otherwise the uninformed are exploited.

The precedential value of this case was not immediately clear. It was administrative ruling by the SEC and not a judicial decision. Conversely, there was a long line of precedent, represented by *Goodwin v Aggassiz.*[20] Seven years later, a Federal Circuit Court endorsed the SEC ruling in *Sec v Texas Gulf Sulphur*.[21]

3.5.1.2- SEC v Texas Gulf Sulphur Co (TGS)

TGS explored commercially significant deposits of copper, zinc and silver in the area of Ontario. Its president ordered to maintain strict confidentiality and withheld the news from other employees and directors. A number of insiders bought options on TGS stock and also tipped outsiders. The information was kept confidential in order to prevent the competitors from buying up the mineral rights and to keep down the prices landowners would charge them. SEC sued the inside traders for violating Rule 10b-(5). The Court applied *disclose or abstain rule* established in re Cady and Roberts and found them liable. The Court further added that section 10b (5) was enacted to prevent unfair practices in securities transactions generally, whether conducted face to face, over the counter or on exchange.

The policy grounds on which the Second Circuit Court endorsed the disclose or abstain rule was equality of access to information for all investors trading on

---

[20] 186 N.E 659 (Mass.1933). This held as an authority that for trading on impersonal exchanges that the directors and officers owe no duty of disclosure to the person with whom they trade.

[21] SEC v Texas Gulf Sulphur Co, 401 F.2d at 833 (2nd Cir. 1968) Cert. denied, 394 U.S 976 (1969)

impersonal exchanges.[22] The court stated that the federal prohibition was intended to assure that all investors trading on impersonal exchanges have relatively equal access to material information. Majority thought that the Congress intended that "all members of investing public should be subject to identical risk."[23]

3.5.2- Classical Theory of Fairness

The 1980s bought some of the most publicised cases of insider trading of Dennis Levine, Ivan Boesky and Michael Milken. During this period the Courts narrowed the scope of the *equal access theory* in the case of *Chiarella*[24] and propagated a *classical theory*. This theory represented a narrow construction of the deception requirement of Rule 10b-(5). It was adopted in the case of *Chiarella* and reaffirmed in *Dirks.*

3.5.2.1- Chiarella v United States

Vincent Chiarella worked for Pandick Press, a financial printer that prepared tender offer disclosure materials, among other documents. Pandick used codes to conceal the name of the companies involved, but chiarella figured out the codes and bought the stock in the target company. He was convicted of violating Rule 10b-(5) by trading on the inside information. The Second Circuit Court affirmed his conviction, applying the same equality of access based *disclose or abstain rule* it had created in TGS.[25]

The Supreme Court reversed the criminal conviction and rejected (the equal access theory) the recognition of a general duty between all participants in the market transactions to forgo actions based on material non-public information. It refused to impose such a duty without clear evidence of any congressional intent. The Court used the classical theory in interpreting the Rule to the case. They stated the *disclose or abstain rule* of liability for inside trading was now premised on the inside trader being subject to a duty to disclose arising from the *relationship of trust and confidence* to the party on the other side of the transaction.[26]

---

[22] Ibid at 848

[23] Ibid at 852

[24] Jill Fisch, Start Making Sense: An Analysis And Proposal For Insider Trading Regulation (1991) *Georgia Law Review* at p 187. Chiarella v United States, 445 U.S. 222 (1980).

[25] Stephen Bainbridge, *Securities Law- Insider Trading* (1999) Foundation Press at p 49.

[26] Ibid at 52.

Chiarella limited the scope of insider trading prohibition as compared to TGS. Academics have criticised this classical theory as it would not convict anyone other than classical insiders such as directors, officers and perhaps large shareholders on the basis of trading on inside information. It also created a variety of significant gaps in tippers and tippees liability. The Supreme Court addressed these issues three years later in the case of *Dirks.*[27]

3.5.2.2- Dirks v SEC

Dirks was an investment analyst. He discovered fraudulent activity found in the company accounts carried out by a former officer. Dirks made this information available to the SEC and Wall Street. He also advised his clients and some of them sold their stocks.[28] The SEC censured him for being a tipper under Rule 10b-(5). He appealed to Court of Appeal and then to the Supreme Court. The Supreme Court found nothing wrong with his conduct. *The Court held that the tippees are only liable if they knew or had reasons to believe that the tipper had breached a fiduciary duty in disclosing the confidential information and the tipper had received a direct or indirect personal benefit from the disclosure.*[29] Because Dirks disclosed the information for the purpose of exposing a fraud and not for personal gain, his tippees escaped liability.

The Court stated that a tippee is also subject to the duty to disclose or abstain from trading when he is knowingly in possession of material non-public information which (1) a tipper has improperly passed to the tippee in breach of a fiduciary or similar duty, and (2) if the tippee knows or should have known that the information was passed in violation of that duty, he should not trade on that information. The tippee is therefore derivative of the disclose or abstain duty. The sub tippee is also liable.

The Court also formulated the concept of "constructive insiders" meaning outside lawyers, consultants, investment bankers or others, who legitimately receive confidential information from a corporation in the course of providing services to the corporation. These constructive insiders assume the fiduciary duties of the true

[27] Dirks v SEC 463 U.S. 646 (1993).

[28] Stephen Bainbridge, *Securities Law- Insider Trading* (1999) Foundation Press at p 53-55.

[29] The Court looks at the objective criteria in order to ascertain whether the tipper benefited directly or indirectly, from his disclosure, A personal benefit for this purpose need not be cash or the avoidance of loss, but can be "reputational benefit" that could translate into future earnings.

insiders. The case also resolved the issues revolving around the tipper and tippes liability as detailed below.

3.5.3- The Emergence of Misappropriation Theory of Fairness

SEC suffered a setback in *Chiarella* and *Dirks* and started to advocate the misappropriation theory in order to impose liability. The origins of this theory lie with Justice Steven's dissenting judgement although it took its name from a phrase in Chief Justice Burger's commentary in the same case.[30] The misappropriation theory states that a third party need not owe a duty to either the investor with whom he traded or the issuer of the traded securities. He may be held liable for breach of section 10b or Rule 10b-(5), if he has traded when in possession of non-public material information, in breach of his fiduciary duty owed to the source of information.[31] The majority did not address the merits of this theory, instead rejecting it solely on the ground that the theory had not been presented to the jury and thus could not sustain the criminal conviction.

The decision in *Chiarella* left the way open for the SEC to urge the lower Courts to adopt the misappropriation theory as an alternative basis of insider trading liability. In 1981, the Second Circuit Court adopted this in the case of *U.S v Newman*[32] and followed it in a number of subsequent decisions.[33]

3.5.3.1- United States v Newman

Newman, an employee of an investment bank misappropriated confidential information concerning proposed mergers involving clients of the firm. The defendant's employer worked for the prospective acquiring company whilst the trading took place in target company's securities. As such Newman the defendant owed no fiduciary duties to the investor with whom they traded. Moreover, neither the

---

[30] Jill Fisch, Start Making Sense: An Analysis And Proposal For Insider Trading Regulation (1991) Georgia Law Review at p 199.

[31] Stephen Bainbridge, *Securities Law- Insider Trading*, (1999) Foundation Press at p 94-96.

[32] 664 F.2d 12 (2nd Circuit 1981), aff'd after remand, 722 F.2d 729 (2d Cir. 1983), Cert. denied, 464 U.S. 863 (1983).

[33] Such as U.S v. Chestman, 947 F.2d 551 (2d Cir. 1991) (en banc), Cert. denied, 112 S.Ct. 1759 (1992); U.S. v. Carpenter, 791 F.2d 1024 (2d Cir. 1986), aff'd on other grounds, 484 U.S. 19 (1987); SEC v. Materia, 745 F.2d 197 (2d Cir. 1984), cert, denied, 471 U.S. 1053 (1985).

investment bank, nor its clients, traded in the target company shares contemporaneously with the defendants. The Court held that by misappropriating confidential information for personal gains, the defendants defrauded their employer and its clients, and this fraud sufficed to impose liability on the defendants with whom they traded.[34]

The SEC attempted to recapture as much grounds as it had lost in Chiarella and Dirks by employing the misappropriation theory. The courts viewed the fiduciary duty element as mere inconvenience that should not stand in the way of insider trading liability. Even a former SEC commissioner admitted as much acknowledging that the misappropriation theory was merely a pretext for enforcing equal opportunity in information.[35] The SEC effectively used the misappropriation theory as a means of redirecting the prohibition back towards the direction in which TGS had initially set it. The theory was further applied in the case of *United States v Carpenter*[36] in 1986.

3.5.3.2- United States v Carpenter

The case centred on an article of a columnist "Heard on the Street", which often caused variation in the stock prices of the companies he wrote about. The columnist tipped the information about his upcoming columns to the broker and shared in the profits of the broker made by trading in advance of publication. The Second Circuit Court upheld the conviction of the columnist and the broker for the securities fraud under Rule 10b-(5) and mail and wire fraud. The Court rejected the defendant's argument that the misappropriation theory only applies when the information is misappropriated by corporate or constructive insiders.

The case was controversial because it did not involve inside information and the defendant was not an insider. In fact the contents of the column were merely the product of the defendant's own analytic efforts and did not contain any material non-public information. The Journalist did not have any special relationship with the issuers and therefore was not an insider. The publication had an internal policy which

---

[34] United States v Carpenter, 791 F.2d 1024 (2nd Cir.1986), aff'd on other grounds, 484 U.S 19 (1987); SEC v Materia, 745 F 2d 197 (2d Cir 1984), Cert. denied, 471 U.S.

[35] Charles Cox, Kevin Fogarty, Bases of Insider Trading Law (1998) Volume 49, *Ohio State Law Journals at p 353, 366.*

[36] United States v Carpenter 791 F.2d 1024 (2d Cir, 1986), aff'd 484 U.S. 19 (1987)

deemed that all material produced by employees during their employment belonged to the Journal. Based on this internal policy the SEC successfully argued that the journalist had misappropriated his employer's property and the conviction was upheld. The case was appealed to the Supreme Court and was the first oppertunity where the Supreme Court had to consider the merits of the misappropriation theory. The Court upheld the convictions under the mail and wire fraud statutes however, as the Rule 10b (5) convictions, the Court was split 4 – 4. Following longstanding tradition, evenly divided Supreme Courts affirmed the Lower Court's ruling without opinion, but the ruling had no precedential or stare decisis value.[37]

The ruling meant that in essence misappropriation theory could be used to impose liability on anyone who (1) misappropriated material non-public information; (2) thereby breaching a fiduciary duty or a duty arising out of a similar relationship of trust and confidence; and (3) used that information in a securities transaction, regardless of whether he owed any duties to the shareholders of the company in whose stock he traded.[38] This effectively meant that if this theory was available in Chiarella, his conviction would have been upheld, even though he owed no duties to those with whom he traded.

Over the next nine years, the misappropriation theory gained acceptance in federal Courts.[39] Then in 1995 and 1996, the Fourth and Eighth Circuit Courts, availing the gap left by Supreme Court decision in *Carpenter* rejected the misappropriation theory in *United States v Bryan*[40] *and United States v O' Hagen*[41] . In the case of Bryan the Court found that the text of Section 10(b) or Rule 10b-5 cannot support a conviction based upon the misappropriation theory. Moreover the Rule 10b-(5) imposed liability only where there has been deception on the purchaser or seller of the securities, or upon some other person who has been intimately linked with or affected by the

[37] Stephen Bainbridge, *Securities Law- Insider Trading* (1999) Foundation Press at p 97.

[38] United States v. Bryan, 58 F. 3d 933, 945 (4th Cir. 1995). Stephen Bainbridge, *Securities Law-Insider Trading* (1999) Foundation Press at p 100, 109-110.

[39] In cases such as SEC v. Materia, 745 F. 2d 197, 201 (2d Cir. 1984); Rothberg v. Rosen bloom, 771 F. 2d 818 (3d Cir. 1985); SEC v. Cherif, 933 F, 2d 403 (7th Cir. 1990); SEC v. Clark, 915 F. 2d 439 (9th Cir. 1996).

[40] United States v. Bryan 58 F. 3d 933 (4th Cir. 1995).

[41]United States v O'Hagan, 117 S.Ct. at 2207 (1997).

transactions. Furthermore, the facts of the case presented no such deception, but rather simply a breach of fiduciary duty owed to the source of the information, therefore the theory cannot stand. The conflict among the circuits was resolved by Supreme Court in *United States v O' Hagen*.

3.5.3.3- United States v O'Hagan

O'Hagan was a partner in a law firm who obtained information about a client that was in the process of submitting a tender offer for another company. O'Hagan traded in the target company shares making a profit of more than US$4.3 million. He was charged with Section 10(b) and Rule 10b-(5) of trading on misappropriated non-public information.[42] The trial jury convicted him, but his conviction was overturned by Eighth Circuit Court.

The Supreme Court reinstated the conviction and upheld the misappropriation theory. The Court discussed both theories and considered them to be complementary. *The main issues raised* were about the validity of the misappropriation theory was whether the deceit by the mis-appropiator on the source of the information constitute 'deception' as the term is used in section 10(b) and Rule 10b (5) and any such deceit is deemed to have occurred "in connection with" the purchase or sale of a security.[43] The Court held when a fiduciary secretively use their principal's information to transact in securities, it breaches the duty of loyalty and confidentiality and defrauds the principal of the exclusive use of that information. It therefore satisfies section 10b requirement that there be a "*deceptive device or contrivance*" used "*in connection with the securities transaction*".

The Court further argued that 1934 Act had intended to deal with such behaviour to ensure the maintenance of fair markets. Moreover, an investor's informational disadvantage vis-à-vis a mis-appropiator with material non-public information stems from contrivance, not luck. It is a disadvantage that cannot be overcome with research or skill.[44]

---

[42] O'Hagan was also convicted in contravention of Rule 14e-3, which proscribed insider trading in connection with tender offers, and the federal mail fraud and money laundering statutes.

[43] Central Bank of Denver v First Interstate Bank, 511 U.S. 164, 174 (1994).

[44] United States v O'Hagan, 117 Supreme Court at 2210 (1997).

The decision was regarded as a milestone in defining the scope of the Rule 10b-(5) and misappropriation theory, however, it was heavily criticised for not bringing any clarity.[45] The continuing lack of a clear definition of insider trading presents a threat to fairness and to investors, whose ability to assess when they are insiders will still be largely the result of educated guesswork.

3.6- Prohibition under Section 14(e)

The SEC adopted Rule 14e-3 under Section 14(e) of the 1934 Act to deal with inside trading in the context of tender offers. The SEC was not satisfied with the fiduciary duty in the classical theory after the decision in chiarella case.[46] It attempted to apply the *equality of access theory* making the fiduciary duty as stated in classical theory irrelevant.[47] The only requirement is that insiders must know or have reason to know that the material information is non-public. Section 14(e) made it unlawful for any person to engage in any fraudulent, deceptive or manipulative act in connection with a tender offer. The Rule 14e-3 was adopted to prohibit insiders of the bidder/target company or an intermediary from divulging confidential information about a tender offer to persons that are likely to trade on the basis of that information in the target company securities until there is sufficient public disclosure of the information.[48]

The provision does not prohibit the bidder from buying target shares or from telling its legal and financial adviser about its plans.[49] It prohibits tipping of information to persons who are likely to buy target shares for their own account. The rule was intended to strike at the practice known as warehousing. This increased possibility of hostile takeover because of the increased numbers of shares needed to be bought to

[45] Alcock, Misappropriation Restored (1997) *Journal of Business Law* at p 562.

[46] The Williams Act refers to amendment in Securities Exchange Act of 1934. This was proposed by Senator Harrison William in 1968. It is a popular name of Pub.L.No.90-439, 82 Stat.454 (1968): Full Disclosure of Corporate Equity Ownership and Corporate Takeover Bids. Senator

[47] Hui Huang, *International Securities Markets in China: Insider Trading Law in China* (2007) Kluwer International at p 142. There is no need for showing that the trading party or tipper was subject to any duty of confidentiality, and no need to show that the tipper personally benefited from the tip

[48] The Supreme Court upheld Rule the validity of Rule 14e-3 in the United States v O'Hagan, 521 U.S 642 (1997)

[49] Rule 14e-3 (d) (1) of 1934 Act.

support the bidder's proposal.[50]

3.7- Prohibition under Section 16

The prohibition is divided under section 16(a) (b) and (c).

3.7.1- Section 16(a) - Reporting Obligation

The section 16(a) states that directors, officers and any person who is a beneficial owner of more than ten per cent of any class of equity security must file a report detailing their holdings. The report must be submitted to the SEC and the Exchange on which the securities are registered. Pursuant to Section 403[51] of the Sarbanes-Oxley Act of 2002, section 16(a) was amended to require the aforementioned to report their transactions more promptly, by the end of second day after the transaction. The policy of SEC has been to disclose showing a reluctance to afford insider's report and confidential treatment.

3.7.2- Section 16(b) - the Short Swing Profits Rule

This section was intended to protect outsider shareholders against short swing speculation by insiders with price sensitive information without discouraging long term investment made in good faith.[52]

The section provides that insiders who are defined in section 16(a) as being directors, officers and ten per cent shareholders, may not both *buy and sell* their company's securities *in a six months* period. It provides for the disgorgement of all profits made by the insider trading.[53] The section will only apply if beneficial owners have a holding of at least ten percent in the issuer at the time of both the sale and purchase of securities. The main advantage of section is that it does not require proof of

---

[50] Stephen Bainbridge, The Law and Economics of Insider Trading - A Comprehensive Primer (2001) at p 21. Downloaded from http://papers .ssrn.com/paper.taf?abstrat_id=261277. Accessed on 15th[st] Jan 2008

[51] In light of the financial debacles that recently have occurred, the reporting provisions of Section 16(a) now enjoy strong congressional support and evidently will be subject to vigorous enforcement.

[52] The UK's Model Code also provides that directors should not deal in their companies' securities on short-term consideration.

[53] Whittaker v. Whittaker Corp, 639 F.2d 516 (9[th] Cir. 1981), Smolowe v. Delendo Corp, 136 F. 2d 231 (2d Cir. 1943).

fraudulent, manipulative behaviour or unfair use of inside information. The actions can be brought more readily and the removal of transaction profit has strong deterrent effect.

3.7.3- Section 16(c) – The Rule against Short Selling

Section 16(c) provides that it is unlawful for a beneficial owner, directors or officers to sell, directly or indirectly, any equity of the issuer, if either (1) he does not own the security sold or (2) he owns the security but does not deliver it with in twenty days or deposit it in the mail within five days. There is no liability if, acting in good faith, delivery could not be made within the requisite time limit because to do so would cause undue inconvenience and expense.

The purpose of the section is to prevent insiders short selling in their own securities. It prevents two kind of transaction. *First*, insider may sell that they do not own, borrowing them to make delivery, then buying an identical amount of shares to deliver to the lender or purchasing to make delivery. *Secondly*, insiders may sell their holdings but keep the shares registered in their names, borrowing to make delivery, than buying shares to repay the lender. Thus the insider position is not known until delivery is made at a later date. This is known as sale against the box.

3.8-Prohibition of Selective Disclosure and Regulation FD

The SEC had been long concerned that selective disclosure to analysts undermines public confidence in the integrity of the stock markets and the *Dirks* tipping regime was an inadequate constraint on the selective disclosure practice because it can be difficult to prove that the tipper received personal benefit in connection with a disclosure.

SEC adopted Regulations FD in 2000, in order to create a non-insider trading-based mechanism for restrictive disclosure. The regulation required that disclosure of any material non-public information such as advance warning of earning results to analysts and institutional investors by issuers or any person acting on behalf of issuer must also be:

(a)- Disclosed to general public simultaneously, in the case of intentional disclosure.[54]

(b)- Promptly, in the case of non-intentional disclosure.[55]

3.9- Conclusion

This chapter analysed the underlying ethical theories of fairness in historical evolution of case law on insider trading in US. The law may develop further to refine the contours of insider trading law.

[54] 17 CFR 243.100 (a) (1).

[55] 17 CFR 243.100 (a) (2).

Part II - UK Market Abuse Regime

3.10- Introduction

This chapter analyses the historic development of investor protection from market abuse to promote fair markets in Securities Regulation in UK. In contrast to US case law and Shariah's ethical principles, UK law is statute based. There are three statutes currently regulating the market abuse namely Criminal Justice Act 1993, Financial Services and Market Act 2000 and Financial Services and Market Act 2000 (Market Abuse) Regulations 2005 which sets out the law in this area.

3.11- The Evolution of Law on Market Abuse

The operation of securities markets in UK had been governed *predominantly by self-regulation*. The first statute to sanction market misconduct was adopted in 1284 in the reign of Edward IV. [56] It enacted the offences of engrossing, forestalling, and regrating. These were early days of commerce and the economic system was barter based. The rationale of prohibition was to introduce more certainty in the economic system of demand and supply.[57] Academics view this statute as the origin of UK financial services regulation. It established the tradition of self-regulation in the City.[58]

The City provided extensive financial and political support to the Crown and the government in times of prosperity and adversity. This enabled it to defend any form of external regulation through lobbying. Its underlying belief was that that there should be no interference with commerce as it's a domain of private transactions. A number of attempts were made to regulate market misconduct in the history of securities markets. The first ever legislation to come into force was the 1697 Act to Restrain the Numbers and Practices of Brokers and Stock Jobbers.[59] Another piece of significant

---

[56] Statutes of the Realm (1363) 37 Edw III c 8. Please refer to the "Introduction" for the definition of engrossing, regrating and forestalling.

[57] George Gilligan, The Origins of UK Financial Services Regulation (1997) Volume 18, *Company Lawyer* at p 167-176.

[58] Stock Exchanges and Financial Markets were generally referred to as City.

[59] 8 and 9 William III, c 32 (1697). The Royal Commissioners were appointed in 1696 to analyse the early capital market. Its report criticised the share fraud, insider trading and market manipulation and was catalyst to the 1697 Act which lapsed in 1707. (1696) House of Commons Journals, 25 November 1696.

legislation was the 1734 Act to Prevent the Infamous Practicing of Stock-Jobbing.[60] The Act prohibited short selling, forward transactions and attempted to regulate the broker to client relationship. Subsequently, there were more attempts to regulate market abuse but these failed against the City's lobbying power.[61] Moreover, common law also did not provide for any adequate precedent.[62]

It remained to be a normal practice to earn profit based on price sensitive information. A number of further attempts in 1960-1980 to pass legislation were also aborted. Finally, Part V of the Companies Act 1980 (Sections 68-73) was enacted to make insider dealing a criminal offence. These provisions were subsequently consolidated in the Company Securities (Insider Dealing) Act 1985. Further reform came from the European Community and the Insider Dealing Directive.[63] This was brought into force in UK by enactment of Part V (Sections 52-64) of the Criminal Justice Act 1993.[64] *Self-regulation* of the City predominantly continued until some *statutory control* was introduced through Financial Services Act 1986[65] which marked the end of self-regulation. The Act adopted section 13 of the Prevention of Fraud (Investment) Act 1958 in section 47 (1) and created another offence in section 47 (2) in dealing with market manipulation by means of misleading act or omission.

---

[60] It was also commonly known as Bernard's Act after Sir John Barnard, an Independent Whig parliamentarian. The Act was not properly implemented and the City managed to evade the external accountability. See George Gilligan, Historical Touchstone in the Regulation of Financial Services Sector: the Evolution of Financial Services Regulation (1993) *Journal of Financial Regulation and Compliance* at p 63-71. Romney Sedgwick, The History of Parliament: The House of Commons 1715-1754 (1970) Volume 1, London, at p 435-7.

[61] Barry Rider, Charles Abrams and Ellis Ferran, *Guide to the Financial Services Act 1986* (1989) Bicester: Oxon at p 7. George Gilligan, The Origins of UK Financial Services Regulation (1997) Volume 18, *Company Lawyer* at p 30-32.

[62] Common law lacked any precedent to make a case on insider trading actionable. The authorities relied on common law criminal offence of conspiracy to defraud to cover any forms of market abuse. The scope of this offence was very uncertain creating confusion about the boundaries of liability. Emilios Avgouleas, *The Mechanics and Regulation of Market Abuse* (2005) Oxford University Press at p 315.

[63] Directive 89/592 EEC of 13 November 1989, OJ 1989 L334/32.

[64] This was brought into force on 1 March 1994 by SI 1994/242.

[65] The Government White Paper in 1985, Professor Gower's report and the Big Bang paved the way for the enactment of the Financial Services Act 1986. Department of Trade and Industry, *Financial Services in the United Kingdom: A New Framework for Investor Protection* (1985) London Cmd No 9432. Lawrence Cecil Gower, Big Bang and City Regulation (1988) Volume 51, *Modern Law Review* at p 8. The term Big bang means the concurrent abolition of the London Stock Exchange's system of fixed commissions, member's single capacity, and the introduction of its electronic trading system.

The Act again proved ineffective in practice.[66] The Criminal law covered all market participants, but only a narrow range of serious criminal offences. On other hand the regulatory regime covered wide range of behaviour but extended only to the regulated community. In addition to this, there was a growing dissatisfaction with the self-regulation and the self-regulatory organisations (SROs).[67]

The Labour Government enacted Financial Services and Market Act 2000 (FSMA) under Part VIII to regulate the market abuse in securities markets. It also established Financial Service Authority (FSA) as a single regulator of the industry as a whole.[68] It allowed the FSA to deal with any conduct that is damaging to the markets by way of regulatory penalties.

The Civil regime of FSMA supplemented the criminal prohibition under CJA 1993, which has been retained and remains as part of the current law. In addition to the above, the European Union adopted the Market Abuse Directive[69] (MAD) as part of the Financial Services Action Plan.[70] The UK authorities decided to implement this directive through the Financial Services and Market Act 2000 (Market Abuse) Regulations 2005.[71] These Regulations amended the market abuse provisions in Part VIII of the FSMA 2000. The Act confers broad powers on FSA to combat market abuse, in particular to fill the gap that had existed in the previous legislation.

3.12- The Current Law

The current UK market abuse regime has dual nature and is based both on criminal

---

[66] Economic Secretary in Standing Committee, November 2, 1999, c.652. Hansard, HL Vol. 610, col. 58 (Feb 21, 2000) Alistair Alcock, Market Abuse (2002) Volume 23, *Company Lawyer* at p 143

[67] The Securities and Investment Board (SIB) sat on top of plethora of self-regulatory organisations, such as Stock exchange, Securities and Future Authority, LAUTRO (life Assurance and Unit Trust regulatory Organisation) IMRO (investment Management and Regulatory Organisation) and FIMRA (Financial intermediaries, Managers and Brokers Regulatory Association) with their own rulebooks. Colin Chapman, *How the Stock Markets Work* (2002) Random House Business Books at p.

[68] This included the transfer of regulatory and supervisory responsibility for the banking, securities and insurance sectors from the Bank of England, the Securities and Investment Board and several SROs (such as Securities and Futures Authority) to Financial Services Authority.

[69] Directive 2003/6/EC

[70]European Commission, Financial Services: *Implementing the Framework for Financial Market*: Action Plan (COM (1999) 232.

[71] SI 2005/381 (hereinafter the Market Abuse Regulations)

and civil law.[72]

- The Criminal Law Regime is based on Part V of the Criminal Justice Act 1993 and section 397 (1) and (3) of the FSMA 2000.

- The Civil Regime is set out in Part VIII of the FSMA as amended by the Market Abuse Regulations. The FSA Code of Market Conduct[73] provides guidance on its interpretation of section 118. The code sits alongside the types of market abuse specified by FSMA and the two therefore needs to be considered together.

3.13-The Criminal Law Offences

There are three key provisions which prohibit activities of insider dealings and market manipulation which are treated as criminal offences and for which FSA can take action:

1- Insider dealing as set out in Section 52 of the CJA 1993.[74]
2- Misleading statements as set out in section 397 (1) of FSMA.
3- Market manipulation as set out in section 397 (3) of FSMA.

These offences covered relatively narrow range of very serious misconduct where there is an intention to abuse the market.[75] On the other hand, the criminal offences for which the FSA can take an action are broad and where the behaviour justifies criminal rather than civil penalties, the FSA will be prepared to pursue such cases through the criminal courts.[76]

[72] Morgan Lewis, A Summary of Market Abuse Regime in UK (April 2066) at p 2-8 Downloaded from www.morganlewis.com. Accessed on 29th Nov 2007.

[73] Section 119-122 of FSMA required FSA to prepare and issue a code containing such provisions giving appropriate guidance, in order to assess whether or not behaviour amounts to market abuse. Following the implementation of the Directive, the FSA issued a substantially amended Code of Market Conduct (the "Code"), which forms chapter one of the FSA's Market Conduct Sourcebook. References to the original Code will be given as COMC and to the current Code as MAR.

[74] DTI also has the power to investigate and prosecute the insider trading offences. Annexe 1-G to the FSA's Enforcement Manual sets out the general guidelines for determining whether the FSA or DTI should deal with a particular case of suspected Insider Dealing.

[75] Financial Services Authority Consultation Paper 59, Market Abuse: A Draft Code of Market Conduct, (2007) at paragraph 2.10.

[76] Robert Falkner, Jon Gerty, Regulation of Market Misconduct in the United Kingdom (2005) *Journal of Investment Compliance* at p 35-53.

3.13.1- Insider Dealing

Section 52 of Part V of the CJA 1993 provides for the offence of insider dealing which seeks to prevent individuals from engaging in three classes of conduct. A criminal offence is committed if an:[77]

(i)- "*Insider*" deals in "*price-affected securities*" on the basis of "*inside information.*"[78]
(ii)- Insider encourages another person to deal in "price-affected securities" on the basis of "inside information.[79]
(iii)- Insiders disclose inside information otherwise than in the proper performance of the functions of his employment, office or profession to another person.[80]

It was major weakness of the previous Act that "individual" was defined to exclude corporations and other entities. The market abuse regime under FSMA 2000 remedied this gap by making the offence of market abuse applicable to most legal entities including corporations and natural persons.

The first two offences are committed either when the dealing takes place on a "*regulated market*" or where the person dealing in price affected securities relies on a professional intermediary or is himself acting as a professional intermediary.[81] In order to prove an offence under section 52 it is necessary to demonstrate (a) the status of a person charged as an insider, (b) the type of information used is inside information and (c) that he deals in price affected securities, which if made public would be likely to have significant effect on the market.

(a)- *Insider*

An insider[82] is defined as a person who holds inside information knowing that it is inside information and that it was acquired knowingly from an inside source through being a director, employee or shareholder or by virtue of his employment, office or profession or from a person who obtained in one of these ways.[83]

---

[77] Section 52 (1) and (2) of Criminal Justice Act (CJA) 1993.

[78] Section 52 (1) of CJA 1993.

[79] Section 52 (2) (a) of CJA1993.

[80] Ibid, section 52 (2) (b).

[81] Section 52(3) of the CJA1993

[82] Section 57(1) and (2) of CJA 1993.

(b)- *Inside Information*

Inside information is the information which,[84]

(i)- relates to particular securities or particular issuers but not issuers of securities generally;

(ii)- is specific or precise;

(iii)- has not been made public;

(iv)- is price sensitive (i.e. if it were made public it would be likely to have a significant effect on the price of any security as defined in section 58(2) (3).

(c)- *Price sensitive information*

Price sensitivity[85] is the most essential feature of the statutory definition of inside information. The jury will determine factors information is inside information. Price sensitivity can only be determined at the moment of the transaction when the information is not known to the public and whether it can have any impact on the price. The *securities* to which the Act applies are price-affected securities, which are defined in schedule 2 of CJA 1993. They include shares, debt securities, warrants, depository receipts, options futures, and contracts for difference.[86]

The CJA adopts a broad definition of *"dealing in securities"* to cover any acquisitions or disposals of security, including an agreement to acquire or dispose of a security or the bringing to end of a contract, whether as principal or agent and to the procurement of an acquisition or disposal by third party.[87]

3.13.2- Misleading Statements

Section 397 (1) of FSMA sets out a criminal offence of misleading statement. The offence is committed if a person:

1- makes a statement, promise or forecast which he *knows to be* misleading, false or deceptive.

[83] Section 56 of the CJA 1993.

[84] Ibid Section.

[85] Section 58 (2) and (3).

[86] Section 54 in Schedule 2 CJA 1993.

[87] Section 55 CJA 1993.

2- *dishonestly* conceals any material facts.[88]
3- *recklessly* makes (dishonestly or otherwise) a statement, promise or forecast which is misleading, false or deceptive in a material particular.

For the purpose of inducing or being reckless as to whether it may induce, another person (whether or not the person whom the statement, promise or forecast is made or from whom the facts are concealed) to enter or offer to enter into or refrain from entering or offering to enter into, a relevant agreement or to exercising any rights conferred by relevant investment.

3.13.3- Market Manipulation

Section 397 (3) of FSMA sets out a criminal offence which is committed if a person does any act or engage in any conduct which creates a false or misleading impression as to the market or the price or value of any relevant investments. He does so for the purpose of creating that impression and thereby inducing another person to acquire, dispose of, and subscribe for or underwrite those investments or to refrain from doing so or to exercise, or refrain from exercising, any rights conferred by the investments. [89]

Section 397(3) seems to be based on the assumption that a bright line may be drawn between statements or omissions and other forms of market manipulation as artificial transactions and trade based manipulations.[90] The legislator's aim was to create a statutory offence in relation to acts or conduct and a separate offence for other practices likely to defraud, deceive or mislead the market, which would not require evidence of
intent to defraud or recklessness on the part of malfeasants.[91]

[88] The test of dishonesty is objective and is set out in *R v Ghosh* (1982) QB 1053 by Lord Lane CJ. The Court of Appeal held that the test of dishonesty for offences under the Theft Act 1968, as amended, and for conspiracy to defraud is defined by reference to the ordinary standards of reasonable and honest people. Emilios Avgouleas, *The Mechanics and Regulation of Market Abuse, (2005)* Oxford University Press at p 315.

[89] Morgan Lewis, A Summary of Market Abuse Regime in UK (April 2066) at p 12. Downloaded from www.morganlewis.com. Accessed on 29th Nov 2007.

[90] Jon Gerty Falkner, Regulation of Market Misconduct in the United Kingdom (2005) *Journal of Investment Compliance* at p 37-38.

[91] The decision of Court of Appeal in *New South Wales in North v Marra Developments Ltd* provide additional guidance in determining the false and misleading impression in the market. (1982) 56 AJLR 106. Jonathan Fisher, Jane Bewsey, Malcolm Waters, Elizabeth Ovey, *The Law of Investor Protection* (2003) Sweet Maxwell at p 284.

3.14- The Regulatory Offence of Market Abuse under FSMA 2000

The Civil/Administrative market abuse regime under FSMA is first ever to be introduced.[92] Market Abuse Directive has made significant changes in the relevant UK legislation. Section 118 of FSMA prohibits behaviour (which includes action or inaction) which:

1- occurs in relation to "*qualifying investments*"[93] or in relation to related investment, admitted (or in respect of which a request has been made for admission) to trading on a "*prescribed market*"[94] (or in case of behaviour set out in section 118(2) and (3) investments whose price or value depends on the price or value of the qualifying investments;)

2- falls with in any one or more of the seven types of the behaviour set out in section 118(2) to 118(8) of FSMA, that is:

    (i) Insider Dealing.[95]

    (ii) Improper disclosure of inside information.[96]

    (iii) Misuse of information.[97]

    (iv) Manipulating transactions.[98]

    (v) Manipulating devices.[99]

    (vi) Disseminating false or misleading information likely to give false or misleading impression.[100]

    (vii) Misleading behaviour and market distortion.[101]

---

[92] Morgan Lewis, A Summary of Market Abuse Regime in UK (April 2066) at p 2-8. Downloaded from www.morganlewis.com. Accessed on 29th Nov 2007. Also see Jonathan Marsh, UK Legal and Regulatory Development (2005) *Journal of Derivatives and Hedge Funds* at p 164-172.

[93] Section 118 (1) and 118A (1) of FSMA 2000.

[94] Section 118 (1) (a) (i) and (ii) of FSMA 2000.

[95] Section 118 (2) of FSMA. Based on Article 2 of Market Abuse Directive (MAD)

[96] Ibid Section 118 (3). Based on Article 3 (a) of MAD.

[97] Ibid Section 118 (4). Reflecting the original market abuse offence under former s 118 (2) (a).

[98] Ibid Section 118 (5). Based on Article 1 (2) (a) of MAD.

[99] Ibid Section 118 (6). Based on Article 1(2) (b) of MAD.

[100] Ibid Section 118 (7). Based on Artice 1(2) (c) of MAD.

[101] Ibid Section 118(8). Reflecting the original market abuse offence under former s 118 (2) (b).

The three behaviours falling under misuse of information (iii), misleading behaviour and market distortion (vii) ceased to have an effect on 30th June 2008.[102] In practice this is unlikely to make a difference since there will be few situations where the conduct subject to complaint will not fall under at least one of the other behaviours set out in FSMA.[103]

Civil market abuse is not limited to conduct with in the UK. Any behaviour can amount to market abuse if it occurs in the UK or in relation to qualifying investments, which are admitted to trading on a prescribed market situated or operating in the UK. *Prescribed market* is defined in the Financial Services and Market Act 2000 (Prescribed Markets and Qualifying Investments) Order 2001. It includes any market established under the rules of UK Recognised Investment Exchange ("RIE"), OFEX and all other regulated markets based in EEA countries.

3.14.1- Insider Dealing

This form of market abuse requires the person to be an "*insider*", who deals or attempts to deal in a "*qualifying*" or "*related investment*" on the basis of "*inside information*". An insider is defined in section 118(b) of FSMA, as anyone in possession of inside information however obtained as a result of:

1. being a director, manager, or a shareholder
2. having access to the information through his employment, profession or duties.
3. criminal activities.
4. his holding in the capital of an issuer of qualifying investment.
5. other means which he or she knows or could reasonably be expected to know is inside information

There are three different definitions of inside information in section 118C of FSMA. (a)- Section 118C (2) sets out the definition of inside information in relation to qualifying investment or related investments which are not commodity derivatives.

[102] Ibid Section 118(9).

[103] Morgan Lewis, A Summary of Market Abuse Regime in UK (April 2066) at p 2-8. Downloaded from www.morganlewis.com. Accessed on 29th Nov

(b)- Section 118C (3) sets out the definition of inside information in relation to qualifying investments or related investments which are commodity derivatives and
(c)- Section 118C (4) sets out the definition of inside information in relation to a per son charged with execution of the orders concerning any qualifying investments or related investments.

3.14.2- Improper Disclosure[104]

The second type of behaviour, which constitutes market abuse is where the insider discloses inside information to others and is not in the proper course of exercise of his/her employment, profession or duties.[105] The definition of "insider" and inside information as described above, apply to improper disclosure in the same way that they apply to insider dealing. FSA guidance on improper disclosure is set out in paragraph 1.4 of MAR. Examples of improper disclosure include director of an issuer who discloses inside information to another in a social context and a trader who, having received details of large client order, discloses details of that order to another client prior to execution.[106]

3.14.3- Manipulating Transactions

This form of behaviour amounts to transactions or orders to trade which[107]

(i)-give, or are likely to give, false or misleading impression as to the supply of, or demand for, or as to the price of, one or more qualifying investments; or which
(ii)-secure the price of one or more such investments at an abnormal or artificial level.

Paragraph 1.6 of MAR provides guidance on manipulating transactions. Examples of such behaviour would be buying or selling at the close of the market with the effect of misleading investors who act on the basis of the closing prices other than for legitimate reasons. This includes wash trades or entering orders into electronic trading system at prices which are higher than the previous bid or lower than the previous bid or

[104] Morgan Lewis, A Summary of Market Abuse Regime in UK (April 2066) at p 6. Downloaded from www.morganlewis.com. Accessed on 29th Nov 2007. Also see Jonathan Marsh, UK Legal and Regulatory Development (2005) *Journal of Derivatives and Hedge Funds* at p 168.

[105] Section 118 (3) of FSMA

[106] MAR 1.4.6 G.

[107] Section 118(5) of FSMA

lower than the previous offer and withdrawing them before they are executed.[108] Such orders are carried out to give a misleading impression that there is a demand or supply of the qualifying investment at the price.

The Code also sets out indications of behaviour which is for legitimate reasons[109] and behaviour which is not for legitimate reason.[110] A non-exhaustive list of factors that the FSA takes into account in assessing whether to accept a particular market practice is also set out in the Code at Annex 2 G. The Code also sets out the examples of market abuse amounting to manipulating transactions.[111]

3.14.4- Manipulating Devices

The fourth type of behaviour which constitutes market abuse effects transaction or orders to trade, which employ fictitious devices or any other form of deception or contrivance.[112] Paragraph 1.7 of MAR contains guidance on this offence. Examples of the behaviour include pump and dump, trash and cash schemes, and taking advantage of occasional regular access to the traditional or electronic media by voicing an opinion about a qualifying investment whilst having previously taken position on qualifying investment and profiting subsequently.

3.14.5- Dissemination

The fifth type of behaviour which constitutes market abuse[113] is dissemination of information by any means which gives, or likely to give, false or misleading impression about a qualifying investment by a person who knew or could reasonably be expected to have known the information was false or misleading. Paragraph 1.8 of the MAR contains guidance on dissemination. Examples of the behaviour, which in the opinion of the FSA, falls with in this category include:

(i)- knowingly or recklessly spreading false or misleading information about qualifying investment through the media, for example by posting information which contains

[108] MAR 1.6.2 E

[109] MAR 1.6.6 E

[110] MAR 1.6.5 E

[111] MAR 1.6.15 E

[112] Section 118 (6) of FSMA

[113] Section 118 (7) of FSMA

false or misleading statements about a qualifying investment on an internet bulletin board or in chat room in circumstances where the person knows that the information is false or misleading.

(ii)- undertaking a course of conduct in order to give a false or misleading impression about a qualifying investment.

3.15- The Offence of Encouraging Market Abuse

In addition to the primary offence of market abuse, section 123 has also introduced another *offence for encouraging market abuse***.** The offence is committed if a person takes or refrains from taking any action that requires or encourages another person to engage in behaviour, which if engaged by the former would amount to market abuse.

3.16- Conclusion

The chapter analysed the legislation on market abuse in UK and the various forms of market abuse practices as well as the explanatory Code of Market Conduct issued by the Financial Services Authority.

4- Shariah Principles for Securities Markets

4.1- Introduction

Shariah is set of ethical principles and prohibitions which are applied in the context of Islamic banking, securities markets, financial institutions and financial products.[1] As Shariah compliant securities market is evolving, different interpretations from various schools of thought have been a major stumbling block in the codification of law amongst the Middle-Eastern countries and standardisation of financial products. This has also been a hindrance in conceptualising a uniform market abuse legal framework across the Gulf region where Shariah is generally considered as binding force of law.[2] In this context, the establishment of international regulatory organisations has made some progress towards standardisation by setting out criteria for Shariah compliance of its products.[3]

This chapter analyses key ethical principles and prohibitions which formulate under-pinnings of Shariah to protect investors from market abuse without referring to legal

---

[1] Different Middle-Eastern countries follow different School of thought. There are namely Mailiki, Hanbalis, Shafi and Hanafi. They all interpret various hadiths, proscriptions and principles in their own way, some strictly and others leniently. Thesis takes in account the opinions of various schools of thought at different points instead of giving examples of particular countries. As mentioned above, the Middle-Eastern countries lack Shariah based market abuse framework and in consultation with my supervisor decided to refer to the original sources of Quran, Sunnah and various schools of thought in analysing their interpretation where ever possible. This is the first ever attempt to conceptualise Shariah's approach for investor protection.

[2] Shariah compliant securities market lack Shariah based legal and regulatory framework at the moment. However scholars are slowly moving towards that direction by way of Ijtihad. A classical way of Ijtihad, when faced with a novel situation or problem, is by resorting to Quran and Sunnah. However, two other methods by which to reach to an opinion are by way of *ikhtiar and Maslahah.* Ikhtiar is method of choice by which contemporary scholars align their views with the classical scholars of the past which provides assurance that nothing contravenes the basic principles of shariah. The second method is by ascertaining which view best serves the interest of the general public and commonly referred to as Maslahah.

[3] Islamic Financial Services Board, Accounting Auditing Organisation for Islamic Institutions, International Islamic Financial Market and Islamic International Rating Agency has facilitated the formulation of legal and regulatory standards. For further details, please see page 99-100.

framework of any particular country.[4] Based on this analysis, chapter six and seven conceptualise Shariah's theoretical approach to regulating market abuse.

4.2- The Origins of Islamic Finance

The modern Islamic Financial Services Industry originated from humble beginnings in Egypt, with the establishment of the Mit Ghamr[5] project followed by Nasser Social Bank[6] in 1971 and Tabung Haji in Malaysia.[7] Egypt and Malaysia were pioneers in introducing a parallel system.[8] The next landmark was the establishment of the Islamic Development Bank in 1973 in Saudi Arabia, Dubai Islamic Bank in 1975 and Kuwait Finance House in 1977, all of which gave immense support to the momentum to develop Islamic finance. A continued demand for Islamic banking in 1980s led to sustainable growth and by 1990s it had shown considerable growth attracting the attention of mainstream conventional banks.

Currently, there are 650 Islamic financial institutions across 95 countries around the globe. Islamic financial institutions continue to develop a solid track record with a current annual growth rate of 10-20 per cent, which is highest in the contemporary international markets.[9] In recent years, the sector has also been embraced by mainstream banks.[10] The total assets held by fully Shariah compliant institutions rose to

---

[4] There is no dispute as to these ethical principles and economic objectives among shariah scholars of various Schools of thought. Some interpret these hadiths and principles in a strict way and others take a more lenient approach. This chapter takes in account the views of different School of thoughts.

[5] Mit Ghamr was the first Islamic saving bank which operated on the basis of profit sharing basis.

[6] This was first recognised interest free commercial bank. It was established in Cairo.

[7] Tabung Haji was the Malaysian Pilgrim Fund Board. It facilitates savings to be invested in shariah compliant vehicle. Frank Vogel, Samuel Hayes, *Islamic law and Finance* (1998) Kluwer International at p 4-6.

[8] Zamir Iqbal, Emerging Islamic Capital Markets – A Quickening Pace and New Potential, *Islamic Finance* at p 1. Downloaded from http://www.iefpedia.com/english/wp-content/uploads/2009/09/Emerging-Islamic-Capital-Markets.pdf. Accessed on 24rth July 2011.

[9] Gulf One Investment Bank at Arthur Little, Islamic Finance: Opportunities and Challenges (December 2008) Volume 1, Research Bulletin No 12 at p 6.

[10] The commercial potential of this has not gone unnoticed and number of western financial have established Islamic practices to serve this growing market. This includes Citibank, Kleinwort Benon, Grindleys, Chase Manhattan bank and HSBC-Amanah etc.

£822 billion in 2008 with forecasts to hit $4 trillion in 2015.[11] The existence of a 1.2 billion Muslim population[12] has the potential to propel the industry at a faster pace. It is also beginning to appeal to non-Muslims due to its ethical approach, social responsibility, sustainability and link with the real economy.

Islamic finance is no longer specific to the Middle East now. Although it is largely concentrated in Gulf Council Co-operation (GCC) Countries, however, it has grown at a phenomenal rate in all 57 countries in OIC.[13] Outside GCC, US have 20 Islamic banks, which provide Shariah compliant products. Islamic banking is being offered through specialised Islamic banks and Islamic windows[14] of conventional banks in UK and US.

The first Islamic Bank of Britain was established in 2004 in the UK. Since then four more Islamic banks have been established including the European Islamic Investment Bank (EIIB) and the Bank of London and Middle East (BLME). There are also 24 conventional banks that provide Islamic financial services. The UK Government aims to establish *London as the hub of Islamic Finance*.[15] Accordingly, it has made a number of changes in its financial services and taxation laws to accommodate Shariah compliant products.

---

[11] The compound annual growth rate for 2006-2009 is 27.86 percent. Estimates of the future size of Shariah-compliant assets vary considerably. For instance, McKinsey and Co estimates that global Islamic finance assets could reach $1 trillion whilst Moody's predicts that it could reach $4trillion with in the next five years.

[12] Gallup Centre for Muslim Studies, March 2008.

[13] OIC stands for Organisation for Islamic Conference. It's a platform to unite Muslim countries in order to serve their political, economic, financial and social interests. Its membership consists of 57 countries and is representative of 1.5 billion Muslims.

[14] Islamic window is generally defined as part of conventional financial institutions that undertakes shariah compliant deposit taking, investment and or fund management activities.

[15] Lord Edward George (Governor of the Bank of England) in his speech in 1995 at Islamic Foundation Conference acknowledged the growing importance of Islamic banking. He recognised the need to put Islamic banking in the context of London's tradition of competitive innovation. These sentiments were translated into practice in 2001 when a High level working group chaired by Lord George with representatives from the city, government, Muslim community and FSA was established to examine the barrier to Islamic finance in the UK. One of the main barriers identified was that Islamic mortgages pay double stamp duty. This transformed into legislation in Finance Act 2003. Michael Ainley, Ali Mashyekhi, Robert Hicks, Arshdur Rehman, Islamic Finance in UK: Regulations and Challenges (2007) The Financial Services Authority. Downloaded from http://www.fsa.gov.uk/pubs/other/islamic_finance.pdf. Accessed on 18th March 2010.

4.3- Shariah Compliance of Modern Securities Markets

From ancient times, different members of tribes, societies and countries had access to varied level of economic resources. Their social and economic prosperity depended upon optimal allocation of these resources rather than their quantity and quality. The social organisation of allocation of these resources was key to achieving the sustainable and continuous development in the society.[16] The early Muslim communities pursued practices and techniques, similar to today's stock market, in mobilisation of resources from surplus units to deficit ones in order to propel international trade.[17] The rich Arabs picked entrepreneurial partners based on their honesty and knowledge of business[18] although the terms of the business were based on Musharakah and Mudarabah rather than today's debt based financing.[19]

The same principle is followed in today's stock exchanges although the direct contact is replaced by impersonal financial intermediation and money is raised by issuance of stocks and debt equities. It transfers wealth from surplus units to deficit ones who use these funds to invest which facilitate the creation of the wealth and prosperity of the society. The business is conducted by big corporations who employ highly talented entrepreneurs. Good conduct of these corporations is monitored in accordance with a legal and regulatory framework incorporating economic philosophy and principles of ethics.[20]

---

[16] The concept of financial intermediation to fund economic activities can be traced to ancient societies. Mohammed Ali El Gari, Stock Exchange Transactions: Shariah Viewpoints (1991) *Journal of Objectives Studies* at p 133. Mohammed Obaidullah, Islamic Risk Management: Towards Greater Ethics and Efficiency (2002) Volume 3, *International Journals of Islamic Financial Services* at p 1. Also see Mohammed Obaidullah, Ethics and Efficiency in Islamic Stock Market (2001) *International Journal of Islamic Financial Services* at p 1-10

[17] Societies are generally divided among individuals who have capital in excess of their needs and those who do not but have entrepreneurial skills. From antiquity men have attempted to find ways to transfer these resources to promote prosperity in the society.

[18] One of the examples is Prophet Mohammed (PBUH) who used to run business for Khadija, a rich Arab widow. Muhammad Anwar, An Islamic Perspective on Capital markets and Islamic Securities in Malaysia (1995) *The Pakistan Development Review* at p 867

[19] Mohammed Ali El Gari, Stock Exchange Transactions: Shariah Viewpoints (1991) *Journal of Objectives Studies* at p 133.

[20] Ibid at p 868

The conceptual role of the Stock Market is in alignment with Shariah[21] as long as the products and the legal and regulatory framework complies with Shariah principles. It is argued that the model of joint stock companies is parallel to the concept of Mudarabah.[22] The ownership of the company through equity shares can also be equated with the Islamic concept of Shirkah and partnership[23] which is a way of extending ownership based on partnership.[24] Similarly, Musharakah can also be equated with the private equity investment or venture capital.[25] There has also been willingness of scholars as to the acceptability of limited liability[26] in case of corporate insolvency. It has been based on the rationale of debtor's inability to pay due to circumstances not in his control.[27]

---

[21] The Islamic philosophers, scientist and engineers made phenomenal progress during the golden age of 750 to 1258 century. However, from the onset of 12th century Ijtihad was generally replaced by taqleed which resulted in slowing down of socio-economic development in Islamic economics. By the end of 17th century, the western economic philosophy was beginning to prevail. There were three major Muslim empires namely Moguls, Safavids and Ottoman Empires. Moguls were ruling in sub-continent India and united Hindu and Muslims, Safavids were ruling in Iran and Iraq and Azerbaijan. On the hand, Ottomans were ruling Turkey and one of the biggest empires of its time. The 18th century marked the beginning of demise of Muslim empires and onset of colonialism. The important characteristic of than emerging capitalistic philosophy was that it was divorced from religious morality and ethical values. It started in 1515 when Lantern Council of the church passed a motion that Franciscans lending money for a fee does not amount to sin. This made the interest widely available and opened the road for the modern banking industry. This also formed the foundation of current global financial system and underpinned the evolution of the current financial products and legal and regulatory framework in the western countries. Andrew McGosh, *Financial Ethics* (1999) Kluwer Academic Publishers at p 55.

[22] The joint stock companies have played a very important role in the investment of large magnitude for industrial revolution to take place. Mohammed Algari bin Eid, Stock Exchange: Shariah View point, (1991) *Journal of Objectives Studies* at p 82-83. Dr Noor Mohamed Osmani claims that the concept of Mudarabah is analogous to joint stock companies were actually devised after the advent of Islam. Noor Mohammed Osmani, Mohammed Farukh Abdullah, Towards an Islamic stock Exchange: A Review of Classical and Modern Literatures (2009) Volume 5, *International Review of Business Research Paper* at p 5. Seif-el-Din, Taj-el-Din, Towards an Islamic Model of Stock Market (2002) Volume 14, *Journal of King Abdul-Aziz University* at p 3-4.

[23] Rodney Wilson, Islam and Business, (2006) *Thunderbird International Business Review* at p 111. Mohammed Khan, Stock Market in Islamic Framework, (1999) *International Journal of Islamic Financial Services* at p 4.

[24] Ibid at p 83. For a detailed discussion see Seif-el-Din, Taj-el-Din, Towards an Islamic Model of Stock Market, (2002) Volume 14, *Journal of King Abdul-Aziz University* at p 4-7.

[25] Ibid at p 111

[26] It is argued that prohibition of joint stock companies in Muslim countries would place them at much disadvantage. Trevor Gambling & Rifaat Ahmed Abdel Karim, *Business and Accounting Ethics* (1991) at p 123-124. Also see Rodney Wilson, *Economics, Ethics and Religion* (1991) New York University Press at p 209.

[27] Ibid at p 112. Rodney argues that the concept of Limited liability has become acceptable in Islamic finance. As long the parties are aware of their liabilities and obligation from the outset. Quran also articulates that if the debtor is in difficulty, grant him time until it is easy for him to repay. But if you remit by way of charity that is best for you. Al-Quran: Al-Baqarah - 278 -290. Prophet also said that "May Allah's mercy be upon him who is lenient in buying and selling and demanding back his debt." Al-Bukhari – No 1934.

4.4- The Emergence and Development of Shariah Compliant Securities Markets

The emergence of Shariah compliant Securities Markets (SCSM) is a natural progression as the Islamic banking industry has become more sophisticated and assets transferred from the banking industry to securities markets.[28] This came about when in 1980s and 1990s, Islamic banks were successfully able to mobilise dormant savings into investments through their Shariah compliant financial instruments. The development of shariah compliant tradable securities formed the basis for the Securities markets.[29]

There are several reasons for the faster growth of the Shariah compliant securities markets. Islamic financial and insurance institutions had surplus funds after providing for statutory reserves and financing for clients. The unavailability of efficient Shariah compliant financial products on a liquid Islamic capital market was making Islamic financial and insurance institutions operations less efficient.

In addition to this, prohibition of interest based loans, absence of money market and greater emphasis on equity investment also meant that there had to be a greater reliance upon securities markets to mobilise funds. Moreover, the reliance of central banks for liquidity risk management upon short-term Shariah compliant financial instruments[30] also required a stable Shariah compliant securities markets. This made an efficient, transparent, sound and fair Shariah Compliant Securities Market indispensable for a stable Islamic finance.

The development of SCSM, Shariah compliant financial instruments and products is at various stages in different countries.[31] It provides three key vital functions, liquidity and risk management, pricing of assets and specialised services in resource mobiliza-

---

[28] International Organisation of Securities Commission (IOSCO), Islamic Capital Market Fact Finding Report: Report of the Islamic Capital Market Task Forces, (2004) at p 27.

[29] Ibid at p 15

[30] Islamic Financial Services Board, Role of Capital Markets in the Financial Services Industry, http://www.ifsb.org/ifsb/uploadfile/daowload.php?uf_id=754. Accessed on 1st Feb 2010.

[31] Malaysia and Bahrain are apt examples.

tion and allocation.[32] SCSM offers many different types of products, which include Shariah compliant stocks, Islamic bonds, Islamic funds, Islamic derivatives, structured products and Islamic risk management products.[33] Thus Shariah compliant products have increased the ownership base in the society and are regarded as a new asset class by the conventional investors. They have also grown to represent an alternative investment philosophy and are progressing parallel to the conventional ethical stocks and shares. They are open to non-Muslims investors who wish to invest in socially responsible investment (SRI).

There are also a number of indices that track the performances of Islamic finance markets such as Dow Jones Islamic Market Indices (DJIMI),[34] Standard and Poor's Shariah Compliant Indices,[35] Morgan Stanley Capital Index (MSCI), FTSE global Islamic Index Series[36] etc. Prominent rating agencies have also entered the markets creating their own rating methodologies for shariah compliant products. The DJIMI tracks performance for diverse regions such as Asia, BRIC,[37] GCC[38] and globally emerging markets. It also has an "index on Islamic Market sustainability."[39] This index outperformed the conventional market during 2007-2008 by a small margin. On

[32] Khalil Hanware, Global Platform Needed for Islamic Finance (27th July 2009) *Arab News*.

[33] Bahrain Financial exchange offers all these products.

[34] DJIMI was launched in 1999 in Bahrain. It was the first index created for investors seeking investments in compliance with Shariah law. Since the launch, the DJIMI family has expanded to provide a wide variety benchmarks tracking Shariah-compliant securities including indexes for specific countries, regions, industries and market capitalization ranges.

[35] Standard & Poor's introduced the S&P Shariah indices in 2006. S & P applied Shariah screening to three headline indices, the S&P 500, the S&P Europe 350 and the S&P Japan 500. The results are the S&P 500 Shariah, the S&P Europe 350 Shariah and the S&P Japan 500 Shariah indices. The indices measure three major markets of US, Europe and Japan by screening out stocks that are not Shariah compliant thus making it ideal investment vehicles for observant Muslims. In 2007, S & P launched the S&P GCC Shariah Indices and the S&P Pan Asia Shariah Index, to cater for the demands of Islamic investors in that region.

[36] The FTSE Global Islamic Index Series GIIS are equity bench mark indices introduced in 2006, designed to track the performance of leading publically traded companies whose activities are in compliance with the shariah Law.

[37] BRIC means Brazil, Russia, India and China.

[38] GCC means Gulf Council Corporation and includes six Middle Eastern countries. It includes Bahrain, Kuwait, Qatar, Saudi Arabia and UAE.

[39] Gulf One Investment Bank, Islamic Finance: Opportunities and Challenges, (December 2008) Volume 1, *Research Bulletin* at p 17-18

the other hand, indices such as MSCI have also shown clear superiority of the performance of Islamic funds during the above period.[40]

The Shariah compliant securities market is at an important juncture of becoming a vibrant market place after the last financial crisis. The growth indicates that capital seekers and providers are becoming increasingly comfortable with shariah compliant instruments for financing and investment tools. It also provides an excellent opportunity to tap into liquidity rich Islamic countries.[41] The amount of funds mobilised by the Shariah compliant instruments[42] and the current demand for the Shariah compliant financial products in Middle East, South East Asia, North Africa and Western world has reached a critical threshold to support a well-functioning capital market.[43] This is also evident from the estimates of total market capitalisation of Dow Jones Islamic Market World index which has reached to US$12.05 trillion.[44]

This has created competition among the regional and international financial centres such as Bahrain, Dubai, Kuala Lumpur, London and Singapore to position themselves as a gateway to Islamic finance.[45] Bahrain Financial Exchange (BFX) is first Multi-asset exchange in the Middle East. It will be internationally accessible and enable shariah compliant corporations to be listed. It will also facilitate raising finance, managing risk through Islamic derivatives and investments through Shariah compliant instruments. This will also help create a liquid secondary market.[46]

---

[40] Ibid 37.

[41] Malaysian Securities Exchange Commission's Annual Report 2004, Islamic Capital Market Review (2004) at p 1

[42] The growth rate is 15-20% for the last three years. See IOSCO "Analysis of the Application of IOSCO Objective and Principles of Securities Regulation for Islamic Securities Products" September 2008 at p 7. Also see Gulf One Investment Bank, Islamic Finance: Opportunities and Challenges, (December 2008) Volume 1, *Research Bulletin* at p 10-17.

[43] Brian Kettle, *Islamic Capital Market* (2009) Harcourt Litho Swansea at p 83.

[44] Press Release, Dow Jones Islamic Market Indexes Index Review Results for Q1 2010, http://www.muslims.net/news/newsfull.php?newid=343371 Accessed on 28th August 2010.

[45] Duncan McKenzie, Islamic Finance, http://www.exchange-handbook.co.uk/index.cfm?section=articles&action=detail&id=78445 Accessed on 28th August 2010.

[46] Bahrain Financial Exchange, The Exchange Business-An Insight, http://www.bfx.bh/downloads.html Accessed on 22nd August 2010.

The rise of Shariah compliant stock exchanges necessitates a supportive infrastructure for efficient operation. The establishment of key supervisory and self-regulatory organisations such as Islamic Financial Services Board,[47] Accounting Auditing Organisation for Islamic Institutions,[48] International Islamic Financial Market[49] and Islamic International Rating Agency[50] has facilitated the formulation of legal and regulatory standards. It has also galvanised the efforts to standardise the global Islamic finance market.[51]

The International Organisation of Securities Commissions (IOSCO) has also acknowledged the growing importance of Shariah compliant securities markets in the global financial market. IOSCO established an Islamic Capital Market task force to assess the extent of development and identify the gaps in the legal and regulatory framework. The report stated the importance of "timely formulation of standards, guidance or best practices"[52] in order to promote fair, efficient and transparent markets free of insider trading and manipulations.[53] It emphasized the need and presence

[47] Islamic Financial Services Board is an international body inaugurated in November 2002 and based in Malaysia. It is the result of co-operation between several Islamic central banks and monetary authorities of various countries together with the support of International Development bank, the International Monetary funds and Accounting Auditing Organisational Institutions for Islamic Institutions. The IFSB is essentially an international standard setting body of regulatory and supervisory agencies and its scope broadly includes banking, capital markets and insurance. During 2004 and 2005, the IFSB conducted four major surveys exercises in corporate governance, the supervisory review process, transparency and market discipline and shariah compliant banking statistics.

[48] The Accounting and Auditing Organisation from Islamic Financial Institutions was established in 1999 in Bahrain as an international autonomous non-profit making corporate body. Four major Islamic banking groups and IDB assisted with the setting up of AAOIFI. So far it has issues 24 financial accounting standards and statements, four governance standards, 21 Shariah standards and code of ethics for accountants and auditors of IFIs.

[49] International Islamic Financial Market is an international infrastructure, non-profit institution formed by the collective efforts of the central banks and money agencies of Bahrain, Brunei, Indonesia, Malaysia, Sudan, and IDB based in Saudi Arabia. It was one of the key organisations with the objective to establish, develop, promote and regulate and international market based on shariah rules and principles.

[50] Islamic International Rating Agency was established in 2002 and provides an independent assessment and opinion on the creditworthiness of the rated entity or financial instruments.

[51] Christos Alexakis, Alexandros Tsikouras, Islamic Finance: Regulatory Framework – Challenges Lying Ahead, (2009) Volume 2, *International Journal of Islamic and Middle Eastern Finance and Management* at p 90-95

[52] International Organisation of Securities Commission (IOSCO), Islamic Capital Market Fact Finding Report: Report of the Islamic Capital Market Task Forces (July 2004) at p 1.

[53] IOSCO, Analysis of the Application of IOSCO Objective and Principles of Securities Regulation for Islamic Securities Products, September 2008.
http://www.iosco.org/library/pubdocs/pdf/IOSCOPD154.pdf, Accessed on 20th March 2010.

of a “sound, regulatory and appropriate infrastructure” in order to foster the innovation and growth of Shariah-compliant products and services.[54] Similarly, international Islamic institutions such as the Islamic Research and Training Institution[55] have also undertaken significant research projects to track new developments and incorporate IOSCO standards in formulating policies.

4.5- Key Principles and Prohibitions in Securities Markets

One of the fundamental principles of Islamic finance is that the universe is created by one God[56] and alone He provides sustenance to everyone.[57] It is believed that human beings are the vicegerents of the one God, who is the creator of the universe and everything in it.[58] All available resources are held on trust from Him and should be used to promote brotherhood, socio-economic justice and equitable distribution of resources. Al-Quran says “And your actions should not be harmful to the society, as you will be held accountable on the day of judgement.”[59]

The aforementioned approach dictates the philosophical basis of regulation of the Islamic securities markets. In alignment wit this approach, the ethics and finance is utilised to promote the religious objectives of serving society, socio-economic justice and welfare[60] through the Shariah compliant securities market. It achieves these objectives

---

[54] IOSCO Islamic Capital Market Fact Finding Report at p 72.

[55] IRTI is part of Islamic Development Bank. Its objectives are to carry out research in economic, financial and banking activities in Muslim countries. It aims to develop Shariah compliant banking as well as train finance professionals.

[56] Taqi Usmani, *An Introduction to Islamic Finance* (2007) Maktaba Ma’Ariful Quran at p 1.

[57] Mohammed Sharif Chaudhary, *Fundamentals of Islamic Economic* (1999) Burhan Education and Welfare Trust at p 99.

[58] Al- Quran 31:20.

[59] Al-Quran 6:166. See also Umer Chapra, *Towards a Just Monetary System* (1985) The Islamic Foundation at p 215- 220. Ehsan Zarrokh, Iranian Islamic Banking (2010) Volume 29, European *Journal of Law and Economic* at p 178. See also Umer Chapra, *What is Islamic Economics* (1996) Islamic Research and Training Institute at p 22. Belief in the Day of Judgement is one of the fundamental pillars of Islam. It will come after the second appearance of the Jesus Christ. Every human being would have to be accountable for all their actions, deeds and words uttered. The sequence of events would unfold as annihilation of all creatures and resurrection of every one on this day.

[60] Pre-classical economist treated the economics and ethics as one. Adam Smith also classed himself as moral philosopher and Political economist and his major work was theory of Moral Sentiments. However, by the nineteenth century the finance was pretty much divorced from ethics. Moral judgements were regarded as scientifically unsound. Theories which could stand the test of empirical analysis were regarded sound and acceptable as opposed to theories which were morally well founded. See Rodney Wilson, *Economics, Ethics and Religion* (1997) New York University Press at p 3.

by mobilising funds in accordance with the principles of Shariah.[61] It attempts to strike a balance between the individual/corporate investor's freedom to maximise profit in pursuit of self-interest and collective social responsibility.[62] It endeavours to bring harmony between self-interests, individual preference and the interest of the whole society. This approach is evident from features of contractual structures such as risk sharing and welfare philosophy embedded in most Shariah compliant financial instruments.

Scholars argue that Maqasid al-Shariah (objectives of shariah) sets the overriding approach. It takes a holistic view of human existence and believes Islamic finance is a tool to promote it. It sets out the *primary objective* of safeguarding life, intellect, faith, wealth and lineage.[63] Impairment of any may result in chaos leading to the collapse of the normal operation of society.[64]

Since securities markets have the potential to facilitate equitable distribution of wealth in society and alleviate poverty, they can play an important role of achieving Shariah's objectives of promoting social prosperity. Social prosperity can only be achieved if all means of perpetrating abuse and exploitation are eliminated in the Shariah compliant securities markets. Shariah advisory boards achieve these objectives by integrating ethical principles and prohibitions in its products and incorporating them in the legal and regulatory framework of the securities market. The ethical principles and prohibition takes the role of overriding objectives. These are as follows:

1- Achievement of falah (prosperity)
2- Socio-economic justice
3- Fair and equitable distribution of wealth
4- Social solidarity and egalitarianism

---

[61] Umer Chapra, *What is Islamic Economics* (1996) Islamic Research and Training Institute at p 9.

[62] Mohammed Manan, Understanding Islamic Finance - A Study of Securities Market in an Islamic Framework (1993) Research Paper No 18, Islamic Research and Training Institute of Islamic development Bank at p 21- 22.

[63] Some scholars have added dignity or honour to this list. Eddy Yusof, Ezry Fahmy, Kashoogie, Jhordy and Anwar Kamal, Islamic Finance: Debt versus Equity Financing in the Light of Maqasid al-Shariah, http://mpra.ub.uni-muenchen.de/20722/ Accessed on 20th August 2010.

[64] Mohammed Hashim Kamali, *Shariah law: An Introduction* (2008) One World Oxford at p 33.

The sole purpose of the above ethical principles is the protection of consumers and investors from oppression, coercion, abuse, manipulation unfair transfer of wealth based on asymmetric information and ensuring that markets are transparent, efficient and fair.[65] Islamic rules of commerce (*Fiqh-al-Muamlat*) give precedence to ethics[66] as opposed to efficiency.[67] These ethical principles are of overriding importance in Islamic securities markets for investor protection.

Shariah also prohibits certain elements in the financial system and products. These elements negate its concept of fair transactions and lead to an imbalance in the negotiating powers of the parties in the markets.[68] The chapter sixth will illustrate their significance in the modern securities markets. The prohibitions are as follows:

1- Prohibition of Riba
2- Prohibition of Gharar

---

[65] International Organisation of securities Commissions, Islamic Capital market Fact Finding Report at p 2. Downloaded from http://www.iasplus.com/resource/ioscoislamiccapitalmarkets.pdf Accessed on 30th November 2011. Also see Rodney Wilson**,** Regulatory Challenges Posed by Islamic Capital Market Products and Services (2011) Centre for Middle Eastern and Islamic Studies, University of Durham, UK http://kantakji.com/fiqh/Files/Markets/y136.pdf.

[66] Shariah subscribes to a divine code of conduct. The ethical values are based on combined interest of individual and the society, honesty, clarity and fairness and purging of exploitative practices. Rodney Wilson, Islam and Business (2006) *Thunderbird International Business Review* at p 112. Also see Ahmad Abdel Fattah El-Askar, Towards an Islamic Stock Exchange in transitional Stage (1995) *Islamic Economic Studies* at p 81.

[67] Christine Walsh, Ethics: Inherent in Islamic Finance through Shariah Law; Resisted in American Business despite Sarbanes Oxley (2007) Volume XII, *Fordham Journal of Corporate and Financial Law* at 757. Islamic ethics may be defined as set of ethical or moral principle which distinguishes what is right from wrong. They are derived from Quran as Sunnah. Islamic Business ethics takes in account the social implication of conducting business transaction and its financial product are intertwined with ethical values. These ethical principles are applied to financial industry through Shariah law. It is different from secular ethical system which has been more transient in development of economic and financial system in the recent decades. Rafiq Issa Beekun, *Islamic Business Ethics* (1996) International Institute of Islamic Thought at p 8. Joan Robinson has also argued that there has to be essential pre-conditions for the economic system. They should be based on set of rules, ideology and conscience. He argued that human beings are ideology motivated. This appears to similar to Islamic ethics. Rodney Wilson, *Economics, Ethics and Religion* (1997) New York University Press at p 5. Also see Gillian Rice, Islamic Ethics and Implication for Business (1999) *Journal of Business Ethics* at p 345-358.

[68] International Organisation of Securities Commission (IOSCO), Report of the Islamic Capital Market Task Forces, July 2004 at p 5-9, Ali Adnan Ibrahim, The Rise of Customary Business in International Financial Market, An Introduction to Islamic Finance and Challenges of International Integration, http://works.bepress.com/ali_ibrahim/3 at p 17-20. Iqbal and Molyneux, *An introduction to Finance - Theory and Practice* (2007) John Wiley at p 77-87. Aaron Pitluck, Moral Behaviour in Stock Markets – Islamic Finance and Socially Responsible Investment (2008) at p 4. http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1156346 Accessed on 15th July 2010.

3- Prohibition of Maisir and
4- Prohibition against engaging in harmful activities.

Shariah scholars believe that the prohibition of these elements promotes impartial price bargaining by eliminating the possibility of exploitation through imbalanced contractual structures and ultimately promote fair price formation mechanism. The subsequent chapters will link the principles and prohibitions and their role in facilitating market abuse in the securities markets. These above principles and prohibitions are briefly analysed below.

4.5.1- Achievement of Falah

This is one of the key principles of Shariah. It is also referred to as Maslahah in Arabic or consideration of public interest and is often used to connote welfare, interest or benefit. It is a juristic device in Islamic legal theory which aims to promote *maximum public benefit, removal of hardship and prevention of harm* by proscribing destructive practices in the markets.[69] A similar concept is called *sad-al-dhari* which means "obstructing the means to something that may cause social harm, backwardness and degradation."[70]

One of the main purposes behind Shariah compliant instruments, products and practices is that they promote falah through the markets. The Shariah advisory department of financial institutions are set with this task of ensuring that they do not permit any such product to be launched in the markets which may cause harm or injury. Scholars have argued that the juristic method of public welfare must not breach the fundamental principles of shariah in anyway. A prominent scholar of Islamic jurisprudence, Imam Malik[71] regards this as a source of Shariah. Although there is a general consen-

[69] A classical way of Ijtihad, when faced with a novel situation or problem, is by resorting to Quran and Sunnah. However, two other methods by which to reach to an opinion are by way of *ikhtiar and Maslahah.* Ikhtiar is method of choice by which contemporary scholars align their views with the classical scholars of the past which provides assurance that nothing contravenes the basic principles of shariah. The second method is by ascertaining which view best serves the interest of the general public and commonly referred to as Maslahah. Frank Vogel, Samuel Hayes, *Islamic law and Finance,* (1998) Kluwer Law International at 36.

[70] Mohammed Hashim Kamali, Islamic Commercial Law: An Analysis of Futures (1996) *The American Journal of Social Sciences* at p 209.

[71] He was born in Medina in 711 and died in 795. He was scholarly giant in his own right. He was contemporary to many Tab'ins.

sus that all commandments of Shariah seek to secure general benefit for the public, other scholars have rejected Maslahah as a source of developing Islamic jurisprudence.

Al Ghazali[72] endorsed Imam Malik's opinion and defined Maslahah as follows:
"Maslahah is essentially an expression for the acquisition of benefit or the repulsion of injury or harm, but that is not what we mean by it, because acquisition of benefits and the repulsion of harm represent human goals, that is, the welfare of human through the attainment of these goals. What we mean by Maslahah, however, is the preservation of the Shariah's objectives."[73]

Al-Shatibi agrees with the above and regards Maslahah as an overriding principle which is broad enough to cover all principles of Shariah. He restricts the application to issues of immense or genuine public importance and categorised Maslahah into three sections namely Daruriyat, Hajiyat and Tahsinyat.[74] On the other hand, the critics have argued that by endorsing this as a juristic device, human beings has been given as open hand to depart from the basic principles of Shariah on the basis of its reasoning as to what is good and bad for the society. Vogel and Hayes have referred to this as a utilitarian choice. It is an ethical framework which expounds that moral worth of an action is assessed solely by its utility to the largest segment of the public.[75]

The concept of falah in the context of the Islamic capital market refers to the application of a set of values and ethics derived from Shariah, which does not change with the time and has to be adjusted to change.[76] It is applied to the Islamic Capital market

---

[72] Al-Ghazali was born in Persia on 1058 and died on 1111. He was theologian, jurists, and philosopher. He wrote the famous book of Incoherence of the Philosophers and the changed the course of early Islamic Philosophy.

[73] Primary objectives of shariah are life, intellect, faith, wealth and lineage.

[74] The Daruriyat is the most essential and indispensable which are related or connected with life, faith, intellect, property and lineage. Hajiyat are regarded as complementary and supplement to the essential interests but whose avoidance does not lead to total disruption of life. Tahsinyat refers to embellishment whose accomplishment may enhance and improve life.

[75] Frank Vogel, Samuel Hayes, *Islamic law and Finance* (1998) Kluwer Law International at p 37.

[76] Asyraf Wajdi Dusuki, Nurdianwati Irwani Abdullah, Maqasid al-Shariah, Maslahah, and Corporate Social Responsibility (2007) Volume 24, *The American Journal of Social Sciences* at p 30

in such a way that in the course of its development, its operation and various practices bring ease for investors and the society, removes hardship and prevents harm[77] which ultimately leads to improvement, economic stability and growth in this world. Thus falah is spread through the markets by prohibiting various forms of market abuse which disrupt the flow of benefit to the market participants and public and causes harm to the investors and the society as a whole.

4.5.2- Socio-Economic Justice

Islamic finance aims to promote socio-economic justice through the markets. It is further divided in two sub-groups: equitable and fair distribution of wealth in the society and elimination of economic exploitation of the weak by the strong.[78] Since being employed is the only way of earning a living for the majority of the people in any society, *sustainable economic growth* which leads to the creation of employment opportunities is a key element of maintaining social justice.[79] Moreover, it requires freedom from economic, political and financial misuse of powers. The Quran articulates:

"Be staunch in justice, even it be against you, your parents and kindred, whether a rich man or poor man, for God is nearer unto both."[80]

At another place;

"Give full measure and full weight in justice and wrong not people in respect of their goods."[81]

The Islamic principle of justice is the *most* important principle of Islamic finance which applies to all spheres of the economic system such as the production, distribu-

---

[77] Harm shall neither be inflicted nor reciprocated in Islam. Ibn Majah, Sunan Ibn Majah, 11, 784, Hadaith no 2340. The Hadiath has been adopted into a legal maxim that prevention of evil takes priority over the attraction of benefit. Also see Nicolas Foster, Islamic Perspectives on the Law of Business Organisation1: An Overview of the Classical Sharia and Brief Comparison of the Shariah Regimes with Western-Style Law (2010) *European Business Organisation Law Review* at p 9. Also See Mohammed Hashim Kamali, *Shariah law: An Introduction* (2008) One World Oxford at p 35.

[78] Justice is the one most repeated word in the Holy Quran. It has been repeated almost one thousand times. The other two words equally repeated are God and knowledge. Syed Nawab Haider Naqvi, *Ethics and Economics* (1981) The Islamic Foundation at p 86.

[79] Ibid at p 86, 91 and 94.

[80] Al-Quran 4:135

[81] Al-Quran 11:85.

tion, consumption and exchange. It prohibits unjust, unfair, immoral and fraudulent means of acquisition of wealth which may unfairly lead to accumulation in fewer hands. It is argued that this may lead to financially powerful lobby to take control at the expense of ordinary investors in the stock market. Thus Islamic finance aims to regulate the inequitable distribution of wealth and bridge the gap between the rich and the poor.

Islamic finance also promotes socio-economic justice through its products based on a profit and loss mode and risk share basis. Islamic products are based on the Musharakah and Mudarabah mode, which makes the credit equally accessible to the skilful but less well-off members of the community. Conversely, the conventional financial institutions do not take social responsibility and leave socio-economic justice in the invisible hands of the market. The Shariah compliant securities markets also aim to promote socio-economic justice through the aforementioned products and instruments and prohibit all practices which facilitate enrichment of some at the expense of the whole community.

4.5.3- Distribution of Wealth and Elimination of Exploitation

The conventional economic system subscribes to the view that there is scarcity of resources in the world and these scarce resources need to be efficiently utilised. It relies upon taxation and social security system in order to redistribute wealth.[82] On the other hand, the Islamic economic system is based on the belief that God has created abundant resources for all humans to meet their basic needs of food, clothing and shelter however it argues that the problem lies in equitable and fair distribution.[83]

---

[82] One of the examples is inheritance tax in Britain. In 20th century, the government decided that the hereditary landowner possess far too much wealth than ordinary people. They decided to impose the above tax to transfer the wealth over many decades through death duties.

[83] God says "He has placed therein firm hills rising above it and blessed it and measures therein its sustenance in four days, alike for all who ask." (Al-Quran 41:10) Kiran Afshan, Huma Naz, Islamic Economic System, Capitalism and Socialism, Un-published MBA Thesis submitted on 13th August 2009. http://www.scribd.com/doc/19653430/Islamic-Economic-System-Capitalism-and-Socialism. Accessed on 1st Sep 2010.

The Islamic economic system presents its own ideology in relation to the acquisition, ownership and distribution of wealth.[84] It promotes this through its social, economic, fiscal and monetary policies and banking system. Moreover, Islamic financial institutions operationalize their philosophy through the principles of partnership and risk sharing features in their financial products. These features attempt to provide equal opportunities to prosper to those who do not have access to equal credit in any economy. This, in turn, distributes wealth equitably. Its products also link the investment with the real economy thus ensuring prosperity through distribution of wealth in the society.

Shariah aims to ensure equitable distribution of wealth by maintaining a natural equilibrium in the markets.[85] The Islamic concept of equilibrium refers to a just balance of forces of consumption, supply, production, and demand. It aims to achieve the quality of equilibrium.[86] Moreover, the success and failure of any civilisation is measured in terms of its distance from this just equilibrium in the possession of wealth.[87] All products which put the parties in a better position than their contemporaries and facilitate transfer of wealth based on zero sum contractual structures are classed as gambling. Shariah prohibit all such products and practices in securities markets. Thus Shariah compliant securities markets can only ensure equitable distribution of wealth through establishing a natural equilibrium and the prohibition of abuse and harm.

In contrast to Shariah's robust measures to ensure equitable distribution of wealth, the market based economic system and freedom of financial engineering leaves the distribution of income to the invisible hands of the market. It has failed to provide equal access to capital and enterprise leading to monopolies and the accumulation of wealth

---

[84] Masud Alam Chaudhary, Dispensation of Wealth in Islam, www.nd.edu/.../Choudhury%20Wealth%20Creation%20in%20Islam.doc at p 1. Accessed on 1st Sep 2010.

[85] Mufti Mohammed Shafi, Translated by Mohammed Hassan Askari, Karrar Husain, *Distribution of Wealth in Islam*, Downloaded from http://ccm-inc.org/oldsite/iqra/articles/distrw/index.html at p 1. Accessed on 1st September 2010.

[86] Quran says "It is not for the sun to overtake the moon, nor doth the night outstrip the day. They float each other in an orbit" Al-Quran 36:39. [86] Naqvi argued that natural equilibrium ensures the just distribution of wealth. Moreover, the survival of any civilisation depends upon the quality of equilibrium. Thus Islam makes it mandatory to establish equilibrium but in fact promotes quality of equilibrium.

[87] Syed Nawab Haider Naqvi, *Ethics and Economics* (1981) The Islamic Foundation at p 51.

in fewer hands across the globe.[88] The protracted inequalities in access to credit due to an interest based banking system requiring collateral have widened the rich and poor gap in the western countries and across the globe which has led to absolute and chronic poverty.[89]

Any society tends to disorder and anarchy when it becomes too unequal in wealth. There are a number of rationales such as morality, fairness, economic efficiency, social stability as the basis for equitable distribution of resources.[90] The Prophet's overemphasis on just distribution led some of his companions to believe that Islam advocates absolute equality of wealth.[91] However, the reality is that Islam acknowledges the difference in income due to an individual's intelligence, intellect, physical power and endeavour and does not propagate absolute egalitarianism in wealth distribution.[92] Thus Islam introduced the concept of equitable distribution fourteen centuries ago and made it an integral part of its moral principles and financial system.

It is evident from the above that eqtuitable distribution of wealth is one of the cardinal rules of Islamic economic system. Any unfair, unjust and immoral means of acquiring wealth through practice such as insider trading, market manipulation and distortion will disrupt the flow of income to the poor and less informed members of the society. It will also lead to accumulation of wealth in fewer hands.

4.5.4- Social Solidarity and Egalitarianism

Shariah preaches social solidarity and cohesion. It does not prescribe that economic activity should take place in a cold impartiality, immoral detachment or social apathy.

---

88 Ahmad Bello Dogarawa, Achieving Equitable Distribution through the Institution of Zakah, (June 2010) Downloaded from SSRN http://ssrn.com/abstract=1625230) at p 3. Accessed on 20th Sep 2010.

89 Ibid at p 1

90 Ahmad Bello Dogarawa, Achieving Equitable Distribution through the Institution of Zakah (June 2010) at p 6. There are arguments against the fair distribution basis on the libertarians view that private property is sacred, wealthy people create growth opportunities for society and support the arts and poor people are generally lazy, however they have been successfully refuted by the proponents.

91 Umer Chapra, *The Islamic Welfare State and its Role in the Economy* (1979) The Islamic Foundation at p 19.

92 Islam does not promote or endorse a sense of entitlement and does not propose hat one should sit idle and wait for the sustenance to come to you. It inspire human to endeavour and not give up struggle. Quran suggests a system in which people are awarded by measure of his endeavours where no one has more than he strives for. Al-Quran 20:15, 6:165, 6:61 and 53:39.

It fosters and promotes feelings of fraternity and brotherhood in the society through its compulsory rituals such as namaaz, fasting and zakah. It effectively promotes equality between the ruler and the subject, the factory owner and the wage earner, the lord and the peasants, when they stand shoulder to shoulder in a mosque five times a day and bow together to one God. Similarly fasting rouses feelings of empathy and sympathy for starving and hungry. The concept of Zakah transforms these feelings into distributing a certain portion of wealth to the poor and needy to ensure a sustainable society.[93]

The general tenor of the aforementioned paragraph forms the foundation of Islamic markets. Financial engineering is strictly monitored by the Shariah Advisory Board in every financial institution. Products can only be innovated and launched in the markets as long as they do not harm the collective benefit of the society. In this context, the Islamic concept of socio-economic justice, as explored above, provides unwavering support for social solidarity and brotherhood. Chapra argues that equitable distribution of wealth and equality in Islamic finance is based on social solidarity and spiritual feelings of brotherhood which is fundamental aspects of faith in Islamic religion. These Islamic values are interwoven into the banking and securities market system, financial products, monetary, fiscal and economic policies. On the other hand, equality and equitable distribution is not a component of capitalist theory and is rather an outcome of group pressure in capitalist countries. This is obvious from the money and banking system which does not support the above goals and objectives of collective benefit and is also obvious pursuant to recent financial crisis.[94]

4.5.5- Prohibition of Interest

Historically, all major religions in the world namely Hinduism,[95] Buddhism,[96] Judaism,[97] Christianity,[98] and Islam[99] have restricted and condemned this practice of lend-

[93] Mohammed Sharif Chaudhary, *Fundamentals of Islamic Economic System* (1999) Burhan Education and Welfare Trust at p 22.

[94] Mohammed Umer Chapra, *Towards a Just Monetary System*, (1985) The Islamic Foundation at p 36.

[95] In Hinduism, the Vedic texts of Ancient India (2000-1400BC), the prohibition of usury is mentioned several times. Furthermore, similar prohibition is also mentioned in Sutra texts (700-100BC). It is also mentioned in Jain (1929) a special law was devised to prohibit the higher caste of Brahmans (Hindu Priests) and Kashtriyas (Warriors) from charging interest.

ing money on interest. The rationales of prohibition have been based on ethical, religious, socio-economic equality, distributive justice, and inter-generational equity.[100] Over a period of history, most religions, except Islam, have yielded to capitalistic and secular forces in favour of levying interest.

The rationale for prohibition in Shariah is based on the fact that wealth is held on trust from God and therefore must not be used to exploit the weaker or the poorer in society.[101] The prohibition is intended to prevent the accumulation of wealth in fewer hands which is also regarded *as exploitation and injustice and inconsistent with the Islamic notions of fairness and property rights*. Charging interest on lending for consumption is regarded as even more onerous, a form of unjust enrichment with out giving a counter value.

There have been many controversies over the meaning of usury over the course of history. There has been a difference of opinion between a reasonable rate of interest which was regarded as acceptable and an extortionate rate of interest which was prohibited. However the majority of Muslim scholars have upheld the view that interest is an offence against public morality.[102]

---

[96] The reference to the prohibition of interest is also found in the religious book of Buddhism called Jatakas (600-400BC).

[97] In Judaism, the Old Testament clearly prohibits the charging of interest. The Hebrew word for "Neshekh" is used to refer to interest. In exodus and Leviticus texts, it reads "If thou lend money to any of my people that is poor thee, thou shall not be to him as usurer, neither shalt thou lay upon him usury (interest). Exodus 22:25.

[98] From the second century to the thirteenth century Pope, Councils and the Church condemned usury. In 1311, Pope Clement V made the ban on usury absolute regardless of the anti-usury movements. He declared all the secular legislation favouring charging of interest null and void. The decline of influence of orthodox church, the rise of Mercantile era (1500-1700AD) and capitalism made usury as a matter of private conscience rather than an offence against public morality.

[99] Several verses of Quran prohibit usury. "Those who charge usury (interest) are in the same position as those controlled by the devil's influence. This is because they claim that usury is the same as commerce. However God has permitted trade and prohibited usury." Al-Baraqah 2:275

[100] Iqbal and Mirakhor, *An Introduction to Islamic Finance: Theory and Practice* (2007) John Wiley at p 69.

[101] Al-Quran 6:166.

[102] Umer Chapra, The Nature of Riba in Islam, (2006) Volume 2, *The Journal of Islamic Economic and Finance* at p 7-25.

Riba is regarded as an increase which has no parallel asset created in the society.[103] It means the charging of interest or premium in excess of amount of the loan. Under principles of shariah, money has no inherent value and can only be used to measure the value of assets. It has categorised Riba in two forms: *Riba al Nasiah and Riba a-fadl.* Riba al-Nasiah is an increment or additional charge demanded when the return of the money is delayed.[104] On the other hand, Riba al-fadl deals with the barter or exchange of the commodities.[105] Shariah also does not allow sale of debt except at the face value. Thomas Von Aquinas, Plato and Aristotle[106] with many other eminent jurists and scholars, in the history advocated similar views against usury. Plato contended that since money is sterile, "it cannot beget more money the way cows begets more cows."[107] To make money from money was regarded as sinful for centuries. Usury, in this context was deemed to be an unfair advantage because it was an anti-social misuse of money.

Interest has four characteristics: (a) it is pre-determined (b) its payment is guaranteed irrespective of the outcome of business enterprise ventured (c) it normally depends on the amount of money advanced and the time period of borrowing and (d) the government's legal and regulatory infrastructure enforces the transaction.[108] The profit of conventional financial institutions, in the form of interest is ex-ante and charged irrespective of performance of investment, which may turn out to be unsuccessful. Thus banks are not prepared to assume any risk of loss, leaving the borrower at the mercy

[103] According to Lane, the term Riba meant "to increase, to augment, swelling, forbidden addition, to make more than what is given, the practicing or taking of usury or the like, an excess or an addition, or an addition over and the above the principle sum that is lent or expended."

[104] Abu Umar Farooq, Kabir Hassan, Riba and Islamic Banking (June 2007) Volume 3, *Journal of Islamic Economics, Banking and Finance* at p2-5

[105] The authority for the prohibition of Riba al-Fadl lies in what prophet said on numerous occasions, "Gold for gold, silver for silver, wheat for wheat, barley for barley, dates for dates and salt for salt – like for like, equal for equal, and hand to hand.; if the commodities differ, then you may sell as you wish, provided that the exchange is hand to hand.

[106] In ancient Greece, Aristotle developed the notion of fair price for any thing that could be bought or sold. He argued the money was sterile and thus to make money from money was regarded as sin. Mark Smith, *A History of Global Stock Market: From Ancient Rome to Silicone Valley* (2003) The University of Chicago Press at p 9. See also Iqbal and Mirakhor, *An Introduction to Islamic Finance: Theory and Practice* (2007) John Wiley at p 69.

[107] Mark Smith, *A History of Global Stock Market: From and Ancient Rome to Silicon Valley*, Ibid at p1.

[108] Iqbal and Mirakhor, *Introduction to Islamic Finance - Theory and Practice* (2007) John Wiley at p 56. Clifford Chance, Limiting the Regulation of Islamic Finance: Lessons from Dubai, htt: //www.cliffordchance.com Accessed on 1st April of 2010.

of the actual outcome of the business venture. Islamic finance regards this practice to be glaringly unjust.

In contrast to this, Islamic philosophy prohibits Islamic financial institutions from levying interest and encourages *trade* by sharing the risk in commercial activity undertaken or profit sharing. This promotes *justice* between the entrepreneur and financier. Profit sharing earned ex-post signifies successful entrepreneurship and creation of additional wealth. Thus Shariah promote *trade in socially beneficial commercial activities* by risk sharing or profit sharing rather than lending on interest.

Based on the above analysis, ICM can only promote products which are profit and loss sharing instruments such as equity based (Mudarabah) or Joint venture (Musharakah). Pursuant to this, an Islamic bank or fund cannot offer a guaranteed and positive rate of return which would be analogous to interest. It must link the return to the profit generated by the actual underlying assets or economic activity. It is also argued that the profit and loss sharing (PLS) paradigm integrates the assets and liabilities of Islamic financial institutions. It ensures that borrowers share the profit and losses with the bank which in turn shares it with the depositors.[109] Because the bank's return on capital is directly related to how effectively and efficient resources have been allocated and the viability of the project, it leads to a more efficient secondary market and greater market discipline in the banking industry.[110] The chapter six will illustrate how equity investment in comparison with debt based investment leads to a lower possibility of market abuse.

The emphasis of equity based instruments has been of immense importance for the development of the Islamic securities market. In this context, a common stock is permissible in Shariah as it represents a share in the company and thus the stock holder has an ownership claim in the business similar to Shariah.[111] Elimination of interest and the prevalence of equity based instruments also have positive effect on the finan-

---

[109] Beng Soon Chong, Ming-Hang Liu, Islamic Banking: Interest Free or Interest Based (2009) Volume 17, *Pacific-Basin Finance Journal* at p126.

[110] Ibid at p 127

[111] Nangi Sardehi, *Islamic Capital Markets* (2008) VDM Verlag Dr. Muller Aktiengesellschaft & Co. KG at p 11-21.

cier and entrepreneur. It makes the capital less burdensome because dividends can be easily varied in accordance with the level of profit earned in any particular year. In contrast, the interest has to be paid regardless of good or bad economic situations. It reduces the riskiness of the entrepreneur's position.[112]

Shariah also disapproves of debt as much as the payment or receipt of interest. It deems the companies which are highly leveraged as not Shariah compliant. Although the general perception has been that companies operating without debt financing have been the only way of complying with Shariah, however, this would have drastically limited the Shariah complaint companies and shrunk the pool of investment. Bearing the economic realities in mind, Shariah advisory Board has taken a flexible approach of a debt to equity ratio of 1:3. This is generally regarded as safe.[113] Such an equity based system has demonstrated stability and resilience to shocks and also asserts ethical superiority. In contrast to this, the debt based market economy is inherently unstable and fragile. It is evident from history that without asset based banking, conventional banking has had the tendency to create an incentive for massive expansion in credit and debt, through leveraging, leading to asset bubbles and subsequent crises.[114] The link is further analysed and elaborated in seventh chapter.

4.5.6 - Prohibition of Gharar

Shariah also prohibits gharar which literally means excessive hazard, chance, stake or risk. It is related to excessive uncertainty, ambiguity or hazard caused due to lack of clarity in relation to the core element of contract or sales transactions such as *subject matter, price, completion or delivery date.* It can also arise as a result of lack of sufficient information or inability of the parties to be able to perform or complete their obligation by a set future date. Lack of certainty can make the contracts null and void,[115]

---

[112] Ibid at p 13.

[113] Source: The Financial Times, 4rth August 2004.

[114] Abbas Mirakhor, The Islamic Financial System and Lessons from the Recent Crisis, Dowwnloded from http://www.islamonline.net/English/index.shtml Accessed on 4rth April 2010.

[115] Zamir Iqbal and Abbas Mirakhor, *An Introduction to Finance - Theory and Practice* (2007) John Wiley at p 67

however this can be set aside if gharar is small, common and bearable and there are clear economic benefits from the contract.[116]

The rationale behind prohibition is that transaction or sale may lead to future dispute and conflict between the parties involved. Another popular view is that prohibition of gharar lies in the fear of uncertainty, fear of unknown and excessive and abusive speculation. All four major schools of thoughts in Islam have consensus that gharar is forbidden, however there is no consensus on the definition of gharar. The interpretation or definition as articulated by the different school of thoughts is as follows:

1- Hanafi School defines gharar as transactions or contracts "whose consequences are hidden."
2- Hanbali School has a somewhat similar definition which states "gharar is that whose consequences are unknown" or something which is undeliverable whether it exist or not.
3- Shafi School has defined gharar as "transactions or contracts which admit two possibilities with the less desirable one being more likely.
4- Maliki School interprets gharar to mean "gambling and degree of risk".
5- Al-Zarqa has defined gharar as the "sale of probable items whose existence or characteristics are uncertain which make the entire transactions similar to gambling.[117]
6- Ibn Taymiyya has interpreted gharar to mean something that demarcates "soundness from destruction" in transactions and contracts.

Since gharar has been defined as uncertainty, it is often equated with excessive risk taking. Some Shariah scholars have argued that it is a way of managing excessive risk. The Islamic principle aims to ensure that parties should thoroughly assess the risk of transactions on the stock market and also check the available information affecting its value before assuming binding obligations. By prohibiting excessive risk taking, Shariah attempts *to integrate notions of fairness and balance of negotiation power for the benefit of weaker parties*. There are three important conditions before a

[116] Mahmoud Al-Ghamal, *Islamic Finance: Law, Economics and Practice* (2006) Cambridge University Press at p 59

[117] Ibid at p 63.

financial contract could be invalidated; first gharar must be substantial or entail excessive un-certainty, secondly, it must affect the component of the contract such as price, object of sale, terms and conditions, thirdly, the real purpose behind the contract (entailing gharar) can be achieved by employing other means.

A general criticisim is that risk leading to uncertainty is regarded as part and parcel of business ventures in Islamic finance and cannot be completely eliminated. Shariah has also stipulated risk share as one of the pre-conditions for the profit entitlement in any business venture. In this context, the extent of risk amounting to uncertainty in stock sales and commercial transaction, financial instruments and products has not been clearly differentiated and forms a grey area in the Islamic capital market. In this context, Al-Zaraqa characterized excessive risk and excessive uncertainty analogous to gambling that makes the contract invalidated. This has encouraged other Shariah scholars to define the extent of uncertainty permissible and has lead to categorising gharar into two groups of too much and nominal uncertainty (In Arabic Gharar Kathir and Gharar Qalil). Nominal amount of uncertainty in the business structure and finance is regarded as acceptable in contrast to the Riba, the slightest involvement of which makes the transaction non-Shariah compliant.[118]

In contrast to the Islamic perspective, Klein has articulated the western perspective. He argued that risk and uncertainty is used interchangeably, although technically their meaning differs. Both concepts are also mixed up with probabilities, confidence, ambiguity, inconsistency, confusion and complexity as well. On the other hand, Vaughan argued that uncertainty is characterised by doubt, lack of knowledge as to what may or may not happen in the future.[119] However, risk may not be the same as uncertainty because there may not be any loss involved therefore uncertainty is not risk in the probability context. It is therefore observed from the diverse literature that there is no unified definition of uncertainty and it is commonly correlated with or measured in risk. This may be compared with lack of precise definition of gharar which is quite broad from according to different Shariah schools of thought.

---

[118] Scholar argued that it is because none of the Quranic verses refer to the phrase Gharar. Some quote this a reason that Gharar is less significant than Riba as it has not been mentioned in the Quran. Muhammad Ayub, *Understanding Islamic Finance* (2007) John Wiley at p 59-61.

[119] Emmett Vaughan, *Fundamentals of Risk and Insurance* (1999) John Wiley at p 3.

The principle of gharar has a number of implications for products, contractual structures and financial transactions involving excessive risk in the Shariah compliant securities market. The nature of these investments was not contemplated at the time of the Prophet and therefore has to be resolved by way of juristic consensus based on the basic principles and objectives of Shariah (Maqasid-al-shariah). Shariah defines gharar as an avoidable risk originating from transactions with significant and unnecessary outcomes on the economy and contemporary investors. The problem lies in calculating the extent of gharar. The solution lies in devising a clear methodology or formula to ensure clarity for the common investor in day to day financial transactions.

Derivative products present an ideal example of gharar in financial transactions. These products are used to trade or transfer risk and therefore present a high level of gharar. Shariah disallows such transactions of risk with no asset base. Ninety percent of the contracts in derivative markets are settled without delivery of the real instruments or commodities underlying the contract. Since derivative transaction is a zero sum game, it creates an intolerable level of systemic risk and creates excessive uncertainty. Shariah prohibits such excessive gharar in the contractual structures of the financial transactions.

In addition to the above, the operation of the market takes place without any centralised clearing mechanism, lack of intermediaries and total lack of transparency of the transactions. The total worth of the conventional derivative market has increased to $480 trillion, almost 30 times of the size of US economy and 12 times the size of the entire world economy.[120] The sheer size of this market carries great significance for the systemic stability of global financial system, as they are very much interdependent. This creates excessive gharar in the global financial system. The implication of the concept of gharar for reducing the occurrences of market abuse is illustrated in the subsequent chapter.

4.5.7- Prohibition of Al - Maisir

---

[120] Abul Hassan, The Global Financial Crisis and Islamic Banking, http://www.islamic-foundation.org.uk/IslamicEconomicsPDF/Hassan-financialcrisis-if.pdf Accessed on 22nd April 2010.

Maisir and Qimar have been used interchangeably in Arabic literature for excessive and abusive speculation, although the latter is an important kind of the former. It collectively refers to obtaining money without making any efforts or due diligence towards it. Maisir originates from the word *Yusr*, which means desire to attain something precious, expensive or valuable without undertaking any liability or paying equal consideration in any shape or form.

Qimar also means earning money by taking excessive chances as opposed to by endeavour.[121] It effectively points towards gambling and games of chance. It refers to any decision, whereby an individual or institution stakes money in the hope of making a large return and at the same time, taking an excessive risk of loosing the entire sum. The advantage in a risky venture is interlocked with excessive risk, uncertainty, hope of gain based on luck and chance. It's a generally zero sum game: one's gain at the expense of others without any positive contribution to the economy.[122] Thus it may be inferred that Shariah draws a delicate line between excessive and abusive speculation and gambling.

There are many references to the prohibition of wagering and gambling in the Quran.[123] It articulates that "the devil intends to excite enmity and hatred among you with intoxicants and gambling, and hinder from the remembrance of God, and from prayers; will ye not abstain?" [124]

It is argued that excessive risk taking is the essence of excessive and abusive speculation and is therefore regarded as a form of gharar. The rationales described to proscribe excessive and abusive speculation and gambling in the above verses of Quran are enmity and distraction from religion. These reasons are also common to other religions and leads to immorality, depravity and social harm.[125] It is argued that com-

[121] Mohammad Ayub, *Understanding Islamic Finance* (2007) John Wiley at p 62.

[122] Ibid at 62-63.

[123] O you who believe! Intoxicants and gambling, sacrificing to stones and divinations by arrows, are abominable action of Satans; so abstain from them, that you may prosper." Al-Quran: 5:90

[124] Al-Quran: 5:91

[125] As mentioned by Chen and Hansel in their writing, they stacked not only their teeth, eyebrows, their wives, their families and their freedom, but also risked their lives on a single throw of the dice. John

mercial gain through acceptance of risk and uncertainty is acceptable in Shariah however expectation of unearned profit without working for it makes the enterprise or venture void and forbidden in Islam.

Bernstein argued that games of chance must be separated from the games in which skills make a difference. In this context, gambling and speculation has been a game of chance. Its techniques and methods have seen innovations with the development in technology but the odds or probability of winning or losing is still dependent on chance. Similarly, speculation exhibits itself in various practices and financial instruments such as futures, options, trading on margin, short selling and naked short selling. The outcome is also dependent on luck, chance and law of average and is evident with in a short period of time.[126]

It is argued that participants in stock trading can also act like gamblers in a casino. In a conventional stock market, the capital suppliers can be largely classified into two segments; rational investors and irrational investors or more correctly speculators. Investors are those who invest their money with the intention of gaining a long-term profit and their choice of company is based on fundamental factors such performance of the company. The profit is reaped in the form of dividends and capital profit which indicates business profit as well as an increase in share values. In contrast to this, speculators buy, sell and hold shares for a short period and rely upon the technical analysis of past price movement. They merely use the commodities and shares as a store of wealth which will increase in value in the near future.[127]

In some economic literature, the rational speculator is distinguished from blind speculators and categorised in the same group as of rational or prudent investors. Blind speculators want to make money without making any real physical or intellectual effort or contribution in the economy. Samuelson regards them as "hour to hour, day to

---

Hansel, Mark Cohen, *Risk and gambling: The study of subjective probability* (1956) Longmans at p 136.

[126] Peter Bernstein, *Against the Gods: The Remarkable Story of Risks* (1998) John Wiley at p 14.

[127] Paul Davidson, *Money and Real World* (1978) Palgrave Macmillan Press at p 106-107

day ticket watchers”[128] Adam Smith described speculators by their readiness to pursue short term profits and their tendency to make fluid investments as opposed to fixed conventional businesses whose investments are fixed. John Maynard Keynes endorsed the above definition and described speculation which he referred to as “the activity of forecasting the psychology of the market”[129] Thus speculators trade based on the trend of price movement and sometimes rumours whispered in the market. Speculators have assumed an important role in the continuous operation of the markets and seem to be the dominant group in today’s stock market.[130]

Speculators largely buy and sell based on the sentiments of the participants in relation to the price movement in the market which has no solid foundation and standard of measure. In doing so, they are completely detached from the economic reality. They tend to profit from other people’s stupidity. It is argued that speculators buy stock and investors buy in companies. Excessive speculation can cause volatile price movement resulting in inefficient markets and has a negative influence on economic stability.[131] This in turn, has a destabilising effect for value investors and amounts to inequitable wealth distribution based on the ability to take excessive risk in the market.

Speculators tend to invest their money based on imaginative and unrealistic forecasts. When big speculators make the price move upwards in a limited and controllable environment, irrationality sometime overcomes rationality and generally decent investors also turn into part time speculators. This has the potential to turn into a speculative euphoria and stocks do not really reflect the true economic strength of the economy. Continued frenzied speculation can turn the assets prices into a bubble and leads them to crash. Historically, speculative euphoria turned into mass hysteria to get rich quick has preceded the financial crises. In this context, frenzied speculation, eagerness to win big has been described as a notorious form of gambling. The speculation and

[128] The most common characteristic between the rational speculator and the blind speculator is that both draw their profits from price fluctuations. Paul Samuelson, *Economics: An Introductory Analysis*, (1967) McGraw Hill at p 428-429.

[129] Edward Chancellor, *Devil Takes the Hindmost* (2000) Plume Books at p ix.

[130] Mohammed Akram Khan, *Issues in Islamic Economic* (1983) Islamic Publications at p 87-88.

[131] See Charles Kindleberger, *Manias, Panics and Crashes* (2005) John Wiley at p 41-50. Samual Armstrong Nelson, *The ABC Stock Speculation* (2007) Market Place Books at 7-12 and 16-20. Also see Edward Chancellor, *Devil Takes the Hindmost* (2000) Plume books at p 3-10. John Kenneth Galbraith, A Short History of Financial Euphoria (1993) Penguin Books at p 1-5.

irrational exuberance facilitate in creating circumstances, which allow the unscrupulous to perpetrate market abuse leading to panics, crashes and crises.[132]

It is also observed that speculation is not based on any rational investment decision and is a form of gambling.[133] It does not represent optimal efficiency and makes the markets more volatile and leads to irrational exuberance. The irrationality has been further amplified by the proliferation of derivative and futures contracts.[134] Hazen argued that gambling or speculative activities are rife because they seem to offer the working class and poor the opportunity to get rich quick. This is mainly due to the inadequacies of the capitalistic system which gives a perception of equal opportunities but in fact inherently promotes inequality in society through capitalist institutions.[135] Thus the psychology of speculator and gambler is motivated by greed and the temptation to make quick profit. Both are dangerously addictive.[136]

Borna and Lowry also categorised the speculative business practices as a form of public gambling and argued that as a matter of social justice it should be either legalised or completely abolished.[137] They classified the risk into two groups. The first one is regarded as 'artificial risk', which is the essence of gambling, and the second type is 'legitimate business risk' which is inherent in the industry; for example a farmer hedging the risk to the crops from the weather. Contrast this to the risk taken by

---

[132] Thomas Lee Hazen, Rational Investment, Speculation, Or Gambling – Derivative Securities and Financial Futures and Their Effect on the Capital Markets, *North-Western University Law Review* (1991-92) at p 1002.

[133] In the letter to President Washington, Thomas Jefferson wrote: the wealth acquired by speculation and plunder is fugacious in its nature and fills the society with the spirit of gambling. More than a century later, Theodore Roosevelt commented that: "there is no moral difference between gambling at cards or in lotteries or on the race track and gambling in the stock market. One method is as pernicious to the body politic as the other kind and in degree the evil worked is far greater. See Thomas Lee Hazen, Rational investment, Speculation, Or Gambling – Derivative Securities and Financial Futures and their Effect on the Capital Markets, *North-Western University Law Review* (1991-92) at p 987. Also See Robert Junior Shiller, Financial Speculation: Economic Efficiency and Public policy (Background paper prepared for the 20th Century Fund 15 Jan 1991.) Also See Ann Fabians, Card Sharps, Dream Books & Bucket shops: gambling in the 19th century America (1990). Also See Edward Chancellor, Edward Chancellor, *Devil Takes the Hindmost* (2000) Plume books at p xi.

[134] Robert Steiner, Heard on the Street (May 1991) *Wall Street Journal,* at p C1, C2.

[135] Most surveys indicate that poor people spent a greater proportion of their wealth on lotteries. Gabriel A Brenner, *Gambling and Speculation* (1990) Cambridge University Press at p 19 and 27

[136] Edward Chancellor, *Devil Takes the Hindmost* (2000) Plume books at p xii

[137] Shaheena Borna, James Lowry, Gambling and Speculation (1987) *Journal of Business Ethics* at p 222.

speculators, who does not consume the products but by simply selling it short creates the an artificial risk. Gambling is a zero sum game and does not change the cumulative wealth of the parties involved in speculative activities. It simply transfers the wealth from one to another without contributing anything useful to the economy. In fact the time and resources consumed in the entire process is an inefficient and uneconomical exercise.[138] According to Keynes, "when the capital development of a country becomes a by product of the operations of a casino, the job is likely to be ill done."

At the opposite end of spectrum, Nelson argued that although speculation and gambling are substantially interchangeable there is a marked distinction between them. He argued that speculators are not gamblers but all gamblers are speculators.[139] The difference is that speculation requires intellectual effort whereas gambling is taking a blind chance. Because speculation takes place in investments in businesses of exceptional uncertainty, therefore it gives an illusion as if chance is the only or major part of the undertaking but it's actually an enterprise based upon computation in contrast to gambling which is an enterprise without calculation. He argued that speculators stabilise the prices and trigger the market in case of thin trading.

Chapra challenged the above claim that speculators stabilises the prices of stocks. Although the claim holds its validity in a commodity market with respect to demand on consumable goods it is flawed in sale or purchase in the securities market. He argued that speculators could only stabilise the markets if their buying and selling took place in an opposite direction to each other and these actions were mutually remedial or counteractive. In reality all speculators move in the same direction at any particular time. They either hype the prices upward by trading in the same direction or cause it to fall downward by short selling and therefore the above claim is incorrect.[140]

It is argued that most of the speculative transactions show elements of gharar (excessive uncertainty), chance, unethical activities and malpractices. They are so entangled that it is difficult to separate the transactions involving gharar from gambling. There

[138] Ibid at p 220.

[139] Samuel Armstrong Nelson, *The ABC Stock Speculation* (2007) Market Place Books at p 11.

[140] Mohammed Umer Chapra, *Towards Just Monetary System* (1985) The Islamic Foundation at p 97-99

are two aspects to Islamic prohibition of speculative transactions; the first one is the unethical aspect of the transaction and the second is the unearned income aspects of transaction. The transactions are regarded as unethical because the profit is earned at the expense of investors, small unprofessional speculators and the market.[141] This is regarded as oppressive and unfair in Islam.

Excessive speculation can turn the stability of the economy into chaotic situation, which may potentially harm the general public. Moreover, practices such as short selling, trading on margin and derivative instruments also tend to magnify price swings and distract from the quality of natural equilibrium.[142] Since speculative activities bring more harm than good to the individual economy therefore these activities are regarded as unethical and income generated is prohibited. Therefore for a predominantly equity based Islamic capital market, prohibition of speculation by discouraging the practices that causes rapid fluctuations is the only way to ensure stability in the markets.

4.5.8- Prohibition of Haram Activities

Shariah makes a clear distinction between permissible (Halal) and forbidden (Haram) business activities. The distinction is made on the basis of a strict ethical code, which dictates that Islamic banks, Muslim investors and Shariah compliant funds are not allowed to invest or finance activities, which are morally or socially detrimental. This may include production, distribution and consumption projects involving businesses, which are involved in the following core activities.

- Financial services based on riba (interest)
- Gambling
- Pornography
- Entertainment activities not permissible in shariah such as prostitution and alcohol
- Manufacturing and sale of tobacco
- Armament and weapons
- Illegal drugs

[141] As Quran clearly denounced taking advantage of others; "O you who believe, eat not up your property among yourselves in vanities but let there be among traffic and trade with mutual consent." Al- Quran, 4:29.

[142] Consult chapter sixth for a detailed discussion.

- Environmentally harmful products and activities[143]

The rationale lies in the fact that some activities infringe the general moral, ethics and decency of members of the society and are generally regarded as harmful regardless of the profitability. The legal system enacts legislation to transform these ethical principles and social norms into the legal and regulatory framework.[144]

Conventional investors generally based their decision on risk and return. However quite recently, a large segment of investors in the UK and US, are becoming increasingly conscious of the moral and ethical values of the companies they invest. They are not comfortable investing in companies using sweatshop labours, those who pay excessive remuneration to executives and produce products harmful to the consumer or who have made profit by violating environmental regulations. It is observed that Socially Responsible Investments (SRI) exercise similar prohibitions such as on tobacco, alcohol, gambling and weapons and refers to them as sin stocks. The study carried out in the United States indicates that $7 out of $ 100 is invested in the SRI in contrast to Malaysia where $15 out of every $100 is invested in SRI or Shariah compliant investments.[145] SRI and ethical investment and shariah compliant investment is a largely growing phenomenon now as opposed to during the last decades when it was squeezed out of conventional finance by making it difficult for their purpose to be achieved.[146]

Conclusion

This chapter analysed the cardinal principles of Shariah in the fight against exploitation, abuse, harm and unfair transfer of wealth. These principles provide for constant ethical criteria for future development of Shariah compliant securities markets. They form the backbone of investor protection in Islamic finance. They will

---

[143] Anzal Mohammed, Understanding Islamic Finance, Downloaded from http://www.allenovery.com/AOWEB. Accessed on 7th June, 2010.

[144] Aamir Rehman, The Relevance of Islamic Finance Principles to the Global Financial Crisis, (16th March 2009) Islamic Finance Project –Harvard Law School at p 3.

[145] Aaron Pitluck, Moral Behaviour in Stock Markets: Islamic Finance and Socially Responsible Investment, (2008) Published in Katherine Brown, Barbara Milgram, Economics and Morality: Anthropological Approaches (2008) The Rowmann and Littlefield Publishing Group at p 235.

[146] Elmelki Anas, Ethical Investment and Social Responsibilities of the Islamic Banks (2009) Volume 2, International *Business Research* at p 123-124.

be further explored in the sixth chapters to put together a philosophical foundation for shariah based market abuse framework.

5- Contractual Structures of Financial Instruments in Islamic Capital Markets

5.1- Introduction

This chapter analyses the important features of Shariah compliant equity, debt and risk hedging contractual structures. As mentioned in the abstract and the introduction of thesis, Shariah regulates financial instruments as part of its overall philosophy of investor protection. It regards financial instruments as tools to facilitate exchange through its contractual structure leading to natural equilibrium and economic development. Shariah regards the fulfilment of these basic purposes of contract an integral and mandatory part of its ethics.[1]

The contractual structures analysed in this chapter are used as building blocks for the innovation of modern equity, debt and derivative financial instruments in the emerging Islamic capital markets. These structures aim to circumvent riba, gambling, gharar and maisir in financial transaction that lead to exploitation, harm and market abuse.[2] They also aim to achieve Shariah's economic objectives of socio-economic justice, equitability amongst the trading parties, introduce certainty and fairness in the exchange mechanism. Chapter six will further illustrate how these features offer inbuilt safety mechanism in the battle against market abuse and have the effect of minimising its occurrences in the secondary trading.

5.2- Equity Based Shariah Compliant Contractual Structures

The strict prohibition of interest dictates that individual and institutional investors are reliant upon equity as opposed to debt financing. Equity financing products in Islamic finance are based upon partnership and profit and loss sharing (PLS) modes similar to

[1] This is in stark contrasts to the approach followed in conventional securities markets which subscrivbes to freedom of financial innovation and is further analysed in the sixth chapter.

[2] These ethical principles are elaborately analysed in the previous chapter.

venture capitalism.[3] The cost of financing through the contractual modes directly links returns to the performance of the investment, proportionate to the risk undertaken.
It is argued that profit and loss sharing and risk undertaking features promote fairness. This is in contrast to a fixed rate of interest accrued on debt which does not have any link with the return on the real investment and is viewed as oppressive.[4] By employing equity financing based on the PLS structure and shirkah, Shariah promotes balance of power, mutual dependence among the financiers and entrepreneurs. In conventional banking terminology, these instruments are referred to as a trustee project and joint venture project finance.[5] The main modes of Shariah compliant equity financing are as follows

1- Mudarabah
2- Musharakah

5.2.1- Mudarabah (Profit-Sharing Dormant Partnership)

Mudarabah is one of the most important principles of the Shariah investment.[6] There could be two or more parties involved. One of the parties involved is the capital owner (Rab-al-Mal) and the other one act as an investment manager or entrepreneur (Mudarib). The capital owner invests the money without becoming involved in the actual day to day running of the project. In the case of any losses, its liability is limited to the capital invested. On the other hand, the entrepreneur solely controls the en-

---

[3] Mohammad Omar Farooq, Partnership, Equity-Financing and Islamic Finance: Whither Profit-Loss-Sharing, Downloaded from http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1415239 at p 1. Accessed on 21st June 2010.

[4] Rodney Wilson, Capital Markets: The Role of Sukuk (June 2010) http://www.qfinance.com at p1. Accessed on 21st June 2011.

[5] Mohammed Obaidullah, Islamic Financial Services (2005) Downloaded from www.islamiccenter.kau.edu.sa/english/publications/Obaidullah/ifs/ifs.html at p 57. Accessed on 21st June 2010

[6] Qirad, Muqarda and Mudarabah are used interchangeably with no difference in meaning. The difference in terminology is due to the geographical factors. Qirad and Muqarda find its origin in Arabian Peninsula and term Mudarabah originated in Iraq. Later on, schools of jurisprudence such as Maliki, Shaafi and Hanafi maintained the difference. Maliki and Shafi adopted the term Qirad and Muqarda and Hanafi adopted the term Mudarabah. Most common usage has used the term Mudarabah as it corresponds to the book of God. As it states: While others travel in the land in search of bounty; that is travel for the purpose of trade. Mohammed Mannan, *Understanding Islamic finance: A Study of Securities Market in an Islamic Framework* (1993) Islamic Research and Training Institution at p 29. See also Michael Mahlknecht, *Islamic Capital Market and Risk Management* (2009) Risk Books Ltd at p 53.

tire project and provides professional, technical, managerial expertise in making the project a success. His liability is limited to the loss of opportunity, time and effort unless loss is incurred deliberately or negligently. The role of investment manager is fiduciary and honesty and diligence is expected of him.[7]

The profit from the project is distributed in accordance with the pre-arranged ratio agreed in advance between the investor and the entrepreneur.[8] The ratio may depend on the risks assumed by the capital and the endeavours and contributions made by the entrepreneurs. It may be 50:50 or 70:30 ratio. One of the distinguishing features of the Mudarabah contract is that the lender is *not* guaranteed any pre-arranged fixed amount on its investment. The profit is distributed once the success of the project is proven *ex-post*. It is also important to note that if the capital providers demand any guarantee from eventuality of any loss, the whole contract becomes null and void.[9] This is in contrast to conventional financing interest based loans, which require the interest on the loan to be specified *ex-ante* regardless of success or failure of the business enterprise. In addition to this, the loan amount is also required to be secured on collateral,[10] which makes it difficult for less well-off members of society to obtain access to capital.

The concept of Mudarabah also introduces the unique concept of capital provider bearing the risk from the venture. In other words, in case of failure of enterprise, losses should only be borne by the capital provider rather than the entrepreneur. The loss is limited to the amount invested by the capital providers and reflects the concept of limited liability analogous to what a company enjoys in conventional system.[11] On

---

[7] Islamic Capital Market Task Force of the International Organisation of Securities Commissions, Islamic Capital Market fact Finding Report (July 2004) at p 10

[8] Administrative expenses are charged to the expense account and profits cannot be distributed before paying off the liabilities. Ali Ibrahim, "The Rise of Customary Business in International Financial Market: An Introduction to Islamic Finance and the Challenges of International integration" http://works.bepress.com/ali_ibrahim/3 at p 27. Accessed on

[9] Nabil Saleh, *Unlawful Gain and Legitimate Profit in Islamic law* (1986) Cambridge University Press at p 103.

[10] Abdus Samad, Norman Gardener, Bradley Cook, Islamic Banking and Finance in Theory and Practice: The Experience of Malaysia and Bahrain (2005) *The American Journal of Islamic Social Sciences* at p 74.

[11] Ian Burghardt, Caroline Ful, Islamic Banking Credit Products in Germany and in the United Kingdom (October 2004) Department of Finance Working Paper Series at p18.

the other hand, in conventional finance, in case of the failure of the enterprise, losses are born by the debtor and not the lender. This is regarded as oppressive. It is also observed that Shariah links the profit with the investment return which provides an inbuilt stabiliser and more sustainable development in comparison with the pre-fixed interest rate and uncertain profitability.[12] Thus Shariah encourages and fosters more entrepreneurship in the society.

It is also observed from the preceding paragraph that partnership and profit loss sharing form of Shariah financing is more ethical and also serves to promote justice in the society. It provides an opportunity for the less privileged and poorer segments of society to obtain funding for a feasible business venture. This gives them an oppertunity to climb out of poverty providing hope.

In comparison, the conventional system of finance only favours the rich to obtain access to financing. Wealthy businessmen obtain large capital by being able to offer collateral and utilise the depositor's money for a highly successful project.[13] The profit is not shared with depositors except the meagre amount of interest on the capital advanced. From the macro perspective, they offer nothing back to the society, as the cost of interest is passed on to the consumer through the price of the product. Thus the interest based products of capitalist banking system creates greater inequality, as increasing financial disparities occur between different segments of society due to access to capital with a consequent inherent imbalance in distribution of wealth.[14] On macro-economic basis in economy the rich are favoured in contrast to the poor segment of the society.[15]

5.2.2- Musharakah (Risk/Profit-sharing Partnership)

[12] Mohammed Mannan, *Understanding Islamic finance: A Study of Securities Market in an Islamic Framework,* (1993) Islamic Research and Training Institution at p 30.

[13] Mohammed Omar Farooq, Partnership, Equity Financing and Islamic Finance: Whither Profit-Loss Sharing, Downloaded from http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1415239 at p 1. Accessed on 21st June 2010.

[14] Mohammed Taqi Usmani, *An Introduction to Islamic Finance* (2007) Maktaba Ma'Ariful Quran at p 113.

[15] Ibid at p 1.

Musharakah is an arabic word which means sharing.[16] In the business context, it represents Islamic financial instruments that are based on profit and loss sharing and risk sharing partnership techniques with comprehensive effects on production and distribution.[17] It is a partnership contract (also referred to as shirkah) between two parties: the investor and the entrepreneur.[18] It resembles a western style joint venture, partnership financing or private equity financing. Both parties contribute equity capital and assets, technical and managerial expertise to an agreed proportion. They jointly have the right to manage the day to day affairs of the business except when one party voluntarily waives its rights to manage.[19] This is in contrast to Mudarabah where one party provides the funds and the other contributes through their special business skills.

Entitlement to profit depends upon the risk assumed and the commercial worth of the contributions by each party but not in proportion to the capital invested.[20] The entrepreneur or investment manager may be able to negotiate a higher share of profit depending on greater contributions or efforts as compared to the investor. This may also be possible if the bank decides to waive its rights of management and entrust supervision solely to the entrepreneur.

---

16 Ibid at p 27.

17 Seif Tag Al-Din, Capital and Money Market of the Muslims: The Emerging Experience in theory and Practice, (2007) *Kyoto Bulletin of Islamic Areas Studies* at p 58.

18 Although the correct terminology used in early Islamic Jurisprudence for the above profit loss sharing and partnership contracts is Shirkah. More modern and contemporary scholars use the terminology of Musharakah. Musharakah has a rather limited connotation in comparison to Shirkah, which has a wider meaning. Shirkah has been divided in two sub classification: Shirkat-ul-Milk and Shirkat-ul-Aqd. In the former type the partnership may come into existence on voluntary or non-voluntary basis. This may happen voluntarily if both parties decides to purchase an asset with prior agreement or they may inherit ownership of the asset upon the death of a person. In the later type parties comes into partnership by mutual contract. Shirat-ul-uqd has further three types: Shikat-ul-amwal, Shirkat-ul-amal and Shirkat-ul-wujuh. It is observed that Shirkah and Musharakah can be interchangeably used and the thesis above considers the most common type of Musharakah. See Mohammad Taqi Usmani, *An Introduction to Islamic Finance* (2007) Maktaba Ma'Ariful Quran, Karachi at p 33.

19 Ibid at p 58

20 And no fixed amount of profit can be pre-determined. See Zamir Iqbal & Abbas Mirakhor, *An Introduction to Theory and Practice* (2007) John Wiley at p 92.

On the other hand, if the business accrues losses, both the parties share liability for the losses in proportion to the contribution of financial capital.[21] This distinguishes the Musharakah from Mudarabah where the investor is liable for all looses with his entire contribution and entrepreneur may only loose his efforts for the business venture.

Islamic jurist has endorsed that the principle of Musharakah mode of financing can operate in the corporate form of joint stock companies. A joint stock company is a corporation involving two or more legal persons. Joint stock companies issue shares for financial contribution by the parties who can sell their share by offloading their stock holding to the public.[22] Thus the Musharakah mode of financing can be operationalised to raise financing through the securities market in a shariah compliant fashion.[23]

5.3- Debt Based Shariah Compliant Financing

Islamic finance acknowledges the importance of debt for investment, corporate and government borrowing.[24] It can facilitate creation of employment and prosperity leading to economic growth if utilised in a productive way. Islamic finance does not prohibit the debt financing instruments as long as it complies with shariah requirements and pre-conditions. Debt instruments follow different types of shariah compliant mode, which are as follows.

1- Murabaha
2- Deferred Payment (Bai Bithaman-Ajil)

---

[21] Mohammed Mannan, *Understanding Islamic finance: A study of Securities Market in an Islamic Framework* (1993) Islamic Research and Training Institution at p 19. As mentioned above under Mudarbah, Shariah recognises the limited liability of shareholders in Musharakah based legal entity. Also See Zamir Iqbal & Abbas Mirakhor, *An Introduction to Theory and Practice* (2007) John Wiley at p 93.

[22] The role of Islamic banks lies in establishing companies through the securities market further develop the secondary markets and extend their investment in manufacturing and service industry. However one of the restrictions in launching companies through securities market is the central bank's restriction in direct exposure beyond certain limit in western countries.

[23] The principle is accepted but restricted by three conditions to ensure compliance with Shariah. The conditions are (1) that it will totally depend on equity finance (2) all shares are common stock and not preference shares (3) the transfer of ownership is allowed as long as it does not affect the interest of bulk of shareholder from irrational exuberance. See Munawar Iqbal and Rodney, Islamic Perspective on Wealth Creation, (2005) Edinburgh University Press at 28.

[24] Mohammed Ayub, *Understanding Islamic Finance* (2007) John Wiley at p 196.

3- Sukuk

5.3.1- Murabaha

This is one of the most popular and widely used instruments for short term financing by Islamic Banks. Originally Murabaha was not mode of financing rather a form of sale.[25] The Murabaha structure is analogous to the concept of purchase finance. Islamic Financial Institutions (IFI) uses this model to purchase goods, commodities and assets for their (individual and corporate) clients and sell them at a mark-up price. Individuals may use Murabaha to finance real estate and automobile purchases whereas corporate clients may use this model to obtain financing for raw materials or their fixed assets such as machinery and equipment.[26] It is also referred to as mark-up sale, cost plus profit or deferred payment sale.[27]

The best way for effecting Murabaha according to Shariah involves two separate sale agreements. The first contract is between the vendor of the asset and IFI and the second contract is between the IFI and their client. The sequence of the transactions entails client approaching the supplier, wholesaler or manufacturer in order to gather all relevant information in relation to the asset to pass on to the bank. The client then approaches the IFI and undertakes to buy the asset from the bank at a marked up price. The IFI releases the payment to the vendor and takes actual or constructive possession of the asset.[28] IFI subsequently enters into another sale agreement with the client at cost plus financing. The client agrees to pay in full or in instalments over a certain time period and this concludes the transaction. Usually the IFI may appoint the client as its agent in order to simplify the sale structure.[29]

---

[25] This is supported by the fact that 80 to 90 percent of all the transactions in Islamic Banking are based on the Murabaha model. Ian Burghardt, Caroline Ful, Islamic Banking Credit Products in Germany and in the United Kingdom, (October 2004) Department of Finance Working Paper Series at p 14. Mufti Taqi Usmani, *An Introduction to Islamic Finance* (2007) Maktaba Ma'Ariful Quran –Karachi, at p 104

[26] Ian Burghardt, Caroline Ful, Islamic Banking Credit Products in Germany and in the United Kingdom, (October 2007) Department of Finance Working Paper Series at p 14.

[27] Arif Mohammed, Islamic Banking (1988) Volume 2, *Asian-Pacific Economic Literature* at p 46-62.

[28] The risk remains with the bank during this time period.

[29] Frank Vogel, Samuel Hayes, *Islamic Law and Finance, Religious, Risk and Returns* (1988) Kluwer Law International at p 43.

The relationship between the IFI and client may change from one phase to another. Initially the relationship is of a promisee and promisor but becomes one of principle-agent relationship in the second stage and then proceeds to seller and buyer in the third stage. Finally when the payment is deferred, it amounts to creditor and debtor relationship. The rights, obligations and duties and other features originating from these roles must correspond to thenature of relationsip at each stage.

It is commonly criticised that the mark-up feature of Murabaha appears to resemble interest in the conventional finance. Murabaha is a crude form of trading practice for commodities between the real buyer and seller. IFIs are simply trying to legitimise interest by structuring the trade financing transaction camouflaged as trading. It is therefore robustly argued that "mark up" is just another word for interest, disguised under a different name and it does not meet the spirit of the Shariah.[30]

Taqi Usmani completely disagrees with the above stance. He argued that Murabaha is not originally a mode of financing but only a mechanism to circumvent interest based transactions. It is a sale of real commodity rather than merely advancing a loan. Shariah allow this with some conditions attached.[31] Furthermore, it is not deemed as an ideal device to promote Islam's economic objectives and should only be used where Musharakah and Murabaha are not practicable.

Taqi Usmani further elaborates upon his response by explaining the philosophical underpinnings of both Murabaha and its conventional counterpart. He argued that modern capitalist theory presume that commodity and money carry the same intrinsic value. Both are treated at equal par and hence can be traded in commercial transaction as long as the parties mutually consent. Shariah does not subscribe to this presumption and argue that both possess different characteristics and value.

[30] Ian Burghardt, Caroline Ful, Islamic Banking Credit Products in Germany and in the United Kingdom, (October 2004) Department of Finance Working Paper Series at p 15. Also See Mohammed Saleem, *Islamic Banking - A $300Billion Deception* (2005) Xlibris Corporation at p 23-24.

[31] All the conditions of sale are enumerated in the above two paragraphs. If these conditions are not complied with the sale transaction becomes invalid according to Shariah.

The Islamic scholars argue that money has no intrinsic value but it is a "measure of value and regarded as medium of exchange."[32] A worn out old $100 bank note has the same value as a brand new one but the same statement may not hold true in relation to a commodity. Hence the commodities, regardless of their age - old or new differ in value accordingly. They hold an intrinsic value and the owner is at a liberty to demand higher prices in cash transactions than market value bearing in mind the market forces. The vendor may do so as long as there is no misrepresentation, fraud or duress involved. Iqbal and Wilson argue that this provides a perfect rationale behind the Murabaha and is based on the principle that wealth can only be generated through legitimate trade and investment in real assets.[33] This furnishes the underlying rationale for the legitimacy of their profit.[34]

5.3.2- Deferred Payment (Bai Bithaman-Ajil)

Bai Bithamin Ajil has features similar to Murabaha. It is a sale transaction practiced in Malaysia and other South East Asian countries. The IFI purchases the assets for resale to the buyer at an increased price as agreed in advance by the both the parties involved. The difference with the Murabaha lies with the fact that the seller is not obligated to disclose the mark up included in the selling price and this mode of financing can be used for long term financing.[35] The payment by the purchaser is made sometimes after the delivery of the assets or commodity.

5.3.3- Sukuk

Saak is singular of sukuk, which means investment title or certificates. It's origin can be of traced back to 7th century where the soldiers and government officials were paid in kind as well as cash. Payment in kind was in the form of "coupons" and "grain permits" which entitled the holder to a fixed amount of the promised commodity. It

[32] Mufti Taqi Usmani, *An Introduction to Islamic Finance* (2007) Maktaba Ma'Ariful Quran –Karachi at p 113.

[33] Munawar Iqbal and Rodney Wilson, *Islamic Perspective of Wealth Creation* (2005) Edinburgh University Press.

[34] Mohammed Ayub, *Understanding Islamic Finance* (2007) John Wiley at p 132.

[35] See Iqbal and Mirakhor, *An Introduction to Islamic Finance- Theory and Practice* (2007) John Wiley at p 91. Also see Islamic Capital Market Task Force, Islamic Capital Market Fact Finding Report, International Organisation of Securities Commission at p 12.

was the usual practice for some to sell their saak in return for cash, although scholars disapproved of these transactions at the time.[36]

The modern concept of sukuk originated from the need to devise riba free instruments in the Islamic capital market. The implication of the principle of prohibition of riba and the prohibition on trading of debt meant that conventional fixed interest securities such as conventional bills, bonds and notes were not an acceptable form of investment instruments in the Islamic Capital Market. The innovation of shariah-compliant debt securities that linked the return with the performance of underlying real assets revolutionised the Islamic capital market.

Sukuk[37] represents "the fractional, proportionate and undivided beneficial ownership of the underlying assets, usufructs, services, projects or investment activities with a corresponding right to income stream generated from the underlying assets."[38] It is not a debt of the issuer as in conventional bonds.[39] The sukuk holder assumes the market risks involved from the underlying business venture, the performance of assets are exposed to the real market to justify profit. The income stream from the underlying asset, nature of the business activity, contractual mode and transactional structure must also comply with the requirements of shariah principles. The asset and income is securitised into tradable securities and issued in the primary market and subsequently traded in the secondary markets.[40]

---

[36] Ali Ibrahim, the Rise of Customary Business in International Financial Market: An Introduction to Islamic Finance and Challenges of International Integration" http://works.bepress.com/ali_ibrahim/3 at p 33. Historical evidence shows that sukuk was extensively used in medieval times by Islamic financiers for transferring financial obligations arising from trade and commercial activities. The Arabic word for securitisation is Taskeek, which means transforming an asset's future cash flow into the current income. See also Brian Kettle, *Islamic Capital Market* (2009) Harcourt Litho at p 212.

[37] Sukuk is sometimes referred to as an Islamic bond however the correct terminology is Islamic investment certificates. Bond indicates that the issuer is in contractual obligation to pay the bondholder certain amount of interest and capital on a certain date whereas in the case of sukuk, issuer only has to pay the income stream generated from the underlying assets. Brian Kettle, *Islamic Capital Market*, Harcourt Litho Swansea (2009) at p 212

[38]See Michael McMillan, Contractual Enforceability Issues: Sukuk and Capital Market Development (2007) Volume 8, *Chicago Journal of International Law* at p 429.

[39] Ibid at p 429

[40] Brian Kettle, *Islamic Capital Market* (2009 Harcourt Litho at p 213.

The concept is based on transparency whereby the capital is only used for legitimate Shariah compliant purposes, which are beneficial to society. The structure is marked by the clarity of rights and obligations.[41] Sukuk holders are entitled to the inherent right of disclosure of information in relation to the investment of their money. In this context, Shariah Board of Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) has provided guidelines for the issuance of Sukuk.[42]

Sukuk are generally divided in two different types: Islamic bonds and Islamic asset securitization. Islamic bonds are "a credit to the issuer, guarantor or the credit provider that is participating in the transaction."[43] On the other hand, securitization involves forming a Special Purpose Vehicle (SPV). SPV is a separate legal entity and is not affected by the bankruptcy of issuer. The sukuk certificates issued carry the credit ratings of the SPV and their strength depends upon the underlying assets rather than the originator's credit worthiness. An investment bank also provides performance guarantee of the future payments and replacement in case of default. This credit enhancement makes them attractive to the institutional investors. SPV also enjoy certain tax and benefit status, which makes them even more attractive to the investors.[44]

One of the important requirements of this Shariah compliant asset securitisation is to identify the appropriate tangible asset on the balance sheet of the corporate body, banking or financial institution, government or monetary authority wanting to mobilise resources. A pool of tangible and non-tangible (financial) assets must comply with Shariah requirements for securitisation.[45] In this context, sovereign and supranational organisations are in a unique position and currently dominate the sukuk market. Similarly, it is also observed that multilateral institutions such as the Islamic Devel-

---

[41] Ibid at p 213.

[42] AAOIFI, Shariah Standards 1425-26 H No 17 at 296. (AAOIFI 2004)

[43] Michael Mahlknecht, Contractual Enforceability Issues: Sukuk and Capital Market Development (2007) Volume 8, *The Chicago Journal of International Law* at p 428

[44] Iqbal and Mirakhor, *An Introduction to Islamic Finance: Theory and Practice* (2007) John Wiley at p 178-181

[45] Fiqh council of the OIC (Organisation of Islamic Countries) have ruled on the composition of underlying assets in relation to their suitability for trading of bonds. It states "a bond or note can be sold at a market price provided that the composition of the group of assets, represented by the bond, consists of a majority of physical assets, and financial rights as compared to a minority of cash and interpersonal debts"

opment Bank have large-scale assets in contrast to small-scale issuance by the corporations and are ideally placed.[46]

Once the SPV is formed and assets are transferred from the originator, it comes off the issuer's balance sheet. They are held on the asset side of the SPV and the Investment certificates are issued on liability side of the SPV. The structure entails either the sale or lease back of the assets to the originator in return for periodic payments. This part of the structure depends upon the underlying Shariah compliant contractual mode such as Musharakah, Salam, and Istisna etc. Depending upon each particular Shariah compliant contractual mode, the Sukuk will effectively represent ownership in debt (Murabaha Sukuk), in project financing (Istisna Sukuk), in leased assets (Ijarah Sukuk), in investments (Istithmar Sukuk) or in business based on partnership or risk share (Musharakah or Mudarabah based Sukuk). Sukuk based on combination of structures are called hybrid.[47]

The income generated is paid to the Sukuk holders at regular intervals. This is similar to the coupon payment with the conventional bonds. The difference lies in the fact that income from bonds are made regardless of the income generated from the project or business venture whereas the sukuk payments are directly linked with the income from the underlying assets or business. The risk and return associated with the cash flow generated from the underlying asset or business is also passed on to the Sukuk holders. In contrast to this, conventional bonds represent debt of the issuer and conventional securitisation is based upon debt-based loans such as account receivables, mortgages, auto loans, credit cards and home equity loans. Upon maturity, the leased assets are sold back to issuer/originator at a pre-determined price. The price is fixed in advance to avoid capital loss to the sukuk investors.[48] The SPV is wound up by the sale of assets to the originator and money is paid back to the certificate holders.

---

[46] Ibid at p 428.

[47] Such sukuk certificates are only tradable if 51% of the underlying asset does not represent debt. Michael Mahlknecht, *Islamic Capital Market and Risk Management* (2009) Risk Books at p 52. Also See Brian Kettle, Islamic Capital Markets (2007) Harcourt Litho at p 217-219. Also See Zamir Iqbal and Abbass Mirakhor, *An Introduction to Islamic Finance: Theory and Practice* (2007) John Wiley at p 181-184. Also see Mohammed Ayub, Understanding Islamic Finance (2007) John Wiley at p 391-400.

[48] This is a generic process and there will be differences depending on the type of underlying contractual mode used to acquire the asset. Michael Mahlknecht, *Islamic Capital Market and Risk*

Although it is criticised that the structure and design bears a resemblance to the asset backed securities and the securitisation of debt as found in conventional finance,[49] there are some profound differences. Conventional bondholders are seldom interested in the underlying purpose for which the finance is being generated as long as their in--vestment is safe. The risk to their investment is assessed solely by the rating agencies who calculate the likelihood of a default on payment. The rating is mostly based on the creditworthiness of the bond issuer with no reference to the activity being financed.[50] Highly leveraged companies also generate finance by issuing bonds, which merely represent their debt.[51]

Similarly, conventional securitisation repackages residential, commercial mortgages, auto loans and credit card receivables into tradable securities through securitisation. These securities are referred to as mortgage backed securities, asset backed securities and collaterised debt obligations. The recent sub-prime fiasco with the ensuing credit crunch and financial crisis were triggered by the default on the loans secured on properties and other assets. In the declining property market, financial institutions could not ascertain the true worth of this securitised debt adding to the overall confusion. The bonds were dubbed as toxic assets.[52] It has been argued that the financial crises has highlighted major defects in the securitisation process. Originators do not retain any risk despite collecting large fees for securitisation and without bringing any improvements in the underwriting process. The link with market abuse based on the contractual structures is further explored in the eighth chapter.

Management (2009) Risk Books at p 49-55. Zamir Iqbal and Abbass Mirakhor, *An Introduction to Islamic Finance-Theory and Practice* (2007) John Wiley at p 181.

[49] Michael Mahlknecht, *Islamic Capital Market and Risk Management* (2009) Risk Books at p 51. See also Abdel-Rehman Yousri Ahmad, *Islamic Modes of Finance and the Role of Sukuk* at p 3. Downloaded from http://www.qfinance.com. Accessed on 21st June 2010,

[50] There are different types of the bonds such as convertible bonds, foreign currency bonds, corporate bonds, government bonds and high yield or junk bonds.

[51] These are commonly called high yield or junk bonds. It is a type of bond which is regarded as high credit risk or speculative grade. This normally means that chance of default is higher and their return is also higher compare to the normal bond.

[52] The credit rating agencies rated the credit quality of different trenches of securitised debts based on their structure, rating of parties and legal and tax aspects. They are now faced with the litigation for flawed rating mechanism by pension funds and other financial institutions.

In contrast to this, the sukuk are issued on the strength of the assets, projects or businesses plan held by the SPV. The risk is not only measured in terms of creditworthiness of the issuers but on the strength of the underlying ventures or business plans. The process may appear similar to the conventional securitisation but it removes riba and gharar from the sukuk issuance. Sukuk holders also represent the ownership in underlying real assets, project and business. Moreover, the money generated is earmarked to finance the trade or production of real asset rather than for unspecified purposes. Furthermore, the inherent right to disclose information introduces a better discipline of transparency in the market, which conventional bondholders do not enjoy. It also creates investor confidence that the income flowing from the underlying asset together with ownership is safer than conventional bonds.[53]

5.3.3.1- Secondary Market in Sukuk

The first sukuk was issued in 2001 by Kingdom of Bahrain worth $250 million. It was soon followed by a $600 million sukuk issued by Malaysia, a $700 million by Qatar and a $400 million by Islamic Development Bank.[54] Subsequently, Saxony, the German issued Euro-denominated Ijarah sukuk in 2004.[55] The East Cameron Gas Company issued sukuk in the US in 2006. In November 2007, UK HM Treasury also considered issuing a sovereign sukuk however has decided to delay this until the economy recovers.[56] By 2007, global sukuk issuance had peaked at $47.7billion,[57] and it

---

[53] Iqbal and Mirakhor, *An Introduction to Islamic Finance-Theory and Practice* (2007) John Wiley at p 179.

[54] In 2000 there was only three sukuk worth $336 million issued. In 2004 there were 64 issues worth almost $7 billion and in 2005 the figure exceeded $10billion with 54 issues. See Rodney Wilson, Innovation in the Structuring of Islamic Sukuk Securities (2006), paper presented at 2nd Banking and Finance International Conference in Beirut at p 1.

[55] Rodney Wilson, Islamic Capital markets: The Role of Sukuk (2010) at p 3. Downloaded from www.qfinance.com. Accessed on 20th August.

[56] In April 2007, HM Treasury and Debt Management Office jointly undertook a feasibility study. In November 2007, the Government issued a consultation paper “Government Sterling Sukuk Issuance.” The Government received a total of 41 responses to the consultation. Following this the Government decided that sovereign sukuk would not offer value for money at this stage of economic recovery. However, In December 2008, it took a step nearer to facilitating the issuance of UK first corporate sukuk. Furthermore, in order to provide a level playing field, provide clarity and reduce legal costs for these types of investment, the Financial Services and Market Act 2000 Order 2010 was passed. This Order catagorise sukuk a type of alternative finance investment bond (AFIB) exempt from collective investment scheme regulations. See HM Treasury, Government Sterling Sukuk Issuance: A Consultation (November 2007) Also see Her Majesty Treasury, The Development of Islamic Finance in the UK: The Government Perspective (Dec 2008)

became evident that the scope of generating finance by sovereign sukuk, enjoying Shariah compatibility, is enormous.[58]

The structure of sukuk market is similar to conventional bond market. It is comprised of the primary and secondary sukuk market. The primary sukuk market is where the sukuk are issued with the help of the investment bankers who underwrites them. On the other hand, secondary market is where these sukuk are traded through the network of investors, brokers and large institutional dealers. They are not listed or traded in an organised exchange and are generally traded over the counter market (OTC).[59] Although there is a small secondary market for individual investors however it is largely dominated by large financial institutions, pension funds, mutual funds and the governments around the world.[60]

In this context, most of the sukuk are tradable in the secondary markets except the sukuk based on Murabaha, Salam and Istisna structure. This is because shariah holds the view that Salam, Istisna and Murabaha based sale structure creates debt and their sale in the secondary market would amount to the sale of debt. Islam prohibits the sale of debt and the generation of money from money. The controversies about this are considered under the next heading.

Sukuk has proved to be a popular instrument with major financial institutions and wealthy individuals tending to exercise “buy and hold strategy.”[61] Given the strong demand and fragmented market only a small percentage is traded on the secondary

---

[57] Rodney Wilson, Capital Markets: The Role of Sukuk (2010) www.qfinance.com at p 2. Accessed on 21st June.

[58] Rodney Wilson, Islamic Bonds: Your guide to issuing, structuring and Investing in Sukuk – Overview of the Sukuk Market at p 1. Downloaded from http://www.euromoneybooks.com. Rodney Wilson, Innovation in the Islamic Sukuk securities (2006) Presented at 2nd Banking and Finance International Conference at Beirut at p1.

[59] A small number of corporate bonds are listed on the stock exchanges. The NYSE saw an opportunity on the bond trading and launched its NYSE Bond system in April. OTC is the network of dealers who are ready to trade with each other if the price is acceptable. The bond trading desk of the institutional dealer who are located in the major financial centre make the market and provide liquidity.

[60] For comparison, individual traders hold 10% of the US bonds.

[61] Ibid at p 214

market.[62] It has made the sukuk out of reach of the average investor, which may defeat the objective of one of the important principle of Islamic finance, namely the equitable distribution of income.[63] This has also consequently slowed down the development of secondary market. It is also argued that the true size of the secondary market remains unknown although Bahrain LMC claimed the trading of $55.5 million of sukuk in 2007.[64]

It is also argued that trading in the secondary market has been effected by financial crisis in the conventional capital markets. This is evidenced by a statement by European Islamic Investment Bank (EIIB), which states that trading volume has decreased to $0.5 billion in 2008 compare to 2007. The momentum of growth in the sukuk market was halted by contagion effect of financial crisis in 2008[65] however practitioners and rating agencies forecast a rapid growth as the economic slowdown recedes.[66] This may come about as and when the Islamic finance moves towards standardisation. It is also estimated that the global sukuk market will top the $100 billion mark by 2012[67] which will create a deeper and more liquid secondary market.

5.4- Hedging and Risk Management Instruments in Islamic Capital Market

5.4.1- Introduction

Risk is referred to as uncertainty of outcome. The word risk originates from the Italian word *risicare*, which means to dare.[68] Bernstein argued that risk management is making a choice from various possible outcomes rather than fate. In this context, Risk

[62] Bahrain Financial Exchange, The Exchange Business: An Insight at p 52-53. Downloded from http://www.bfx.bh. Accessed on 20th August 2010.

[63] Standard & Poor, Sukuk Comes of Age in Infrastructure and Project Finance (May 2009) Volume 6, Islamic Finance News at p 1.

[64] Sukuk trades executed by LMC in the Secondary Market: LMC Bahrain. 27 March 2007. Downloaded from http://lmcbahrain.com/trade.asp. Accessed on 20th August 2010.

[65] Bahrain Financial Exchange, The Exchange Business: An Insight at p 51 Downloaded from http://www.bfx.bh. Accessed on 20th August 2010.

[66] The average annual growth rate of new issuance over the last six years had been 517 percent for sovereign and 1242 percent for corporate sukuk. See Islamic Research & Training Institute, *Islamic Capital Markets: Products, Regulation & Development* (2008) Islamic Development Bank.

[67] Standard and Poor’s: April 2007. Also see Mohammed al-Bashir, Mohammed al-Amine, Sukuk Market: Innovation and Challenges (2008) Volume 15, *Islamic Economic Studies* at p 1-2. In contrast to the global conventional bond market is estimated at $91 trillion: Bank of International Settlement.

[68] Peter Bernstein, *Against the Gods: The Remarkable Story of Risks* (1996) John Wiley at p 8

management is defined as evaluating exposure to the risk and then putting in place the structures and process to manage, reduce and diversify the risk, in materialising potential opportunities whilst managing adverse effects.[69] Historically, mastery of risk has demarcated the boundary between the developments of modern life from ancient times. The ability to identify, measure, monitor, control and diversify risk provided the catalyst for the economic growth, technological advancement and improved quality of life.

Traders, producers, investors and conventional financial institutions are generally faced with market and financial risks in their day-to-day operation.[70] Market risk originates from price increase risk, regulatory risk, operational risk, commodity price risk, human resources risk, legal and product risks. Financial risk refers to credit risk, liquidity risk, currency risk, and settlement risk.[71] Western financiers innovated financial instruments to transfer and diversify the risk to various participants of the financial exchange in the field of science and enterprise.[72]

The tools commonly used to hedge against the above mentioned risks are referred to as derivative instruments.[73] They have been intrinsic part of the conventional finance, which has evolved over the last two centuries. As long as riba, gharar and gambling is absent, Islamic practitioners can learn from the reservoir of commercial experience in devising structures of derivative products and their markets. It can be used as a tem-

---

[69] In the context of Islamic Bank, Risk Management is defined as "constructing appropriate risk management environment, maintaining an efficient risk measurement, mitigating and monitoring process and establishing an adequate control mechanism" Tariqullah Khan, Habib Ahmed, *Risk Management; An Analysis of Issues in Islamic Financial Industry* (2001) Islamic Research Training Institute at p 26. Also see Husam el-Khatib, Harvard – LSE Workshop: Islamic Economic and Islamic Ethico-Legal Perspectives on the Current Financial Crisis (26th February 2009) Short Report at 12.

[70] Saif Azhar Rosley, *Critical Issues on Islamic Banking and Financial Markets* (2005) Author House at p 482-483. The author argues that market risk is a law in itself, which none other but only God knows. It is also referred to as systematic risk, which no one is able to control.

[71] Ibid at p 482-483

[72] Peter Bernstein, *Against the Gods: The Remarkable Story of Risks* (1996) John Wiley at p 2.

[73] A derivative is generic term. It refers to financial instruments whose value depends upon the underlying asset, equity, currency and commodities. Derivative value may depend upon prices of gold, silver, currencies, price of stock, fruit, vegetables even weather etc. The history of derivative trading can be traced back to Mesopotamia however more modern trading commenced in 19th century in US Chicago Board of Trade (CBOT) and in 17th century in Osaka, Japanese market. Sherin Kunhibava, Balachandran Shanmugam, Shariah and Conventional Law Objections to Derivatives: A Comparison (2010) Volume 24, *Arab Law Quarterly* at p 319-32.

plate for devising new products and for operational purposes.[74] In this context, the design and structure of conventional instruments and their legal and regulatory infrastructure raises several issues that may fall foul of Shariah principles and may facilitate abusive activities, harm and exploitation.

5.4.2- Islamic Concept of Risk Management

The Quran sets the foundation of concept of risk management by narrating a story of the Prophet Yusuf in 1600 BC.[75] He was appointed as the chief treasurer in order to manage the risk posed from catastrophe of famine in the times of the King of Egypt.[76] Shariah scholars share a consensus that its view of risk management lies in *three categories*. On one side of spectrum lie the axioms of Shariah, "*al ghonm bil ghorm*" (no risk no gain) and "*al-kharaj bi dhaman* (profit belongs to those who bear the risk).[77] The two maxims of shariah dictate that gain without undertaking a risk in business venture is not legitimate. This is in stark contrast to the interest based system, which protects its capital and return by passing on the risk of losses to the borrower or at best hedging it with instruments such as a profit default swap.

On the other spectrum of Shariah, there is prohibition of excessive risk taking (Gharar and Maisir) in the form of gambling like activities or zero-sum transactions based on

---

[74] Mohammed Hashim Kamali, Prospects of An Islamic Derivatives in Malaysia (July-October 1999) Volume 41, *Thunderbird International Law Review* at p 523-540.

[75] The King of Egypt had a dream and saw seven healthy cows coming out of the river and grazing on the farmland. He then saw seven weak cows coming out of the river that ate the healthy cows. He also saw seven fields of green spikes of wheat and seven fields of dry fields. He called the eminent scholars of his court and asked them to interpret the dream. (Al-Quran 12:41-43) It was then brought to his attention by one of the servant that there is man of God who has been put in prison on false charges and who has the knowledge and power of interpreting dreams. Prophet Yusuf interpreted the dream that there will be seven years of prosperity and grain will be in abundance, followed by seven years of famine. People will face hardship unless properly managed.

[76] Quran relates the incident in the time of the King of Egypt in 1610 to 1500 BC. The Old and New Testament refer to the Monarch as Pharaohs however Quran, Encyclopaedia of Britannica and Academic American Encyclopaedia confirms that this title was ascribed to King much later in 1400 BC, almost 200 years later than Moses times. Prophet Yusuf is referred to as Joseph in Bible. Prophet Yusuf proposed the solution to the King. He stated that in the first seven years of prosperity cultivate all the land and store the grains for use in the later years of famine. (Al-Quran 12: 47-51) This is also confirmed by the discoveries of archaeologist from pictures on walls depicting starvation of people of Egypt.

[77] Tariqullah Khan, Habib Ahmed, *Risk Management; An Analysis of Issues in Islamic Financial Industry* (2001) Islamic Research Training Institute at p 120. Also see Husam el-Khatib, Harvard – LSE Workshop: Islamic Economic and Islamic Ethico-Legal Perspectives on the Current Financial Crisis (26th February 2009) Short Report at p 11.

gross uncertainty purely in pursuit of profit in the form of speculation. Shariah makes such activities, structures, designs and contracts void and any profit made from it as non-shariah compliant.

Ibn-Tamiyiah has differentiated the excessive risk originating from gambling or similar instruments from the risk posed by economic activities creating wealth and adding value in the society. Risk in itself is undesirable. It only becomes legitimate if, as part of the economic transactions, it adds value to the society. If it adds no value to the society, it is a form of gambling.[78] This distinguishes the legitimate risks from the undesirable one in the Shariah. In contrast to this, conventional finance not only permits these transactions with excessive risk but also allows repackaging of this kind of risk and its sale creating systemic risk throughout the financial system. The correlation with market abuse is explored in the chapter six.

The third category of risk exists in between the above two types. It is a legitimate form of risk and Islamic finance subscribes to this middle path of taking calculated risks.[79] It includes market risk, equity price risk and commodity price risk. Technically, Islamic concept of risk management and products should effectively comply with the following three conditions.

1- The nature of risk to be mitigated should originate from shariah compliant transactions as opposed to non- Shariah compliant transactions.[80]

---

[78] Sami Ibrahim Suwailum, Hedging in Islamic Finance (2006) Islamic Research Training Institute at p 38 -39

[79] It is important not to confuse the concept of ghorm and maisir with gharar (uncertainty and risk). In the Fiqh literature, gharar is more used in the context of ambiguity or uncertainty in the contractual obligations and must be avoided at all costs. Shariah principle stipulates that contractual obligations must be identified accurately. Therefore the concept of gharar is not relevant in risk management although it is one of reason that shariah scholars do not accept that contractual structure of conventional derivative instrument. Saif Azhar Rosley, *Critical Issues on Islamic Banking and Financial Markets* (2005) Author House at p 482-483

[80] Most Jurist have consensus on the nature of risk prohibited in Islam. It includes risk originating from receipt or payment of riba, uncertainty or gharar, economic activities in forbidden materials such as alcohol, armament, gambling/speculation and Maisir. Kazi Hussein, Hedging Market Risk in Islamic Finance at p 1. Downloaded from http://www.worldcommercereview.com/publications/article_pdf/105. Accessed on 15th January 2011.

2- Hedging instruments should also comply with the shariah compliant risk management principles, modes, structure and contracts.[81] Invariably, it means that noble means be employed to achieve the noble ends.
3- The products should only minimise or diversify the risk as opposed to commoditize it into a market of its own. This would be promoting speculation and gambling as a source of earning money.[82]

Scholars concede that the risk management instruments incorporating the above characteristics would be legitimate and would not raise any Shariah issues.[83] The general consensus is that derivative designs should facilitate reduction of corruptive elements in allocating risk to participants in the financial system. In executing economic activities for public interest (Maslahah), it should aim to facilitate the stability of the financial system.[84] It is already established that the concept of Maslahah supports the use of derivatives in food, agricultural products and the commodities market. It serves the interest of public by creating effective planning in advance, hedging of risk of loss. It also provides assurance to the farmers, producers and manufacturers who face uncertainty when storing perishable crops.[85]

The Islamic concept of hedging should also promote the overall objective of promoting an equitable system of distributive justice and the common good. In the context of the allocation of risk, distributive justice refers to the willingness and capability of the various parties to assume risk in promoting general welfare and avoiding adverse ef-

[81] Ibid at p 1. Jurists do not appear to have consensus on the interpretation and applicability of these principles to risk hedging instruments such as futures, options and swaps in commodities, currency and equity market etc. Codification or Ijtihad among jurists of different school of thought is the way forward. However, in designing new hedging instruments Shariah utilises its three set of contracts such as contracts of sale - Murabaha, Istisna and Salam, contracts of lease - Ijarah, Joint enterprise arrangement - Musharakah and Mudarabah.

[82] Husam el-Khatib, Harvard – LSE Workshop: Islamic Economic and Islamic Ethico-Legal Perspectives on the Current Financial Crisis (26th February 2009) Short Report at p 14.

[83] Mohammed Obaid -Ullah, Islamic Risk Management: Towards Greater Ethics and Efficiency (2002) Volume 3, *International Journal of Islamic Financial services* at p 6.

[84] Mohammed Obaid -Ullah, Islamic Risk Management: Towards Greater Ethics and Efficiency (2002) Volume 3, *International Journal of Islamic Financial services* at p 5. Qudeer Latif, Susi Crawford, Introduction to Islamic Financial Risk Management Products at p 1. Downloaded from www.qfinance.com. Accessed on 15th January 2011. Andreas Jobst, Risk Management of Islamic Finance Instruments, Downloaded from www.qfinance.com. Accessed on 15th January 2011.

[85] Mohammed Hashim Kamali, Prospects for Islamic Derivatives in Malaysia (July-October 1999) Volume 41, *Thunderbird International Business Review* at p 523-540.

fects on the financial system. It promotes generation of utility and avoidance of economic waste and financial losses. Avoidance from financial loss is assigned a higher priority than the expectations of large profit in shariah.[86]

The achievements of the above objectives are heavily dependent upon the creative design of Islamic derivative instruments and the mechanics of the market. The Shariah Supervisory Board (SSB) normally analyses the Shariah compliance of any new products. The SSB carries out the research and development on issues related to Fatwas on Shariah compliance.[87] It is involved throughout the entire process of product development. It works with internal, external management to identify and mitigate Shariah compliant risk from pre-certification stage[88] to post certification stage.[89] However, the entire process is so conceptual and subject to interpretation, which creates a risk that Fatwas and certification may still be rejected in different countries following different School of thoughts in Shariah.

5.4.3- Islamic Risk Management Contractual Structures

Risk diversification by derivatives has improved prudential regulation, liquidity management and enhanced financial stability.[90] Similarly, in the evolution of Islamic finance, risk has to be managed to ensure stable growth. Thus risk-hedging instruments in derivative market give investor a wider choice between the risks they want to take. The Shariah compliant contractual structures and modes used on its own or in combination as the building blocks are analysed as follows.[91]

---

[86] Husam el-Khatib, Harvard – LSE Workshop: Islamic Economic and Islamic Ethico-Legal Perspectives on the Current Financial Crisis (26th February 2009) Short Report at p 13. This can also be compared with loss of employments and prosperity of the general public following the financial crisis.

[87] Fatwa is proclamation that the product or service complies with the shariah principles and has been subject to scrutiny by the eminent Jurists.

[88] Pre-certification stage generally requires SSG to ensure that in developing a product, it complies with the structure, modes, principles and precepts of shariah.

[89] At Post-certification stage SSB has to ensure that the product offers sufficient transparency and consumers choice is based on sufficient disclosure and information.

[90] Nidal Alsayyed, Shariah Parameters of Islamic Derivatives in Islamic Banking and Finance (2011) International Shariah Research Academy For Islamic Finance (ISRA) at p 1. Downloaded from http://www.kantakji.com/fiqh/Files/Finance/N362.pdf. Accessed on 14th May 2010.

[91] Ibid at p 1. The juristic consensus about permissibility of derivative contract in Islamic finance is far from settled yet therefore the analysis is limited to basic derivative products and more complicated derivative products are not discussed.

1- Bay-Salam

2- Istisna

5.4.3.1- Bay-Salam (Advanced Purchase)

The instrument has been used to avoid riba-based transactions as an alternative form of contracting.[92] Although the general principle of Shariah prohibited sales of any commodity which was not in physical or constructive possession of the seller, as it amounted to gharar, the Salam was permitted as an exception.[93] Salam was practiced in Medina to purchase fruit, wheat, barley etc with delivery in one, two or three years by making full advance payments. Upon the Prophet's arrival in Medina in 622 CE,[94] He added new features to the sale transaction by making it obligatory to specify the quality and quantity of the commodity (weight and measure), the date and time of the delivery and definitive terms in order to avoid future dispute.[95]

The rationale to allow this sale structure was to mitigate against the hardship for small farmers who struggled to obtain the liquidity required to pay for the expense incurred during the growing of the crop season. Hasanuz Zaman interpreted the justifying rationale as economic necessity. Arab traders had no means of financing their trade, except reliance upon usurers, which would increase the cost.[96] He argued this form of financing was mutually beneficial as it connected the farmers and the traders or prospective traders directly.[97] It enables the farmers to buy seeds and fertiliser whilst avoiding the marketing costs. In return, traders got to pay cheap price for the crops

[92] The buyer is called Rab-us-Salam, the seller is called Muslam-ilaih, the cash price Rasul-Mal and the purchased commodity is called Muslam Fih.

[93] Mahmoud Ghamal, *Islamic Finance-Law, Economics and Practice* (2006) Cambridge University Press at p 81

[94] CE stands for Common Era and one of the designations for most commonly used year numbering system.

[95] The Holy Prophet ordained: Whoever pays money in advance (for fruits) to be delivered later should pay it for a known quality, specific measure, weight and time of the delivery. Mohammed Ayub, *Understanding Islamic Finance* (2007) John Wiley at p 242. Also see Mahmoud Ghamal, *Islamic Finance, Law, Economic and Practice* (2006) Cambridge University Press at p 81

[96] See Mohammed Ayub, Understanding Islamic Finance (2007) John Wiley at p 242.

[97] It meets the requirement of both parties. Salam provides the price hedge for the buyer and protects the seller from the cost of revenue. Mohammed Ayub, *Understanding Islamic Finance* (2007) at p 242.

that allowed them to plan their business in advance with certainty. This also had an overall effect of stabilizing the price of particular commodity from speculative frenzy as Shariah does not allow the buyer to resell Salam goods until possession takes place.[98]

Salam transaction can only take place in commodities where it is possible to define the quantity and quality precisely. It is not possible to particularise the product of specific tree, orchard, farm or field for Salam transaction.[99] Contemporary scholars have reached a consensus that most standardised goods or commodities can form the subject matter of the Salam transaction.[100] Shariah also overemphasize upon unequivocal terms for a valid Salam transaction.[101] It aims to minimise ambiguity leading to gharar to avoid the possibility of disputes later.[102]

Some divergence of the opinion exists between different schools of Islamic jurisprudence in relation to some of the pre-requisite for Salam contract. The Hanafi school argues that it is paramount that the commodity is available in the market from the day of the contract until the day of delivery. However, the other three Schools – Shafi, Maliki and Hanbali believes that it is not essential as long as the commodity is available on the date of delivery.[103]

The structure based on Salam transaction can be used as a mode of Shariah compliant debt financing for farmers and traders in agricultural sector. The price is agreed in advance and is generally lower than the spot rate and this may amount to a profit for the modern IFI. However, IFI may want to insist on a guarantee or security in order to

---

[98] Ibid at p 243

[99] Controversy exist whether in relation to items such as grass, fodder, bread, honey, milk, vegetables, oils, cheese, birds, fish, trained dogs, precious stones, wool, carpets, rugs etc can become subject of Salam transactions. This controversy is understandable because when jurists made the list of these items, it was not possible to standardise.

[100] The example of such commodities is barley, oil, iron, copper, or other grains of this type, which are commonly available at any time. In attempting to further the spirit of the Shariah, jurists have removed any substance of commodity, which may cause dissent in the deal. Mohammed Ayub, *Understanding Islamic Finance* at p 244.

[101] Mohammed Ayub, *Understanding Islamic Finance* (2007) John Wiley at p 244.

[102] Mohammed Taqi Usmani, *An Introduction to Islamic Finance* (2007) Maktaba Ma'Ariful Quran at p 188

[103] Ibid at p 190.

ensure that the seller complies with the Salam contract and delivers on time. Having purchased the commodity once, IFI can resell the commodity by entering into another contract completely independent of the first. This is referred to as parallel Salam. In the first contract, IFI is purchasing and in the second contract, IFI is selling the same commodity. It is mandatory that both contracts should be independent and must not be reliant upon the specific performance of each other.[104]

The similarity of Salam with forward contracts from conventional finance is unmistakeable. However, in reality there are many differences in the structure of both transactions.[105] A conventional forward contract allows the payment of price and delivery of the object at a specified future date. The net profit or loss by the parties over the life of the contract is also settled on the delivery date. These are non-standardised contracts traded on OTC market.

In contrast to this, Salam requires full payment of price in advance. Classical Shariah jurists take the view that deferring the payment of price and delivery of goods bring in an element of *gharar* and parties may exploit each other.[106] Similarly, partial payment is also not permissible as it amount to reliance of credit and is prohibited. Moreover, the resale of the goods without receipt of the goods curbs *speculative tendencies*. The correlation with market abuse is considered in the chapter six.

In this context, forward contracts are very much similar to futures contracts, which are standardised exchange traded contracts. Kamali[107] and other Malaysian jurists contend that legal and institutional development in conventional future exchanges and technological advancements have reduced the element of gharar in transactions. It is therefore now possible to defer payment of price and objects in Salam contracts. They considered the chain of narration of hadith forbidding deferment of both price and object

---

[104] Ibid at p 192-194.

[105] Mahmoud Al-Ghamal, *Islamic Finance-Law, Economics and Practice* (2006) Cambridge University Press at p 83-87.

[106] Ibid at p 87. Also See Beata Paxford, Derivative – An Islamic Finance Perspective http://www.sailanmuslim.com/news/derivatives-an-islamic-finance-perspective-by-beata-m-paxford. Accessed on 24rth July 2010.

[107] Dr Hashim Kamali is a renowned Malaysian scholar and jurists.

as weak and cited Al-Shafi who has questioned its authenticity.[108] In contrast to this, most contemporary scholars subscribing to the classical jurists view have opposed this. They contend that despite technological advancement promoting improved standardised commodities, the essence of Salam contract is the prepayment of the price at the outset.[109]

It is observed from the foregoing discussion that the permissibility of the deferment of both price and delivery of objects may create an opportunity for finance professionals to synthesize forbidden forward contracts. The recent development in the form of fatwas also seems a step in that direction. It permits IFIs to engage in parallel Salam with the similar net results as conventional forward contracts. It allows Salam-long (seller) to open another position as a salaam-short with a third party after the inception of the first contract. Salam-long can engage in this contract on conditions similar to the first contract before the delivery of the goods take place.[110]

Contemporary scholars acknowledge the need for flexibility bearing in mind the tough competition Salam contracts face in the western markets with highly developed derivative products and the organised legal and institutional framework. The Salam contract is an effective tool suitable to seek entry and access these highly competitive markets in providing a credit facility in compliance with the Shariah principles. The Scholars has shown willingness in their fatwas to allow this as a form of systematic trade and debt financing if the existing injustice and consideration of wider benefit to public and economic circumstances so dictates.[111]

---

[108] Mahmoud Al-Ghamal, *Islamic Finance-Law, Economics and Practice* (2006) John Wiley at p 87.

[109] This view is based on the Prophet's tradition they quote that "The Messenger of God forbade gharar sales, trading one deferred compensation for another, and the discount repurchase of debts." In this context, another relevant Hadith relied upon by Abu Hanifa and Abu Yusuf is "Whosoever engages in a Salam contract, let him not take replacement for the contract's specified price or object." Narrated by Al-Daraqutni on the authority of Ibn-Umer.

[110] Mahmoud Al-Ghamal, *Islamic Finance-Law, Economics and Practice* (2006) Cambridge University Press at p 84. This is the second fatwa by the Shariah Board of Al-Rajhi Investment Corporation, Fatwa 41.

[111] Ibid at p 85. This is the second fatwa of the Dalla Al-Bararka Symposium. Taqi Usmani argues that Islam is a practical way of life and it presents two sets of rules; one for ideal and normal circumstances and the second one when the circumstances are not normal. The circumstances are regarded as normal when Muslims are able to foster their own legislative and regulatory infrastructure and in contrast to this circumstances are regarded as abnormal when the regulatory infrastructure is not conducive for Islamic finance.

5.4.3.2- Istisna

The general principles of Shariah prohibits the sale or purchase of the any object which is not in possession of the seller or which has not come into existence as yet and regard it as form of gharar. Istisna is regarded as a second exception to this principle. Classical jurists have legalised this exception on the basis of rationale of Istihsan or falah, which means creating lenience in the wider public interests.[112]

The contract of Istisna involves buyer paying the price in flexible mode of either lump sum or multiple instalments in consideration for the seller to manufacture a commodity with specific requirements to be delivered at some future date. The essential features of Istisna are the specific requirements of the commodity and the price which have to be settled at the time of the contract.[113] Istisna deals in products, which are made to order.[114] Historically, these types of contracts were used in leather products, shoes and carpentry etc.[115]

Although Istisna shares the financing of the non-existent commodity with Salam and structure of transaction appear to be similar, however, both have several differences. Firstly, in Istisna, the object of sale transaction is manufactured or constructed however, in Salam contract the object of sale transaction need not be manufactured.[116] Secondly, Istisna stipulate a unique manufacturing process whereas Salam contracts do not prescribe to any particular production process such as the crops of any particular field.[117] Thirdly, the price in Istisna may be paid on flexible terms at any agreed time whereas Salam requires the payment to be made in advance to ensure validity.

---

[112] Mohammed Ayub, *Understanding Islamic Finance* (2007) John Wiley at p 263.

[113] At the time of delivery if the asset does not conform to the specifications, the party placing the order has the right to cancel the contract. More modern also contracts stipulate a penalty clause to discourage the delay in delivery of manufactured goods. Taqi Usmani, *An Introduction to Islamic Finance* (2007) Maktaba Ma'Ariful Quran at p 98.

[114] International Organisation of Securities Commissioners, Islamic Capital Market Fact Finding Report at p 12.

[115] Mohammed Ayub, *Understanding Islamic Finance* (2007) John Wiley at p 263-269.

[116] Mahmoud Ghamal, *Islamic Finance-Law, Economic and Practice* (2006) Cambridge University Press at p 90.

[117] Frank Vogel & Samuel Hayes, Islamic Law and Finance - Religion, Risk and Return (1998) Kluwer International at p 147.

Fourthly, the object of Istisna sale is usually non-fungibles[118] whereas the object of sale in Salam is usually fungible.[119] In addition to this, an Istisna contract can be revoked before the manufacturer starts the work however a Salam contract cannot be rescinded unilaterally.[120] Finally, the time of delivery is flexible in Istisna whereas in Salam contracts it is fixed.

Istisna can also be used as mode of financing by IFI in the real estate sector for the construction of residential dwellings, hospitals, schools and universities etc. Similarly, government departments can also use Istisna for the construction of bridges, dams, highways, aircrafts, ships and aeroplanes etc. Istisna is flexible enough to allow the manufacturer to subcontract the project to a third party. This arrangement is called a parallel Istisna. A typical transaction entails IFIs signing an Istisna contract with the client and another one with the manufacturer to deliver at certain date. The difference of price amounts to profit for IFI.

5.5- Conclusion

This chapter highlights the important features of Shariah compliant contractual structures through deductive analysis. These features will be compared with conventional equity, debt and derivative products in chapter six and further analysed for their inbuilt strength in curbing volatility, excessive and abusive speculation and manipulation.

[118] The examples are metal and grains.

[119] The examples are highways, building or aircrafts.

[120] Taqi Usmani, *An Introduction to Islamic Finance* (2007) Maktaba Ma'Ariful Quran at p 186-193.

6- Shariah Perspective of Market Abuse and Prohibition of Abusive Speculation

6.1- Introduction

The chapter develops on the major part of my hypothesis. It conceptualises Shariah's philosophical approach to the regulation of market abuse.[1] It also aims to illustrate whether ethical principles and concepts of Shariah are capable of being transformed into a coherent theoretical underpinning for a Shariah based market abuse framework in the securities markets.[2]

The chapter also analyse the implication of Shariah principles of riba, gambling and gharar in the modern financial system and their role in facilitating market abuse.[3] It also illustrates that Shariah compliant contractual structures, which circumvent riba and gambling, have an in-built safety mechanism to minimise excessive and abusive speculation. It also outlines the non-Shariah features from the conventional equity, debt and derivative products and analyse their correlation with volatility, abusive speculation, market abuse and financial crisis. This chapter will provide important background research for future financial innovation in Shariah compliant securities markets with a view to reducing the occurrences of market abuse.

6.2- Philosophical underpinning of Shariah based Market Abuse Framework

---

[1] Islamic economic system is based on values and principles derived from Quran and Sunnah. There is no divine guarantee of its success or its survival. It reflects on the values preferred for Muslims in Holy Book and Sunnah and the economic choices made for the Muslim Ummah. Rodney Wilson, *Economic, Ethics and Religion* (1997) New York University Press at p 134.

[2] Since the advent of Islamic economic and financial system in 7th century, the markets have completely transformed from the barter based system to electronic exchanges with complicated products. These are impersonal, advanced stock exchanges where information plays a key role. Devising a Shariah based theoretical framework based on ancient Shariah principles which provide an adequate framework for the operation of advanced equity, debt and derivative products presents a significant challenge.

[3] Recent financial crisis was caused by the contractual structures of the debt based financial instruments. It erased billions of pounds of equity of the market and various corporations had to axe thousands of jobs. HSBC alone axed 1000 jobs. This led to decline in social prosperity, poverty, disease and starvation in the society.

Shariah compliant securities markets are at the embryonic stages when it comes to developing legal and regulatory mechanisms for prohibition of market abuse. The endeavour to protect investors from abuse can be traced back to 7th century in Islamic civilisation.[4] It is predominantly shaped by its emphasis on overriding ethical principles and the economic objectives of socio-economic justice, equitable distribution of wealth and elimination of oppression and abuse. Shariah has identified 1400 verses out of 6226 relating to economic and financial matters.[5] These verses aimed to safeguard the duties, obligations and rights of the investors in the markets. They are also supplemented by the Sunnah of the Prophet.

The Prophet's[6] migration from Mecca to Medina on 16th July 622 CE[7] marked the beginning of the Muslim political, economic and financial system. The structure of the markets in Medina was based on a barter system and negotiation and bargaining took place among the buyers and sellers. However, there was no complete freedom from coercion, from undue interference from those holding economic power and monopoly and fee and levies from those holding authority. In order to restore the rules of a level playing field and fairness, the Prophet carried out some market reforms. He banished all the taxes, levies and fees on the entry of goods, merchandise, merchants, buyers and sellers. He also prohibited all interference with the market forces. This included any propaganda, rumours and false information that a product, commodity or goods were of good quality.[8] This is similar to the law of prohibition of insider trading and market manipulation in the modern securities market of the UK and US.

Shariah is based on set of ethical axioms, principles, prohibitions and contractual structures originating from Quran and Sunnah, analysed in the fourth and fifth chapters.[9] These ethical

[4] Syed Othman Alhabshi, Development of Capital market Under Islamic Principles (1994) at p 4. Downloaded from http://www.kantakji.com/fiqh/Files/Markets/y102.pdf Accessed on 3rd December 2011. For a detailed discussion please see Seif-el-Din, Taj-el-Din, Towards an Islamic Model of Stock Market (2002) Volume 14, *Journal of King Abdul-Aziz University* at p 4-7.

[5] Rodney Wilson, *Economics, Ethics and Religion* (1997) New York University Press at p a117.

[6] Peace be Upon Him.

[7] This marked the beginning of Islamic calendar from zero Hijrah (H). The year 2011 corresponds with the 1432 AH (After Hijrah). Monzer Kahf, Markets and Prices (1996) at p 4- 7. Downloaded from http://monzer.kahf.com/papers/english/market_and_prices.pdf. Accessed on 4rth November 2011. Also see Monzer Kahf, Market and Prices in Islamic Perspective (1993) *Journal of Objective Studies* at p1-3.

[8] Ibid at p6

[9] Rodney Wilson, *Economics, Ethics and Religion* (1997) New York University Press at p a117.

axioms set the overriding objectives of a regulatory framework of the Islamic capital market which aims to bring spiritual aspirations in line with the material well-being. Naqvi argued that it is also quite normal for the modern economists to categorize social preferences and economic objectives in order to achieve the maximum social welfare and prosperity from the markets.[10] In this context, the moral and religious foundation of investor protection in Shariah compliant securities markets rests on the higher objectives of Shariah.[11] It is argued that the objective of Shariah (Maqasid-al-Shariah) is the realization of the spiritual and socio-economic well being of everyone in society.[12] These principles are set out as follows: [13]

"*The very objective of Shariah is to promote the welfare of the people, which lies in safe guarding their faith, their life, their intellect, their posterity and their wealth. Whatever ensures the safeguarding of these five serves public interest and is desirable.*"[14]

Ibn al-Qayyim articulated this as follows:[15]

"*The basis of Shariah is wisdom and welfare of the people in this world as well as hereafter. This welfare lies in complete justice, mercy, wellbeing and wisdom. Anything that departs from justice to oppression, from mercy to harshness, from welfare to harm and from wisdom to folly has nothing to do with shariah.*"

Ibn-Ashur articulated the objectives of Shariah as the necessity to maintain order and goodness[16] by eliminating corruption (Fasad) from the markets and the society.[17] Since

[10] Sayed Nawab Haider Naqvi, *Islam, Economics and Society* (1994) Kegan Paul International - London at p 40.

[11] Shariah is a system of ethical principles or values which encompasses guidance on personal, political, economic and financial matters. These principles remain fundamentally unchanged however can be developed to the changing circumstances. Asyruf Wajid Dusuki, Nurdianwati Irwani Abdullah, Maqasid as-Shariah, Maslahah and Corporate Social Responsibility (2009) *The American Journal for Social Sciences* at p 30

[12] Eddy Yusof, Ezry Fahmy, Asim Anwar Kamil, Islamic Finance: Debt Versus Equity Financing in the Light of Maqasid-ul-Shariah (2009) at p 3. Downloaded from http://mpra.ub.uni-muenchen.de/20722/. Accessed on 20th October 2011 at p at p 3

[13] Syed Othman Alhabshi, Development of Capital Market under Islamic Principles (1994) A paper Presented inn Conference on Managing and Implementing Interest Free Banking/Financial system. Downloaded from http://www.kantakji.com/fiqh/Files/Markets/y102.pdf. Accessed on 20th October 2011 at p 2. Also see Tariq Ramadan, *Radical reform: Islamic Ethics and Liberation* (2009) Oxford University Press at p 62

[14] Other scholars have added man's dignity to five objectives of shariah and argued that slanderous accusation should be punishable. Also see Asyruf Wajid Dusuki, Nurdianwati Irwani Abdullah, Maqasid as-Shariah, Maslahah and Corporate Social Responsibility (2009) *The American Journal for Social Sciences* at p 30

[15] Ibid at p 2. Also see Eddy Yusof, Ezry Fahmy, Kashoogie, Jhordy, Anwar, Kamal, Islamic Finance: Debt Versus Equity Financing in the Light of Maqasid al-Shariah (2009) at p 3. Downloaded from http://mpra.ub.uni-muenchen.de/20722/. Accessed on 20th October 2011 at p 3.

[16] The Quran has also used other words interchangeably with the concept of goodness such as khyar (goodness), birr (righteousness), Adl (equilibrium and justice) and Taqwa (piety). Rafiq Issa Beekun, *Islamic Business Ethics*, (1996) *International Institute of Islamic Thought* at p 5.

Shariah scholars believe that markets are repositories of the food of God,[18] therefore principles of welfare, public interest (Maslahah)[19] in financial and commercial context and protection of faith, life, posterity, intellect, posterity and wealth may only be achieved by ensuring a fair and trasparent markets devoid of market abuse.

As mentioned in the higher objectives of Shariah, *Justice* is one of the overriding principles in Islamic economics.[20] It is also equated with natural equilibrium in the markets. Naqvi argued that the survival of any civilisation depends upon the quality of natural equilibrium.[21] The concept of socio-economic justice necessitates elimination of all forms of exploitation in the Shariah compliant securities markets and natural equilibrium leads to equitable distribution of wealth through the markets.[22] These economic objectives aim to promote a level playing field, transparent and fair markets devoid of oppression, exploitation and market abuse.[23] Thus the aforementioned principles of *justice and natural equilibrium* are interlinked in the Islamic capital markets for the sustainable development of society.

---

[17] Ibid at p 4

[18] Imam Ghazali, *Revival of Religious Learning's: Ihyaa Ulum-Id-Din* (Late 10th century) Volume II, Dar-ul-Ishat. Translated by Fazl-ul-Karim (1993) at p 46.

[19] Maslahah and Maqasid al-Shariah have been used interchangeably. A number of other scholars have advocated the matters of public good and Maqasid al-shariah. These prominent scholars include Al-Juwayni, Al-Ghazali, Al-Salmi, Al-Qarafi, Al-Shatibi, Ibn Tamayyah and al-Shatibi.

[20] Quran articulates: "And we created not the heaven and the earth and all between them but for just ends." "A Society where there is no justice is doomed to disaster." Al-Quran: 57:25.It is also evident from the history that a society that has a high level of inequality is domed in the long run. Currently in US the disparity in rich and poor is at its peak. Eighty per cent of the wealth is held by the ten per cent of the population. Michael Moor, Capitalism: A Love Story (2010) Holly Wood Documentary Film.

[21] Naqvi bases the foundation of ethics in economic system on Unity (Tawhid), Equilibrium, free will and responsibility. These principles will dictate the rules of economic behaviour in Muslim societies. On the other hand, Chapra bases his world view of Islamic economic system on the principle of Unity (Tawhid), khilafah (vice regency) and Justice (Adalah). It appears that Justice and natural equilibrium is the common denominator. Syed Nawab Haider Naqvi, *Islam, Economics and Society* (1994) Kegan Paul International - London at p xix-xx. Mohammed Umer Chapra, *Islam and the Economic Challenge* (1992) Islamic Foundation - Leicester at p 199-212.

[22] Wealth concentration has been condemned by Quran and Sunnah. There is a levy of zakat on the amount that is not used for the investment to discourage hoarding. It is one of Islamic measure to ensure flow of wealth in the society. Eddy Yusof, Ezry Fahmy, Asim Anwar Kamil, Islamic Finance: Debt versus Equity Financing in the Light of Maqasid-ul-Shariah (2009) at p 1. Downloaded from http://mpra.ub.uni-muenchen.de/20722/. Accessed on 20th October 2011.

[23] Taimur Kurran regards equality and fairness as the two overriding principles of Islamic economic system. Taimur Kurran, The Economic System in Contemporary Islamic Thought" in K.S (Jomo) *Islamic Economic Alternatives* (1992) Macmillan at p 51.

Shariah may also regards insider trading as amounting to riba in securities transactions. Riba is often accorded a narrow definition meaning interest however it actually encompasses exploitation through an unequal bargaining position and abuse in business transaction. Since the trading in an impersonal securities market is based on access to adequate information, any unequal access to information which may enable the participants to be in a more advantageous position than their counterparts may be regarded as a form of riba. Shariah regards it as injustice and transgression. One of the key reasons it has been prohibited is because it rewards the accumulation of wealth,[24] hinders its circulation and harms the general public.

Imam Ghazali articulated this concern in the 10th century, when there were no stock exchanges.[25] He articulated that dharar (harm) from deceit and fraud[26] may affect specific individuals as well as the general public in the markets. Modern economists would interpret this in the form ofundermining the investor's confidence and a decrease in liquidity from market abuse. In this context, avoidance of harm to the integrity of capital formation and contemporary traders would be key objective in the Shariah compliant securities market.

Maslahah (unrestricted public good) is regarded as the essece of Shariah and may form the underpinning of the Shariah based market abuse framework.[27] It is a juristic device to seek public benefit and repel social evil, corruption, harm and injury.[28] It is regarded as unrestricted because its scope of applicability is undefined in Shariah.[29] It is only applied where the subject matter is not covered by explicit instructions from other sources. There are generally three pre-conditions to its applicability. One, it is only applicable in matters of transactions, based on rationality. Secondly, the interest must generally be in conformity with

---

[24] One of the most important tools for the distribution of wealth is Zakat in Islam. It is also one of the five pillars of the Islam. It entails paying 2.5% of your wealth to the poor. This also puts pressure upon the wealth owner to invest money in the business venture. It is a strong principle against hoarding of wealth and ensuring its circulation for prosperity in the society.

[25] Abu Hamid Al-Ghazali (1058 -1111) was a great scholar, theologian and mystic of his time.

[26] Imam Ghazali, *Revival of Religious Learnings: Ihyaa Ulum-Id-Din* (1993) Volume II, Dar-ul-Ishat. Translated by Fazl-ul-Karim at p 51. Rodney Wilson, *Economics, Ethics and Religion* (1997) New York University Press at p 3, 160 and 186.

[27] Masalih is the plural of the Maslahah which means welfare, interest and benefit.

[28] Imam Malik has used this as a source whereas the other scholars have rejected this as a source. Imam Ghazali used the term Istilah – which means to seek the best for public interest.

[29] Mohammed Obaidullah, Islamic Risk Management: Towards Greater Ethics and Efficiency (2002) Volume 3, *International Journal of Islamic Financial Services* at p 4.

the spirit of Shariah and thirdly it must preserve the five tenets of Shariah and promote utility or benefit.

Shariah has a similar concept of Sad-al-Dhari. This means "obstructing the means to something that may cause social harm, backwardness and degradation."[30] Shariah takes a pre-emptive approach in prohibiting practices which are harmful to the general public. It allows Shariah Scholars to monitor the financial engineering and prevent any practice, products or any component of products which may be used as a tool to facilitate market abuse. This is further analysed in subsequent headings at the end of this chapter. In the context of secondary trading, it transpires that trading in secondary markets must not result in harm to the third party and must benefit (Maslahah) society.[31] The above concepts aim to *maximise utility* or *falah* and *prevent harm or injury* through the secondary markets.

6.3- Prohibition of Insider Trading in Islam

Islamic finance endorses freedom of enterprise, embraces the profit motive**,** approves of the market forces determining prices through natural equilibrium, ownership of private property and elimination of external interference.[32] The only major difference with conventional system is that the individual freedom to pursue self-interest in the form of maximisation of profit under freedom of enterprise is curtailed in favour of collective social benefit in Islam.[33]

The Quran also praises commerce and trade in a number of Surah's as honourable and desirable.[34] Some of these Surah's articulate, "God has made trade lawful."[35] At another place,

---

[30] Mohammed Hashim Kamali, Islamic Commercial Law: An Analysis of Futures (1996) *The American Journal of Social Sciences* at p 209.

[31] Mohammed Obaidullah, Islamic Risk Management: Towards Greater Ethics and Efficiency (2002) Volume 3, Number 4, *International Journal of Islamic Financial Serv*ices, at p 3. [31] Mohammed Bashar, Two Aspects of Exchange in Islam Jurisprudence: Rejoinder (1994) Volume 4, *Review of Islamic Economics* at p 19.

[32] Economic freedom is part of the general freedom that is an intrinsic part of the freedom in Islam. Freedom of decision forms the foundation of reward and punishment in the world hereafter which in turn, forms the foundation of doctrine of Islam. The freedom is also subject to the spirit of co-operation in promoting social welfare. Q-Finance, Business Ethics in Islamic Finance, Downloaded from http://www.qfinance.com/business-ethics-checklists/business-ethics-in-islamic-finance. Accessed on 30th October 2011. Also see Monzer Kahf, Markets and Prices (1996) Downloaded from http://monzer.kahf.com/papers/english/market_and_prices.pdf, at p 4- 7 Accessed on 4rth November 2011.

[33] Also see Mohammad Akbar Khan, Consumer Protection and Islamic Law of Contract (2011) at p 2-3. Downloaded from http://ssrn.com/abstract=19619192.

[34] Rodney Wilson, Islam and Business (2006) *Thunderbird International Business Review* at p 109.

the Quran states "Eat not up your property amongst yourselves by vanities: but let there be trade with *mutual consent*"[36] The principle of exchange via mutual consent has been acknowledged as a fair method of distribution of resources leading to mutual benefit.[37] It also discourages any potential for dispute, animosity and harm to the contemporary investors.[38] It is instrumental in leading to fair markets and a fair price formation mechanism.[39]

In this context, Shariah pays great emphasis on the autonomy of an individual's decision making by making "exchange with mutual consent" pivotal in entering into any private contract.[40] Trading based on price sensitive information, manipulation, cheating and coercion undermines the willingness, overrides the mutual consent, and the autonomy of the individual traders and violates the right to engage in trade freely.[41] Such transactions would therefore not amount to mutually beneficially exchange in the Shariah compliant stock exchanges.

In this context, Anwar argued that "….If one of the trading parties manages to obtain price sensitive information, deliberately transmit a false impression by exaggerating positive

---

[35] Al-Quran 2:275, 2:188, 4:10, 9:34. Mohammed Obaidullah, Islamic Risk Management: Towards Greater Ethics and Efficiency (2002) Volume 3, *International Journal of Islamic Financial Services*, at p 2. Also see Monzer Kahf, Markets and Prices, Downloaded from http://monzer.kahf.com/papers/english/market_and_prices.pdf, at p 46, Accessed on 5th November 2011. Prophet said that truthful trades' men will resurrect on the resurrection day with the truthful ad martyrs. Imam

Ghazali, *Revival of Religious Learning's: Ihyaa Ulum-Id-Din* (1993) Volume II, Dar-ul-Ishat. Translated by Fazl-ul-Karim at p 45

[36] Al-Quran 4:29. The prophet said, "The contract of sale becomes lawful with the consent of both parties." Mohammad Akram Khan, Commodity Exchange and Stock Exchange in Islamic Economy (1988) Volume 5, *The American Journal of Social Science* at p 92. Also see Noor Mohammed Osmani, Farukh Abdullah, Towards

an Islamic Stock Market: A Review of Classical and Modern Literatures (2009) Volume 5, *International Review of Business Research Paper* at 121-130. Mohammad Akbar Khan, Consumer Protection and Islamic Law of Contract (2011) at p 4. Downloaded from http://ssrn.com/abstract=19619192.

[37] As Hadith says "Indeed exchange is based on mutual consent." And "someone's property must not be unlawful acquired unless it was given to him willingly." Mohammed Bashar, Two Aspects of Exchange in Islam Jurisprudence: Rejoinder, (1994) Volume 4, No 1 *Review of Islamic Economics* at p 18. Also see

Monzer Kahf, Market and Prices, (1996) Downloaded from http://monzer.kahf.com/papers/english/market_and_prices.pdf, at p 22. Accessed on 4rth November 2011.

[38] Mohammad Anas Zarqa, Rules of Exchange in Islamic Jurisprudence: An Introduction for Economist, Islamic Research and raining and Institute.

[39] Mohammed Bashar, Two Aspects of Exchange in Islam Jurisprudence: Rejoinder (1994) Volume 4, *Review of Islamic Economics* at p 18.

[40] Private ownership is the cornerstone of the Islamic economic system. Islam allows the believers to fight against aggression and any confiscation of his property by force.

[41] Hersh Shefrin and Meir Statman, Ethics, Fairness and Efficiency in Financial Market (1993) Financial Analyst Journal at p 21.

aspects of a commodity and playing down or hiding the defects of the commodity, so that the commodity is conceived to be a value higher than its actual value. The excess so obtained is devouring not profit."[42] Devouring is strictly prohibited in the Quran.[43] The trading may appear to be carried out with mutual consent but technically it is an invalid exchange under coercion or misrepresentation.[44] These transactions are irreconcilable with the principle of *justice* and profit made would be regarded as unlawful.[45]

This is also supported by an incident of high prices in Medina. People complained and asked the prophet to fix the prices. He refused and said "….it is God who pushes the prices up or down, I do not want to face him with a burden of injustice."[46] At another place he said, "God is the price giver…."[47] He equated price control with injustice and transgression.[48] Imam Shaafi and Imam Ibn-Hanbal has argued that "abundance and scarcity of goods upon which cheapness and dearness depend are divine phenomenon"[49] In this context, it is difficult to argue whether the invisible hand of the market,[50] a secular phenomenon, can be equated with the will of God in the price formation mechanism in Shariah compliant stock exchanges.[51]

---

[42] Mohammed Anwar, An Islamic Perspective on Capital markets and Islamic Securities in Malaysia (1995) Part II, *The Pakistan Development Review* at p 877.

[43] Quran articulates that "*Devour* not each other's properties unless it is by means of trading through *mutual consent*." Al-Quran: 4:29.

[44] Mohammed Bashar, Two Aspects of Exchange in Islam Jurisprudence: Rejoinder (1994) Volume 4, *Review of Islamic Economics* at p 18.

[45] Mohammed Anwar, An Islamic Perspective on Capital markets and Islamic Securities in Malaysia (1995) Part II, *The Pakistan Development Review* at p 877

[46] Mohammad Lawal Ahmed Bashar, Price Control in Islamic Economy (1997*) Islamic Economics* at p 31. Kamali argued that setting price considered as the inconsistent with the "Quran's approval of free nature of consent" Mohammed Hashim Kamali, Tasir (Price Control) in Islamic Law (1994) Volume 2, *The America Journal of Islamic Social Sciences* at 27.

[47] Ibid at p 27. Also see Mohammad Lawal Ahmed Bashar, Price Control in Islamic Economy (1997*) Islamic Economics* at p 33.

[48] Tirmidhi, No 1235. Mohammed Hashim Kamali, Tasir (Price Control) in Islamic Law (1994) Volume 2, *The America Journal of Islamic Social Sciences* at p 35

[49] Ibid at p 31-32

[50] Adam Smith argued that pursuit of self-interest brings about invisible hands of the market function which promotes socially advantageous function. Rodney Wilson, Islam and Business (2006) *Thunderbird International Business Review* at p.

[51] He also believed in the random nature of the market which is obvious from his saying "To let people be given sustenance (Rizq) by God from each other." The idea is also mentioned in Quran. Al-Quran 43:32. This is also affirmed later by Ibn-Tamiya in his book Al-Hisbah that markets determine the earnings of owners of factors of production. Although Ibn-Tamiya advocated the price fixing but only on to combat the market anomalies in an imperfect competition. Monzer Kahf, Markets and Prices (1996) Downloaded from http://monzer.kahf.com/papers/english/market_and_prices.pdf, at p 12, 15, 38. Accessed on 4rth November

Despite the above general rule, Scholars have argued that price fixing is legitimate if the market is imperfect. Shariah has the categorised prices as *valid and invalid*. *Valid* price formation occurs in a market "free from deliberate attempt to cheat, defraud, obfuscate, lie disguise or withhold relevant information."[52] It distributes the benefits and cost of exchange fairly and equitably.[53] *Invalid prices* are formed in the markets where there is asymmetry of information, manipulation, hoarding, monopoly, oligopoly, imperfect market, market failure, disequilibrium in the market etc. Shariah regards it as a special form of market failure leading to unequitable distribution of wealth.[54]

Islam did not create or invent the market-based system however it took such measures to enhance, preserve, promote and improve its spirit and efficiency.[55] The Prophet improved upon spreading falah, prosperity and equitable distribution of wealth through the exchange mechanism via the institution of the market by carrying out reforms after migration to Medina in 622. He initiated an institution called Hisbah in order to ensure the proper functioning of the markets.[56] The Islamic terminology used for the appointee was Muhtasib.[57] The Muhtasib used to be appointed by the government.[58] He had the authority to hear complaints against exploitation through monopoly, short selling, insider trading, artificial price rise, unfair weights and accurate provision of information to ensure a fair and level-playing field. He would be equivalent to the Office of Fair Trading in current times.

2011. Also see Ahmad Abdel Fattah El-Askar, Towards an Islamic Stock Exchange in transitional Stage (1995) Islamic Economic Studies at p 29.

[52] Ibid at p 35-39

[53] Ibid at p 44

[54] Mohammed Bashar, Two Aspects of Exchange in Islam Jurisprudence: Rejoinder (1994) Volume 4, *Review of Islamic Economics* at p 24.

[55] Monzer Kahf, Markets and Prices (1996) Downloaded from http://monzer.kahf.com/papers/english/market_and_prices.pdf, at p 8. Accessed on 4rth November 2011.

[56] Hisbah is a quasi- judicial controller of the activities of the market participants. His job is to ensure compliance with ethics and compliance in the market. Monzer Kahf, Markets and Prices (1996) Downloaded from http://monzer.kahf.com/papers/english/market_and_prices.pdf, at p 17. Accessed on 4rth November 2011.

[57] Muhtasib must be familiar with the operation of the markets and principles of Shariah on commerce.

[58] First Muhtasib was appointed in Medina in Prophet's times and the tradition carried on throughout most of the Muslim empires. Saad Bin al-A'as and Umer bin Khatab were appointed I the Mecca and Medina. Monzer Kahf, Markets and Prices (1996) Downloaded from http://monzer.kahf.com/papers/english/market_and_prices.pdf, at p 58. Accessed on 4rth November 2011.

The Muhtasib also had the authority to ensure the provision of adequate information in the markets. There is also an important precedent from the Prophet's[59] time. He made an effective ban on insider trading fourteen hundred years ago. He put a stop to the practice of purchasing goods and commodities from the producers and farmers from remote areas who did not have information or knowledge of market prices. He also appointed guards at the door of the city to prohibit the practice of intercepting imports.[60] He also warned people against meeting trading caravans in the desert. These unscrupulous traders would take advantage of their knowledge of the markets and would negotiate lower prices before the trading caravans arrived in the markets.[61] They would than proceed to sell the assets and commodities at higher prices making undue profit based on their inside information.

Islamic rules of commerce also introduced rules for the reasonable flow of information to the participants by prohibiting the practice of withholding information and taking advantage of the ignorance of others.[62] There are strong hadiths which articulate the need to disclose the defects in a commodity to the buyer.[63] The Prophet provided for a remedy of annulment of contracts in the case of withholding information.[64] There is also a similar Islamic concept of Ghish in Shariah. It makes the contract concealing information null and void. Zarqa regarded the profit made based on asymmetrical information as ghabn.[65]

6.4- Prohibition of Market Manipulation in Islam

The history of prohibition of abusive practices and market manipulation is as old as the history of Islamic Finance. Fourteen centuries ago, Mecca and Medina had buoyant market

---

[59] Peace Be Upon Him.

[60] Mohammed Hashim Kamali, Tasir (Price Control) in Islamic Law (1994) Volume 2, *The America Journal of Islamic Social Sciences* at p 31-32.

[61] Mohammed Obaidullah, Islamic Risk Management: Towards Greater Ethics and Efficiency (2002) Volume 3, *International Journals of Islamic Financial Services* at p 3.

[62] Monzer Kahf, Market and Prices, (1996) Downloaded from http://monzer.kahf.com/papers/english/market_and_prices.pdf, at p 47. Accessed on 4rth November 2011.

[63] Prophet said "He who defrauds us is not one of us." He also said "Deceit in buying and selling and mutual transactions is unlawful." Imam Ghazali, *Revival of Religious Learning's: Ihyaa Ulum-Id-Din*, (Late 10th century) Volume II, Dar-ul-Ishat at p 53-54. Translated by Fazl-ul-Karim (1993).

[64] Imam Ghazali argued in late 10th century in his book that "One who conceals defects is an oppressor, deceit and a fraud. Ibid at p 53

[65] Please see under Prohibition of manipulation for detailed discussion.

places facilitating trade of goods to other parts of the Arab peninsula, Africa and other Asian countries before the advent of Islam. At that time, business and trade was full of exploitative practices of charging compound interest rates leading to the collection of a wealth in few hands, hoarding during famine, the abusive practices of artificially raising prices, collusion to hoard before the supplies reached to markets, exaggerating the quality of the products, concealing material information about the defects in products, use of unfair measures, cheating, monopoly and sale of the entire family in return for complete release from high interest based debt. Moreover, the participants of market were subject to taxes and levies from the influential and powerful in the society.[66]

Shariah took a number of measures to promote a level playing field and to eliminate exploitation, manipulation and abuse. It introduced new ethical principles to conduct business, maintain order and investors confidence in the market.[67] The higher objectives of Shariah set the overriding approach to regulating the markets. They aimed to promote falah, natural equilibrium, the axiom of free will subject to collective social benefit, equitable distribution of wealth, the elimination of exploitation, social solidarity and egalitarianism.[68] Shariah also prohibited riba, gambling and excessive risk taking (gharar) because of their exploitative characteristics, unfair and harmful to the general public.[69] The correlation of interest, gambling and gharar with market abuse is further explored in the context of the securities markets.

Shariah operationalised its above approach, ethical principles and prohibitions through its contractual structures. It introduced requirements in the form of specific restrictions, pre-conditions, certainty and fair balance in the contractual structure. Shariah aim to designe contractual structures in such a way that they promote real benefit from the exchange mechanism in the markets, prevente gambling, interest, discourage transactions laden with

[66] Andrew McGosh, *Financial Ethics* (1999) Kluwer Academic Publishers at p 66-70. Sometime armed gangs' exercised their influence on the markets. Monzer Kahf, Market and Prices (1996) Downloaded from http://monzer.kahf.com/papers/english/market_and_prices.pdf, at p 4. Accessed on 4rth November 2011.

[67] Mohammed Hashim Kamali, Tasir (Price Control) in Islamic Law (1994) Volume 2, The *America Journal of Islamic Social Sciences* at p 26.

[68] For a detailed discussion if these principle, please consult the previous headings and fourth chapter.

[69] Al-Quran - Surah- Maeda: 5-90-91

gharar (excessive risk and uncertainty) to protect weaker parties in the transaction.[70] It also prohibited all deceitful practices which skewed the balance in favour of those who have access to large funds and are in a favourable position vis-à-vis access to money, information and market position.[71] The above measures were introduced with the sole objective of facilitating fair transactions and securing fair and transparent markets.

The Quran also introduced the concept of "trade with mutual consent," fourteen centuries ago, which Adam Smith relied upon later in the eighteenth century. His famous formulation for the rule of capitalism was that every trade must occur "by mutual consent and to mutual advantage."[72] It is thus argued that exchange by mutual consent appears to be the common denominator between Shariah and conventional finance and is a fair method of equitable distribution of resources within the society. Shariah also offered wider protection by going beyond the concept of *mutual advantageous exchange* to *collective social benefit* from the transactions. This approach regulates Shariah's philosophy of financial innovation to ensure that products donot facilitate distortion, manipulation or abuse in the markets.[73] This is further illustrated in subsequent headings.

It is also a criticism that capitalistic freedom is prone to abuse unless the participants are subject to moral and ethical principles. This may come about in a free market system where the economic agents pursue *maximisation of profit*, the inequities will soon enlarge and parties may be inclined to abuse and exploit their superior market position.[74] In contrast to this, the Islamic economic system curtails absolute freedom in favour of collective social

---

[70] The previous chapter explores in detail the features of contractual structures which promotes trade and boost the real economy and protects the weaker party. Also see Mohammad Akbar Khan, Consumer Protection and Islamic Law of Contract (2011) at p 1, downloaded from http://ssrn.com/abstract=19619192.

[71] Habibullah Khan Omar Bashar, Islamic Finance: Growth and Prospects in Singapore (2008) U-21 Global Working Paper Series at p 2. Downloaded from http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1589796. Accessed on 5th November 2011.

[72] Robert Tracinski, The Moral Basis of Capitalism, Downloaded from http://www.capitalismcenter.org/Philosophy/Essays/The_Moral_Basis_of_Capitalism.htm. Accessed on 28th Oct 2011.

[73] Rodney Wilson, Islam and Business (2006) Thunderbird International Business Review at p 109.

[74] Ibid at p 117. Ibn-Taimaiyyah has argued that when the economic freedom leads to monopoly and superior market power which may threaten the system, the Government has the right to limit this freedom. This may mean setting prices of goods and services. This may also be indicative of Islamic finance approach in dealing with the "too bog too fail approach" in conventional finance. Monzer Kahf, Markets and Prices, (1996) Downloaded from http://monzer.kahf.com/papers/english/market_and_prices.pdf, at p 39. Accessed on 4rth November 2011. Also see Monzer Kahf, Market and Prices in Islamic Perspective (1993) *Journal of Objective Studies.*

benefit. It aims to *maximise Maslahah*, a concept that is much wider and incorporates utility, profit and service to society at large.[75]

The Quran also reiterated "*Devour* not each other's properties unless it is by means of trading through *mutual consent*."[76] In the context of trading on a Shariah compliant stock exchanges, devouring would refer to "acquisition of wealth through fraud, riba, usurpations, profit made from unlawful transaction, tampering with measurements, gambling via products based on a zero-sum game, insider trading and market manipulation,[77] fraudulent and abusive practices, dishonesty in buying and selling[78] and any attempt to cheat and deceive."[79]

The Quran has strictly censured this behaviour and prescribed harsh penalties for *devouring* through abusive activities or in other words those who attempt to distort the markets:

> "Woe to those that deal in fraud, those who, when they have
> to receive by measure from men exact full measure, but
> when they have to give by measure or weight to men give
> less than due. Do they not think they will be called to account?"[80]

Some of the exploitative practices in the anicient markets are similar to modern manipulative practices in the UK and US stock exchanges. These are *Ikrah, Ikhtikar,*[81] *Najsh,*[82] *Ghabn,*[83]

---

[75] Habib Ahmed, *Theoretical Foundation of Islamic Economics* (2002) Islamic Research and Training Institute at p 11

[76] Hashim Kamali, Prospects For an Islamic Derivative Market in Malaysia (1999) *Thunderbird International Business Review*, Volume 51 at p 523-540.

[77] Although Kamali disagrees that derivative speculator in commodities market would be devourers or gamblers. Mohammed Hashim Kamali, *Islamic Commercial Law: An Analysis of Futures and Option* (2001) The Islamic Text Society at 151-155.

[78] Quran articulates "Give full measure when ye measure, and weigh with a balance which is straight, that is most fitting and befitting in the final determination." Al-Quran 17:35.

[79] Rodney Wilson, *Economics, Ethics and Religion* (1997) New York University Press at p 120.

[80] Al-Quran 83:1-4. Also see Rodney Wilson, Islam and Business (2006) *Thunderbird International Business Law Review* at p 114.

[81] Imam Ghazali also mentions the prohibition of negotiating with the caravan traders or farmers at the gates of the city in order to negotiate lower prices. He prohibited creating a false market. Andrew McGosh, *Financial Ethics,* (1999) Kluwer Academic Publishers at p 70. Also see Mohammad Akram Khan, Commodity Exchange and Stock Exchange in Islamic Economy (1988) Volume 5, *The American Journal of Social Science* at p 92. Mohammed Hashim Kamali, Tasir (Price Control) in Islamic Law (1994) Volume 2, *The America Journal of Islamic Social Sciences* at p 30.

[82] Seif El-Din, Taj El-Din, Towards an Islamic Model of Stock Market (1985) Volume 3, *Journal of King Abdul Aziz University: Islamic Economics* at p 13.

Ghish,[84] *Tadlees,*[85] *hoarding,*[86] *collusion,*[87] *monopoly,*[88] and *exploitation*.[89] They are analysed as follow.

1- **Ikrah (Coercion)**: Coercion violates Shariah's mechanism of "mutually beneficial exchange with consent" and undermines the autonomy of the investor. It arises in many different forms. One such example is transactions or contracts entered into by duress or compulsion.

   Since information plays an important role in Shariah compliant securities exchanges, withholding information or trading on price sensitive information would undermine the autonomy of the investor. This is a subtle form of coercion leading to invalid exchange and the profit earned is unlawful in Shariah. Ikrah may be equated with trading on price sensitive information, manipulating devices, manipulating transactions, disseminating false and misleading information and misleading behaviour under UK law.

---

[83] Ibid at p 13. God does not like Treacherous. Al-Quran: (Surah- al-Anfal) 8: 58. Also see[83] Siti Farida Abdul Jabber, Financial Crimes: Prohibition in Islam and Prevention by the Shariah Supervisory Board of Islamic Financial Institutions (2010) Volume 17, *Journal of Financial Crime* at p 288.

[84] According to hadith of Prophets, the contracting party who was disadvantaged by lack of information has the right to annul the contract. Andrew McGosh, *Financial Ethics* (1999) Kluwer Academic Publishers at p 70. Mohammed Obaidullah, Islamic Risk Management: Towards Greater Ethics and Efficiency (2002) Volume 3, International Journal of Islamic Financial Services at p 3.

[85] Seif El-Din, Taj El-Din, Towards an Islamic Model of Stock Market, (1985) Volume 3, *Journal of King Abdul Aziz University: Islamic Economic*s at p 13.

[86] Imam Ghazali in his book Al-Ihyaa (Late 10th century) argued that hoarding is not permitted even when the commodity in question is in good supply. The hoarder will only benefit if there is a shortage of the food supply which make it grossly unethical to make money on starvation. Imam Ghazali, *Revival of Religious Learning's: Ihyaa Ulum-Id-Din,* (Late 10th century) Volume II, Dar-ul-Ishat at p 51 Translated by Fazl-ul-Karim (1993). Andrew McGosh, *Financial Ethics* (1999) Kluwer Academic Publishers at p 70.

[87] Ibn Taimiyah discusses the prohibition of coalition of buyers and sellers. He argued in his book that in such circumstances where few buyers or sellers or attempting to inflate or depress the prices, Muhtasib must act to stop the interference in the market**.** Monzer Kahf, Markets and Prices (1996) Downloaded from http://monzer.kahf.com/papers/english/market_and_prices.pdf, at p 41. Accessed on 4rth November 2011.

[88] The general principle is the monopoly is discouraged and competition is encouraged. Mohammad Akram Khan, Commodity Exchange and Stock Exchange in Islamic Economy (1988) Volume 5, *The American Journal of Social Science* at p 93.

[89] Imam Ghazali also produced a list of prohibited practices and items in his book Al-Ihyaa in late 10th century. He severely criticised the practices of hoarding, monopoly and unequal market information although there was no existence of stock market in his time. Andrew McGosh, *Financial Ethics* (1999) Kluwer Academic Publishers at p 70.

2- **Ghabn (Over Pricing):** Shariah's concept of ghabn is referred to as cheating in the market exchange by charging excessive prices thaatare higher than the prices determined by the market mechanism. The difference of price between the real price and the charged price is called ghabn. It can be negligible or excessive. The prices may be raised by lying, cheating, misrepresenting, withholding stolen information. Thus profit earned from fraud, insider trading and manipulation would be regarded as ghabn and strictly prohibited.

3- **Ikhtikar** (Hoarding) Ikhtikar is referred to as withholding necessary goods and supplies to artificially raise their prices. Shariah does not allow any form of manipulation of the natural equilibrium. The prices have to be determined by the free interplay of demand and supply. Although Imam Hanifa confined the prohibition of hoarding to food items only however in the context of the emerging Shariah compliant securities market, no doubt, a consensus may emerge that it is applicable to all classes of assets.

The Prophet has also condemned this practice in a number of Hadiths. Sahih Muslim and Abu Daud quote the Prophet, "He who hoards is a sinner (traitor)."[90] Ibn Majah also quotes him saying, "The importer in the town will be fed but the hoarder in the town will have God's curse upon him"[91]

4- **Najsh** is a form of artificial sale and purchase transactions to defraud innocent traders. This may be equated with "manipulating devices" and "manipulating transaction" under the current UK law. The perpetrator bids higher prices in the market exchange in order to induce other investors to engage in transactions and induce them to buy at higher price and make profit. It also generally raises the commoditiy prices for consumers in the markets.

It also takes the form of collusion between brokers or investors. It was one of the main reasons behind the financial disaster of 1929 in US and the financial crisis in the 16th century in UK. Shariah condemned the practices of collusion to raise prices[92] and

[90] Muslim No: 3910, Abu Daud, No 2990.

[91] Ibn Majjah, No: 2144.

[92] Sahih Muslim No 4650. There are several hadiths of the prophet condemning the practices of raising prices. He said "Whoever practices monopoly to raise the price for Muslims is a sinner." "No one practices monopoly

regarded it as interference in the natural funtion of the markets.[93] Ibn Taimiyah[94] also developed on the concept of collusion to raise the prices in the thirteen century.[95] He argued that exchange resulting from such collusion amounts to compulsion and negates mutual consent in the transactions. He also argued that the seller should not be allowed to hurt contemporary traders in the markets.[96]

5- **Tatfif** is form of manipulation where one party gives less or takes more without being detected. It detracts from fair exchange and falls foul of the Islamic code of lawfulness. This code distinguishes between the earnings with the concepts of halal and haram. Any profit made from manipulation of weight and measure is regarded as unlawful (haram). Quran articulates that "….And give full portion when you measure and weigh with a just balance. This is just and better in the end." The Quran has also allocated an entire chapter under the name of *Mutafiffin* – the defrauders and also states.[97]

"If a man intends to transgress the limits unjustly in transactions, I will give him a taste of chastisement."

---

but a sinner" whoever practices monopoly in food stuff for eighty days has disavowed God and God disavows him." Monzer Kahf, Markets and Prices (1996) Downloaded from http://monzer.kahf.com/papers/english/market_and_prices.pdf, at p 48. Accessed on 4rth November 2011.

93 Siti Farida Abdul Jabber, Financial Crimes: Prohibition in Islam and Prevention by the Shariah Supervisory Board of Islamic Financial Institutions, (2010) Volume 17, *Journal of Financial Crime* at p 288. (Footnote No 13) Also see, Mohammed Anwar, An Islamic Perspective on Capital markets and Islamic Securities in Malaysia (1995) Part II, *The Pakistan Development Review* at p 874. Shahnaz Naughten and Tony Naughten, Religion Ethics and Stock Trading the Case of Islamic Equities Markets (2000) *Journal of Business Ethics* at p 154-155. Mohammed Herwan Sukri Mohammed, Insider Trading from Malaysian Law and Islamic Law Perspective, Downloaded from Accessed on 1st November 2011.

94 Ibn-Taimiyah a Professor of Hanabali School a, who wrote about economic issues in thirteenth and fourteenth century. One of his major writing was treatise on the Hisba. Hisab is Arabic word for markets. Ibn Taimaiyyah, Public Duties in Islam: The institution of Hisba, Islamic Foundation, Leicester, 1992, translated from the Arabic by Muhtar Holland.

95 In this context, Schumpeter has argued that there is very little about the concept of market mechanism before the 18th century. Yet at the same time, it is interesting that Ibn Taimiyah had this concept elaborated in his book in the thirteenth century. Abdul Azim Salahi, Ibn Taimiyah Concept of Market Mechanism (1985) Volume 2, *Journal of Research in Islamic Economic* at p 55. Also see Barry Gordon, *Economic Analysis before Adam Smith* (1979) Lewes Reprint Ltd.

96 Ahmad Abdel Fattah El-Askar, Towards An Islamic Stock Exchange in transitional Stage (1995) Islamic Economic Studies at p 3. Monzer Kahf, Market and Prices, (1996) Downloaded from http://monzer.kahf.com/papers/english/market_and_prices.pdf, at p 47. Accessed on 4rth November 2011.

97 Imam Ghazali, *Revival of Religious Learning's: Ihyaa Ulum-Id-Din* (Late 10th century) Volume II, Dar-ul-Ishat, translated in English by Fazl-ul-Karim (1993) at p 51.

In this context, anything that is socially important is subject to the rules of Ijtihad.[98] Bearing mind the changing situations in the living conditions of society and technologically advanced markets, it is possible to extend the meaning of tatfiff to apply to inside traders and manipulators in the modern securities market.

6- **Infliction of Harm**: Shariah prohibited harm to contemporary traders from market practices. It is one of the higher objectives of Shariah to facilitate Maslahah (utility), to promote falah (prosperity) and avoid injury to others. Shariah requires the traders to be mindful of other participants in carrying out transactions and to pay heed to collective social benefit.

7- **Prohibition of Bay Ba'ad Ala Bay Ba'ad:** This was a practice where unscrupulous traders attempted to benefit from fluctuation in the price by bidding lower or higher offers. This may be equated with pump and dump schemes in the modern securities markets.

8- **Prohibition of Talaqqi-al-Rukban**: This is a practice of approaching the villagers or producers in remote areas to purchase their merchandise before it reaches the market. This was prohibited because it artificially raised the prices and harmed the market participants.[99] The Prophet ordered that products and commodities be brought to the market in order to ensure the natural equilibrium. This may be equated with insider trading in the modern securities markets.

6.5- Shariah Compliant Contractual Structures minimise Abusive Speculation

Shariah regards financial instruments and products as tools of fair exchange and emphasizes having a balanced structure to eliminate abuse and exploitation from transactions.[100] Two important features which are prohibited in any Shariah compliant trasactions are *riba*[101] and

[98] It is one of the four sources of Sunni law and is recognized as the decision making process in Islamic law. By using both the Qu'ran and Hadith as resources, the scholar is required to carefully rely on analogical reasoning to find a solution to a legal problem.

[99] Ibn Taimiyah, Al-ubaidiyah fi al-Islam (1967) Al-Matba'ah al-Salafiyyah - Cairo at p 17.

[100] Shariah aims to promote principles of socio-economic justice, balance of negotiation power, link with the real assets, equitablibility, fairness and public welfare through its contractual structures.

[101] Quran prohibits gambling in Surah Al-Baqarah: 219, Al-Maida 93-94.

gambling.[102] These elements negate their concept of justice and disrupt fair exchange.[103] Shariah compliant equity, debt and derivative contractual structures are markedly different from conventional structures and design. Although the economics (the end result) of Shariah compliant products appears to be the same, differences in mechanics (contractual structures) promote stability and minimises abusive speculation in practice.[104]

In the conventional markets, products are misused as tools to perpetrate excessive and abusive speculation leading to manipulation and distortion. This originates from unsupervised financial innovation. Since excessive and abusive speculation facilitates non-equilibrium prices, it is a form of distortion and manipulation. The regulatory framework fails to take any measures to curb this. The subsequent sections will illustrate how equity based products (riba free) minimise the occurrences of excessive and abusive speculation? Moreover how do interest based debt based products in comparison with sukuk pose a higher threat or have a higher potential for abusive speculation?

6.6- Equity versus Debt Based Product: Does Interest Facilitate Abusive Speculation in Securities Market

Interest has four characteristics. It is predetermined (ex-ante), guaranteed regardless of the productive outcome of the business venture, it depends upon the amount of money borrowed, the length of time and the conventional legal and regulatory banking system enforces it. The interest is also pivotal to the operation of the entire financial system through its instruments, products and mode of contracts. This is facilitated by the ability of the central bank and commercial banks to create money via fractional reserve on a narrow equity base.[105] The

---

[102] Quran prohibits riba in Surah Baqarah: 275-276 and Surah Ale-Imran: 130. Mohammed Anwar, An Islamic Perspective on Capital Markets and Islamic Securities in Malaysia (1995) *The Pakistan Development Review* at p 866.

[103] The Islamic concept of Justice stipulates that the items exchanged between the parties must be of equal value. By implication it is argued that products based on riba and gambling leads to unequal and unfair exchange and result in non-natural equilibrium prices.

[104] Sheikh Yusuf Talal De Lorenzo, Shariah Compliance Risk (2007) Volume 7, *Chicago Journal of International Law* at p 2.

[105] Hossein Askari, Zamir Iqbal, Noureddine Krichene, Abbas Mirakhor, *The Stability of Islamic Finance Creating a Resilient Financial Environment for Secure Future* (2010) John Wiley at p 23 and 37. Also see Iraj Toutounchian, *Islamic Money and Banking: Integrating in Money in Capital Theory* (2009) John Wiley at p 28.

banking system[106] and its refinancing techniques[107] also continually lead to expansion of credit in the financial system which is further lent on interest. Thus the interest rate regulates the supply of money for investment.

The financial institutions provide inexpensive and excessive liquidity during good economic conditions and lower it during depressed markets.[108] The empirical evidence suggests that

financial institutions monitor the fluctuation in asset value and manage provision of liquidity and their own leverage accordingly.[109] The pro-cyclical availability of credit is also connected with the monetary policy which leads to the expansion and contraction of the balance sheet of the financial institutions. The increase in interest rate reduces the supply of credit in the financial markets and lower interest rates increase its supply. The resulting liquidity has an indirect effect on the stock markets and often spills into home, shares and other assets pries.[110] This gives rise to volatility in the securities markets which leads to loss of contact with the

[106] "Banking system borrows money from the individuals, private sector, public sector, from the investors by issuing bonds. The borrowed money is used to expand credit." Maher Kababji, *Islamic Capitalism: Presentation of an alternative Economic System* (2010) Word Clay at p 24.

[107] Banks also raise money through securitisation.

[108] Islamic finance assigns a completely different role to the banks. Whilst based on the fractional reserve conventional financial institutions borrow money from the financial markets on a narrow equity base. This is more prone to creating a bubble. Moreover, they are able create credit in lending. In contrast to this, Islamic banks regard banks as central pool of nation's deposit and invest the money in the economy on profit loss

sharing basis. Adnan Khan, There are alternatives to free market capitalism, http://www.khilafah.com/index.php/the-khilafah/economy/3919-there-are-alternatives-to-free-market-capitalism at p 10

[109] Tobias Adrian and Hyun Song Shin, Liquidity, Monetary Policy and Financial Cycles, Current Issues in economics and Finance, www.nyfed.org/research/current_issues at p 1. Also see Hossein Askari, Zamir Iqbal, Noureddine Krichene, Abbas Mirakhor, *The Stability of Islamic Finance: Creating a Resilient Financial Environment for Secure Future* (2010) John Wiley at p 39, Tobias Adrian, Bubbles Caused by Cheap Cash Menace (24rth July 2006) World Economy, Reuters.

[110] Tobias Adrian and Hyun Song Shin, Liquidity, Monetary Policy and Financial Cycles, Current Issues in economics and Finance, www.nyfed.org/research/current_issues at p 1. Also see Bubbles Caused by Cheap Cash Menace, World Economy, Reuters, 24rth July 2006.

reality and is a departure from natural equilibrium.[111] Thus fluctuation in interest rates may cause credit boom and liquidity injections which may fuel speculation.[112]

The increased interest rates necessitate companies to cut back on their growth spending resulting in lower profit expectation through debt expenses or decreased consumer spending. This may reduce the future profitability of the companies. The decline in stock price appreciation or lower dividends make the stocks a less attractive investment. If this affects sufficient number of companies, it may result in a decline in the whole market or a particular index. The increased interest rates also make treasury bills and bonds more attractive. On the other hand, lower interest rates facilitate larger availability of credit and a rise in stock prices. This results in an increase in asset prices leading to asset bubbles. This illustrates the modern economies with frequent cycles of boom and bust characterised by excessive speculation leading to fluctuating prices and unsustainable growth.[113]

The current financial system enables banks to lend credit on interest to individuals[114] and institutions[115] and wields significant power in the economy. They offer credit to the securities

---

[111] Iraj Toutounchian, *Islamic Money and Banking: Integrating in Money in Capital Theory* (2009) John Wiley at p 28. Galbraith, Kindleberger and Soros have argued that "speculative mania gather speed through expansion of credit." Friedman and Schwartz have also argued that financial instability is a monetary phenomenon and result from expansion of credit. Hossein Askari, Zamir Iqbal, Noureddine Krichene, Abbas Mirakhor, *The Stability of Islamic Finance: creating a Resilient Financial Environment for Secure Future* (2010) John Wiley & Sons at p 24.

[112] Ibid at p 37. Also see Iraj Toutounchian, *Islamic Money and Banking: Integrating in Money in Capital Theory* (2009) John Wiley at p 28 and 38.

[113] The periodic dips and crashes is exemplified by the Dutch tulips, South sea bubbles, technology bubble as well as dotcom crash, subprime crisis and now the EU debt crisis. Adnan Khan, *There are alternatives to free Marker capitalism,* http://www.khilafah.com/index.php/the-khilafah/economy/3919-there-are-alternatives-to-free-market-capitalism, Wednesday, 30th October 2008.

[114] It also leads to implication for distribution of wealth and income. Please refer to the 4rth chapter for a detailed analysis of the importance of equitable distribution of wealth. Also see Umer Chapra, Challenges Facing the Islamic Financial Industry, Chapter 21 in Kabir Hassan, and Marvyn King, *Handbook of Islamic Banking* (2007) Edward Elgar at p. Chapra has argued that equitable access to credit is part of the Islamic principle of justice. Since they come from deposits of wider section of the public, its equitable access for the utility of wider section of the public must be ensured as opposed to further enrichment of the few and far. It facilitates elimination of poverty, create more employment and reduce the disparity in income and wealth. The 99% repayment rate of Garmeen bank is a testament to the success of availability of credit to the most deprived in alleviating poverty in Bangladesh. The Islamic financial instruments correct the tendency of conventional system to contribute to concentration of wealth.

[115] This explains for the reasons as to why the banks become the centre of control and nerve centre in capitalistic system. They are also major stock holders and creditors to the largest corporation on the stock markets. Umer Chapra, Challenges Facing the Islamic Financial Industry, Chapter 21 in Kabir Hassan, and Marvyn King, *Handbook of Islamic Banking* (2007) Edward Elgar at p 90.

dealers and brokers who further offer it their clients through collateralised borrowing[116] or secured lending.[117] The availability of credit on interest leads to artificial expansion and contraction in the volume of transactions, unnecessary heat in the prices and fuelling of excessive and abusive speculation on stock exchanges.[118]

Shariah attempts to curb the availability of credit leading to excessive and abusive speculation through its *principle of prohibition of interest, alternative proposal of equity based Profit and Loss Sharing contractual modes and unique economic concept of money*.[119] Moreover, it *forbids the sale of interest bearing debt based products in the form of exotic asset based securities.* Furthermore, *the contractual structure of its debt financing products (sukuk) correlates its income with the underlying assets in the real economy*. These principles are independently analysed in the fourth and fifth chapters however their positive impact in minimising excessive, abusive speculation and distortion in the price formation mechanism is analysed below.

Shariah regards interest as oppressive, unjust, and inconsistent with its notion of fairness and the equitable distribution of wealth in society.[120] It is considered as a tool of exploitation and therefore financial institutions are prohibited to pay interests on deposits or charge interest on loans.[121] The interest rewards accumulation of wealth and leads to unjust enrichment.[122]

---

[116] Ibid at p 1.

[117] The loan amount is often required to be secured on collateral which makes it difficult for less well-off members to obtain access to credit. This often favours the capitalist and the businessman. Hizb ut-Tahrir, *The turbulence of the Stock markets: Their Causes & the Shariah rule pertaining to these causes* (1998) Al Khalifah Publications at p 13. On the other hand, Islamic finance enables less well of and unprivileged to obtain funding against a feasible idea of business venture. Mohammed Yunus used the similar idea behind the success of Garmeen Bank. Abdus Samad, Norman Gardener, Bradley Cook, Islamic banking and Finance in theory and practices: the Experience of Malaysia and Bahrain (2005) *The American Journal of Social Sciences* at p 74. Eddy Yusof, Ezry Fahmy, Anwar Kamal, Islamic Finance: Debt versus Equity Financing in the Light of Maqasid-al-Shariah, Downloaded from http://mpra.ub.uni-muenchen.de/20722 at p 7.

[118] Dr Abbas Mirakhor has also argued that rapid expansion of credit and debt is detrimental to the emerging economy. Abbas Mirakhor, The Islamic Financial System and Lessons of the Recent Financial Crisis (2010) Islamonline.net.

[119] The principle of justice dictates that financiers should be made available to the poor in the society. Shariah operationalized this through abolition of interest and profit and loss sharing. Moreover, the conventional system often leads to accumulation of wealth which Shariah attempts to readdress by making financiers to share in the risk of business venture.

[120] God has declared war on those who devour other through interest. For detailed discussion, see the previous chapter of Islamic Capital markets and its principles

[121] Islam advocates Qard-e-hasna, a short duration loan for those who does not want to pay interest. This should not be mixed with the charity or Zakat. The theme is that if the money is to be lent, it should be done for productive investment purposes on the basis of PLS mode. There are two popular contractual modes for this

Keynes has also advocated elimination of ex-ante interest based debt based products.[123] In contrast to this**,** Shariah advocates provision of credit through its financial instruments which require sharing of the profit and bearing risk of real loss (PLS) from commercial activity undertaken.[124]

The PLS paradigm integrates the assets and liabilities of Islamic financial institutions. It ensures that corporations (listed on the Stock Exchange) share the profit and losses with the institutional shareholder. The institutional equity partner in turn, shares it with the depositors. It encourages the depositors to monitor the bank's investment and demand greater transparency leading to improved form of governance in evaluating loan applications.[125] It will also link the return with how effectively and efficiently resources have been allocated, viability and profitability of the projects determined by the market forces. This will reduce volatility and bring in more stability in the financial system.[126]

The PLS mode would require double assessment of risk by financiers and entrepreneurs and create a stronger discipline in the financial system. This would also make the banks take overall responsibility and social commitment. It would lead to reduction of excessive credit, unproductive lending and the un-availability of funds for abusive or excessive speculation in the financial and commodity markets. Since financial institutions are going to share the profit and loss of the corporation they have lent to, it would be in their interest to curb excessive

namely Musharakah and Mudarabah. Muhammad Mazhar Iqbal, Prohibition of Interest and Economic Rationality (2010) *Arab Law Quarterly* at p 1.

122 Ibid at p 1.

123 Abbas Mirakhor, Noureddine Krichenen, Recent Crisis: Lesson for Islamic Finance (2009) Volume 5, *Journal of Islamic Economic* at p 60.

124 It is often criticised that there is apparent similarity between shariah compliant financial instruments and riba based loans however the former promotes trade and commerce as opposed to charging interest on money without any value in return. This promotes justice between the financiers and entrepreneur. Profit earned ex-post indicates the successful entrepreneurship and creation of additional wealth. Moreover, the profit is commensurate with the level of commercial risk undertaken as opposed to ex-ante charging of interest without regard for the success of the investment. Umer Chapra, Mechanics and Operation of an Islamic financial Market (1988) Volume 5, *Journal of Banking and Finance* at p 31.

125 Umer Chapra, Challenges Facing the Islamic Financial Industry, Chapter 21 in Kabir Hassan, and Marvyn King, *Handbook of Islamic Banking* (2007) Edward Elgar.

126 A non-Muslim scholar, Rodney Wilson has argued that bearing in mind growth of bad debt, the equity financing is ethically preferable to debt based financing. This is also apart from EU debt crisis. Thus it ay argued that equity financing based on profit and loss sharing better achieve the objective of justice and social prosperity. Eddy Yusof, Ezry Fahmy, Kashoogie, Jhordy and Anwar Kamal, Islamic Finance: Debt versus Equity Financing in the Light of Maqasid-al-Shariah (2009) Downloaded from http;//mpra.ub.uni-muenchen.de/20722 at p 10.

speculation which might lead to their failure. It would also lead to more efficient stock exchanges exhibiting better quality of natural equilibrium and hence better alignment of stock prices with its fundamentals.

In the absence of PLS mode, conventional financial institutions heavily rely upon derivatives like credit default swap in order to secure them in the event of default.[127] It also leads to "too big to fail financial institutions" who often engage in excessive speculation under a false sense of assurance that the central bank will rescue them.[128] PLS contractual mode would curb both the above problems. It would also address the issue of systemic risk due to availability of excessive credit in the financial system which currently is left to be corrected by the invisible hand of the market.[129]

PLS mode is supported by the theory of two interest rates advocated by the Henry Thornton and Knut Wickscell.[130] They distinguished between the market rate of interest set by central bank and the natural rate of interest on the capital in the commodity market. They further argue that if the market interest rate is lower than the natural rate of return, expansion of credit may lead to a speculative price boom resulting in financial crisis.[131] Irvin Fisher also argued that low interest rates encourage market participants to borrow to invest and speculate which leads to exuberance in price fluctuation. Low interest rate policies were one of the reasons for Great Depression in 1929.[132] On the other hand PLS based products ensure the rate of profit is equivalent to economic growth. Such an economy has a better equilibrium and is safe from distortion caused by the difference of interest rate and the natural rate of return.

---

[127] The lending banks purchased the swaps from the hedge funds but at the same time others who were betting on the default of the debtors were also able to purchase the swaps. These swap holder sold it onto others. This exacerbated the risk and made it difficult for the hedge funds and banks to honour their commitment. Umer Chapra, The Global Financial Crisis: can Islamic Finance Help (2008*) International Journal of Economics and Management* at p 120.

[128] Karmila Hanim Kamil, Marliana Abdullah, The Subprime Mortgages and Securitization (2010) *International Journal of Islamic and Middle Eastern Finance and Management* at p 390.

[129] Umer Chapra, The Global Financial Crisis: Can Islamic Finance Help (2008) International Journal of Economics and Management at p 119.

[130] Henry Thornton (1720-1790) was an economist, banker, Member of House of Parliament and Governor of Bank of England. Knut Wickscell is a prominent Swedish economist.

[131] Hossein Askari, Zamir Iqbal, Noureddine Krichene, Abbas Mirakhor, *The Stability of Islamic Finance: creating a Resilient Financial Environment for Secure Future* (2010) John Wiley & Sons at p 17, 19, 20, 37-43. Also see Iraj Toutounchian, *Islamic Money and Banking: Integrating in Money in Capital Theory* (2009) John Wiley at p 28.

[132] Ibid at p 24.

The above proposition is also evidenced by the availability of credit on interest in securities markets in the form of margin accounts. It entails opening a margin account with a broker with the initial amount which is referred to as a minimum margin. This enables the account holder to borrow up to 50 per cent of the securities and also serve to protect the broker from any loss from the decline of the value of the securities. The remaining amount is loaned to the investor in return for the broker to pledge the purchased securities to the bank as collateral. The investor is required to maintain a minimum balance which is referred to as maintenance margin. This creates a safety net for the lending institutions in the volatile markets.

Borrowing money is not without cost. The stock buyer has to pay interest which increases the debt over-time as the interest is applied. This technically makes the margin useful for the short-term investment as it concentrates on capital increment rather than dividends. It also makes it difficult for speculators to break even in the long term. The brokers issue a margin call for a further deposit in case of decline and may sell off the securities from the margin account if the payment is not made. Conversely the investors may be able to withdraw the surplus amount from the margin account in case of a rise in the value of the securities.

Chapra argued that margin trading fuel the opportunists excessive and abusive speculative frenzies. It enables the participants of the stock exchanges to leverage their position with smaller equity leading to heat in prices. It enables participants of the stock market to engage in short term transactions, exaggerates price swings leading to erratic fluctuation and volatility. Moreover, the buying powers of the margin account holder vary daily depending on the price movement. It brings artificial expansion and contraction in the volume of transactions which does not reflect the real demand or supply and fundamental valuation of the securities.[133] It reflects a form of non-equilibrium price and erratic movement which leads to distortion in the markets.

Variation in interest rates also adds an artificial dimension of uncertainty and instability in the markets. Lower interest rates transform easy accessibility of credit into unhealthy and abnormal speculation leading to price swing. This often necessitates increase in the interest rate to bring rationality in the markets, which often makes the speculators liquidate their position. It

[133] Mohammed Umer Chapra, *Towards a Just Monetary System* (1985) The Islamic Foundation at p 95-99.

ruins some speculators whilst others flourish, often those who have access to price sensitive information in advance. This exacerbates uncertainty and instability leading to insanity in the securities markets. Professional speculators seize this opportunity to manipulate the imbalanced market to reap their profit leading to distortion. Thus availability of credit on interest keeps inflating and deflating the prices of the shares facilitating the ideal circumstances for market abuse.[134]

In this context, Bach has argued:

"If rising stock pricing has been financed by borrowed money, a downturn in the market may precipitate a major collapse in stock prices, as lenders call for cash and may place serious financial pressure on the banks and other lenders."[135] Irvin Fisher also argued that debt liquidation triggers distress selling and this may lead to recession and depression.[136] Professional speculator may take advantage of this situation by offloading their large shareholdings purchased from margin account leading to a large supply of shares and chaotically fluctuating prices. Thus a high market based on credit is more vulnerable than a cash market and is more likely to be characterised by cyclically destabilising forces.[137]

This was also evidenced by the 22 per cent drop in the stock prices on New York Stock Exchange in October 1987. The US Central Bank issued billions of dollars to the banks to make them available to the dealers to ensure availability of funds for the purchase of stocks. It enabled the system to ride the storm temporarily without highlighting the flaws of interest based banking.[138]

It is argued that adopting Shariah's approach would minimise the unnecessary speculative frenzies, and erratic price movements and bring sanity and rationality in the markets. This

[134] Hizb ut-Tahrir, *The turbulence of the Stock markets: Their Causes & the Shariah rule pertaining to these causes* (1998) Al Khilafah Publications at p 13.

[135] Ibid at p 14. Mohammed Umer Chapra, *Towards a Just Monetary System* (1985) The Islamic Foundation at p 98.

[136] Irvin fisher also argued that investment financed by debt and equity has completely different implications. He argued that boom fuelled by over indebtedness in equity and gold etc. is followed by decline in the prices often triggering the recession and depression. Hossein Askari, Zamir Iqbal, Noureddine Krichene, Abbas Mirakhor, *The Stability of Islamic Finance: creating a Resilient Financial Environment for Secure Future* (2010) John Wiley & Sons at p 24.

[137] Mohammed Umer Chapra, *Towards a Just Monetary System* (1985) The Islamic Foundation at p 98.

[138] Hizb ut-Tahrir, *The turbulence of the Stock markets: Their Causes & the Shariah rule pertaining to these Causes* (1998) Al Khilafah Publications at p 16.

means introducing 100 per cent margin requirements or introducing margin requirements with profit and loss sharing mode rather than interest. PLS mode will remove the assurance of a definite return to the banks and thus put availability of credit on a more cautious basis. The same stance is taken by the Council of Islamic Fiqh on the availability of credit on interest in Shariah compliant stock exchanges.[139] The empirical research also supports the proposition that the prohibition of the availability of excessive credit would cool off abusive speculation in stocks.[140]

Shariah supports the above stance with the rationale that credit should be used for productive investment rather than excessive and abusive speculation which causes distortion in the markets. In other words, every effort should be made to ensure that scarce credit is not used for unproductive purposes.[141] Thus availability of credit on interest breeds excessive and abusive speculation which harms investors by causing undue fluctuation leading to instability and uncertainty in the stock prices.[142] This is also evident from the financial crisis in 1930 where interest rates rose to 20 per cent and 1 million speculators were borrowing $1 Billion.[143] Similarly, the availability of credit was also identified as a key cause in the recent financial crisis of 2008.

Shariah aimed to safeguard against abuses and exploitation and subscribes to specific ways wealth can be created. [144] It regards money as a medium of exchange with no intrinsic value. It regards commodities and assets as the store of real value and uses its financial instruments to convert capital into real assets through investment or trading transactions.[145] The instruments

---

139 The Fatwa was passed in the seventh meeting held in Jeddah in 1993. See Latest Islamic Fiqh Academy Rulings on Finance, New Horizons, March 1993 (UK) at p 13.

140Mohammed Umer Chapra, *Towards a Just Monetary System,* (1985) The Islamic Foundation at p 98.

141 Ibid at p 105.

142 Shariah advocates safeguarding people from their own destruction and others in the society. Quran states "Do not thro yourself into the valley of destruction. Al-Quran: 2:195.

143 Karen Blumenthal, *Six Days in October: The Stock Market Crash of 1929* (2002) Anthem Books at 56, 59, 61-65. Hossein Askari, Zamir Iqbal, Noureddine Krichene, Abbas Mirakhor, *The Stability of Islamic Finance: creating a Resilient Financial Environment for Secure Future* (2010) John Wiley at p 24.

144 Ibid at p 42.

145 For detailed discussions, see the previous chapter "Shariah Compliant Contractual Structures in Islamic Capital Markets." Also see Razi Pahlavi Abdul and Anne-Sophie Gintz burger, Equity Based. Equity based and Asset Backed Transactional structures in Sharia compliant Financing: Reflection sin Current Financial Crisis (2009) *The Economic Papers of Australia* at p 277.

deal in real economy such as commodity, land, factories, goods and cars which transform into benefit for community. The ultimate process of manufacturing and development create employment opportunities and create social welfare and overall productivity in the economy. Moreover, the link with the real assets curbs the ability of the participants to create expansion of credit, excessive fluctuation, abusive speculation, and volatility leading to market abuse. In this context, Johnson argued that "*the transition from conception of money as a medium of exchange to money as a store of value has raised new problems*."[146]

Conventional finance deals with money, monetary paper and commodities on the same par in commercial transactions. Both are bought, sold and speculated in exactly the same way. This provides the rationale for creation of money without any corresponding wealth in the real economy.[147] Several episodes of financial instability were connected with discretionary excessive liquidity injection in the eighteenth and nineteenth century.[148] The Banking Act 1844 was brought in to control the supply of money and control credit expansion and financial crisis.[149] Similarly, US had also adopted an approach (similar to Islamic finance) of linking its currency with the Bretton wood system of gold standard exchange rate. However it unilaterally abandoned it in 1973.

This enabled the US to print huge amount of its inconvertible currency and money ceased to have any intrinsic value.[150] It set the stage for the creation of fiat money resulting in availability of excessive credit characterised by artificial inflation, speculative and chaotic mania leading to crash.[151] It also went far beyond the ability of the economy to match the rapid increase of the quantity of credit with the real assets or services.

---

146 Iraj Toutounchian, *Islamic Money and Banking: Integrating in Money in Capital Theory* (2009) John Wiley at p 28.

147 The central bank has the power to create un-backed money out of thin air. Hossein Askari, Zamir Iqbal, Noureddine Krichene, Abbas Mirakhor, *The Stability of Islamic Finance: creating a Resilient Financial Environment for Secure Future* (2010) John Wiley at p 23.

148 Ibid at p 38.

149 The Bank of England was established in 1644. The Bank Charter Act 1844 was only allowed to issue new notes if they were backed by the gold. It aimed to restrict the supply of currency. Similarly in US, Federal Reserve was established with the same view. It is also noteworthy that financial catastrophe of Great depression did not happen before the federal Reserve was established.

150 See Gulf One Investment Bank, *The Global Financial Crisis and Its Impact on the GCC*, October 2008) Research Bulletin at p 3.

151 Hizb ut-Tahrir, *The turbulence of the Stock markets: Their Causes & the Shariah rule pertaining to these causes* (1998) Al Khilafah Publications at p 25. Also see Maher Kababji, *Islamic Capitalism: Presentation of an alternative Economic System* (2010) Word Clay at p 3.

This led to disparity between the financial economy[152] and the real economy.[153] The excessive speculation has led the financial economy to grow more in value than the real economy. The situation is further exacerbated by unsupervised financial engineering which ends up providing potent tools to speculate with little money. The speculators do not wait for the dividends and instead make their profit from inflated prices.[154] Excessive and abusive speculation in conjunction with the availability of credit often leads to financial crisis. The decline in the financial economy necessitate increasing liquidity by printing more money, increased government spending, lowering of interest rate and further expansion of credit.[155]

The inter-link between interest rate, expansion of credit and excessive speculation was evidenced in the US mortgage crisis of 2008.[156] The decline in the markets in 2000, pursuant to collapse of Enron, world com, Tyco and Qwest etc. and lower interest rates directed the flow of funds to housing markets.[157] The availability of excessive credit gave rise to speculative buying and phenomenal rise in the house prices. Subsequently, the rise in interest rates from 1% to 5.35% in 2006 led to the inability of the mortgage borrowers to meet their instalments and increased defaults. The resultant crash necessitated governments to increasing liquidity

---

[152] Ibid at p 10. Financial economy means anything other than productive activities. It predominantly entails offering money on interest. 80 per cent of US economy is service based industry. The largest portion of this sector is based on financial services. Gulf Investment Bank Research Bulletin, The Global Financial Crisis and its Impact on the GCC" October 2008. http://wwwgulfbank.com/knlowledge-research-bulletin.html. Accessed on 20th March 2012. Maher De Kababji, Islamic Capitalism, (2009) Word clay at p 5.

[153] Ibid at p 7. Productive economy is the practice of converting credit into the real assets, goods and service. Hizb ut-Tahrir, *The turbulence of the Stock markets: Their Causes & the Shariah rule pertaining to these causes* (1998) Al Khilafah Publications at p 8.

[154] The world's total bond market stands at $95 trillion, the total estimated size of world stock market is £32.5 trillion and the total worth of derivative market is $1.2 quadrillion. In contrast to this, the annual word's GDP is $50-60 trillion.

[155] This encourages the investment, increasing the supply which leads to lower prices. Lower prices leads to increased demands and commensurate increase in prices. Thus the system is characterised by fluctuation of prices leading to volatility. Maher Kababji, *Islamic Capitalism: Presentation of an alternative Economic System* (2010) Word clay at p 20

[156] Abbas Mirakhor, Recent Crisis: Lesson for Islamic Finance ((2010) Volume 5, *Journal of Islamic Economics, Banking and Finance* at p. Also see Iraj Toutounchian, *Islamic Money and Banking: Integrating in Money in Capital Theory* (2009) John Wiley at p 39.

[157] Soros have argued that "such was the case in the US financial system as bubbles rolled from emerging markets debt to the dotcom, real estate and commodities markets. At each turn, bail outs, low interest rates, inflow of funds from emerging markets and financial innovation created powerful sources of funds in search of yields which poured into new asset class." Abbas Mirakhor, The Islamic Financial System and Lessons of the Recent Financial Crisis (2010) Islamonline.net at p 3.

and lowering of the interest rates to 0.5%[158] and it exposed the world to the longest period economic slowdown experienced since World War II. In contrast to this, none of the Islamic banks suffered any losses or were affected by toxic debt problem. Thus it may be argued that extensive lending on higher interest and inadequate market discipline in the absence of PLS mode was one of the root causes of the problem.[159]

Although interest is prohibited, Shariah approves of debt financing in creating employment, prosperity, economic development and alleviating poverty. It does so as long as the debt financing instruments comply with Shariah's requirement of justice with its contractual structures and its pre-conditions.[160] It uses murabaha, ijarah, istisna and sukuk contractual structures. These structures are different than the conventional debt based products and play an important role in minimising excessive and abusive speculation. They entail the purchase of real commodity and sale back at a profit margin. Shariah compliant debt financing have to comply with the following conditions.[161]

1- The transactions must finance a real asset and not fictional.[162]
2- It must be a genuine transaction with the intention of giving or taking delivery.
3- The debt cannot be sold[163] and the lender must bear the risk.

The first two conditions ensure that the lender shares in the real risk to get part of the return. It also put a restraint on short selling which often drives the prices down artificially.[164] More-

[158] It rewarded those who created the problem. Maher Kababji, *Islamic Capitalism: Presentation of alternative Economic System* (2010) Word clay at p 24-25.

[159] This led to number of investment banks to suffer total losses in the sum of $400 billion from the subprime. UBS suffered losses of $37 billion, Merry Lynch 37 Billion, Morgan Stanley $12 billion, City Group$ 38 billion, RBS $15.2 billion, JP Morgan $5.5 billion, Credit Suisse $9.5 billion and the list goes on.

[160] The promotion of equity reliance does not mean that debt financing is ruled out in Islam. Debt is legitimate but regarded as undesirable due to its consequences. Umer Chapra, The Global Financial Crisis: Can Islamic Finance Help (2008) *International Journal of Economics and Management* at p 121.

[161] Shariah permits debt financing for fixed period. Al-Quran: Surah Baqarah: 282-283. It also permits debt resulting from deferred trade irrespective of the length of duration of the debt. Muhammad Anwar, An Islamic Perspective on Capital markets and Islamic Securities in Malaysia (1995) *The Pakistan Development Review* at p 868.

[162] Umer Chapra, The Global financial Crisis: Can Islamic Finance Help (2008) *International Journal of Economics and Mana*gement at p 121.

[163] According to Hanafi, hanbalis and Shaafi jurists, sale of debt is not allowed however some of the Maliki and Hanafi jurists allowed the sale of debt as long as debt must be confirmed and debtor must accept the debt and recognise the sale.

[164] This is further elaborated in the section below.

over, a further two requirements will also put a stop to volume and value of transactions. It may be argued this may reduce the overall size of the economy. However the speculative and derivative transactions are zero sum games and do not really add anything to the real economy. Therefore credit needs to be correlated with the real economy through financial instruments and not used in speculation and gambling. The link between the contractual structures and gambling is further explored under subsequent headings.

Products with the above conditions may also keep the debt in proportionate to the real economy which will control excessive and abusive speculation. Without asset based banking, the conventional banking and securities market system provides incentive for expansion of credit and debt through leverage to asset bubbles leading with the potential for crisis.[165] This leads to non-equilibrium prices which present opportunities for the unscrupulous to perpetrate market abuse. The IMF has also argued that interest based debt contracts are susceptible to financial instability and fragility.[166]

It is also criticised that conventional debt financing in conjunction with its complicated contractual structures often lead to excessive speculation and instability. Instability leads to harm in the form of unemployment, inflation, poverty, starvation and economic downturn. The recent financial crisis which distorted the markets across the globe originated from the *sale of high interest mortgage debts* (subprime mortgages). The irresponsible lending, securitisation into exotic securities and the *subsequent sale of debt* with risk to the ultimate purchaser were identified as one of the key causes of this recent financial crisis. These securities were also labelled as toxic assets in the midst of the crisis and caused a great deal of distortion in the securities markets.

The PLS mode would have made the banks act more cautiously and cut the supply of excessive credit to the speculators. This would not have allowed irresponsible lending to climax into a full blown crisis.[167] Moreover, the prohibition on interest turned out to be the strength

---

[165] Abbas Mirakhor, The Islamic Financial System and Lessons of the Recent Financial Crisis (2010) Islamonline.net at p 3.

[166] Irvin fisher also argued that investment financed by debt and equity has completely different implications. Hossein Askari, Zamir Iqbal, Noureddine Krichene, Abbas Mirakhor, *The Stability of Islamic Finance: creating a Resilient Financial Environment for Secure Future* (2010) John Wiley at p 24.

[167] A similar example of EU debt restructuring may also be cited which has escalated into full scale crisis requiring bail out from European countries. Some have argued that this may end the euro.

of Islamic financial institutions in the build-up to the financial crisis. They were prohibited from borrowing on interest from the interbank market and were unable to hold interest bearing collateralized debt obligations. This avoided any distortion in the Shariah compliant markets and financial institutions.[168]

Scholars have set practical limits on the proportion of equity debt in modern corporations. The general perception is that the companies on the securities markets which are in debt are not Shariah compliant. However this would have drastically limited the pool of investment in Shariah compliant companies on the stock exchanges. In view of this economic reality, Shariah Advisor Boards have taken a flexible approach of a 1:3 debts to equity ratio.

The reliance on this ratio curtails the corporation's ability to generate excessive funds on a narrow equity base. The ratio of 1:3 is regarded as safe and not overly leveraged.[169] The reliance upon this equity to debt ratio and Shariah compliant debt based contractual structures insulated Islamic finance from shocks. It has enabled Islamic finance to emerge unscathed from the recent financial crisis and previous Asian Crisis of 1997. Rogoff, an economics professor at Harvard articulated that "with a better balance between equity and debt, risk sharing would be greatly enhanced and financial crisis sharply muted."[170]

The slight rise in interest and drop in the profitability of highly indebted companies can cause a massive decline in the valuation of their securities. Fluctuation in prices can affect the whole sector leading to short term volatility. Highly leveraged companies may also raise more capital by issuing high yield bonds. They are often referred to as junk bonds. It means the chance of default is higher as well as the return. It is argued that interest on debt based financing has to be paid regardless of good and bad circumstances whereas dividends can be easily varied in accordance with the level of profit in any year.[171] It reduces the riskiness of

[168] Riyaz Farooqi, Global financial Crisis Unthinkable under Islamic Banking Principles (1st March 2009) *Sunday Observer* at p 1.

[169] Mohammed Umer Chapra, *Towards a Just Monetary System* (1985) The Islamic Foundation at p 74.

[170] Munawar Iqbal, David Llewellyn, Islamic Banking and Finance (2002) Elgar Publishing Ltd at p 232.

[171] Umer Chapra, Mechanics and Operation of an Islamic financial Market (1988) Volume 5, *Journal of Banking and Finance* at p 32. Nangi Sardehi, *Islamic Capital Markets* (2008) VDM Verlag Dr. Muller Aktiengesellschaft & Co at p 13.

the entrepreneur's position and makes the companies less leveraged to sustain shocks in the event of a depressive markets.[172]

The implication of prohibition and sale of debt also means that all fixed interest securities such as bonds are impermissible. They are issued by governments and corporations and are a form of debt based financing. They offer a *pre-determined rate of interest* to the holder. The bond markets may fluctuate subject to the rise and fall of interest rate. It has also been alleged that UK and US governments have been buying their bonds before maturity and distorting their markets. It artificially lowers the interest rate and the debt is not traded subject to forces of demand and supply. In addition to this, quantitative easing also lowers the yield on the bonds. Moreover, the regulatory requirements to hold higher liquidity buffers also put artificial pressure on the financial institutions to hold risk free bonds.[173] Thus the bond market does not reflect the market forces and the true risk in loaning money. This creates distortion and artificial bubble in the bond market.

On the other hand, sukuk provides an alternative to conventional bonds for raising capital with safety and stability.[174] There has been a phenomenal rise in the issuance of sukuk in the recent years after the crisis in Middle-Eastern and western countries. Conventional bonds represent the debt of the issuer which is rated by credit agencies to measure the likelihood of default.[175] In contrast, the market appraises the value of the sukuk based on the strength of the assets, project and business plans held by the SPV.[176] It links the return with performance of

---

[172] Abbas Mirakhor, The Islamic Financial System and Lessons of the Recent Financial Crisis (2010) Islamonline.net at p 2. Umer Chapra, Mechanics and operation of an Islamic Financial Markets (1988) Volume 5, *Journal of Islamic Banking and Finance* at p 32. Muhammad Mazhar Iqbal, Prohibition of Interest and Economic Rationality (2010) *Arab Law Quarterly* at p 1.

[173] Jeremy Warner, Why Government Bond Market have become the latest Mad and Bad Asset Bubble, *The Daily Telegraph*, 22nd October 2010.

[174] Please refer to the 5th chapter for comparative analysis of structure of conventional bonds and sukuk. Chapra has criticised that sukuk may not be appropriate replacement to the Treasury bond especially where the governments need to utilise the funds for a non-profit oriented projects. Umer Chapra, Mechanics and Operation of an Islamic Financial Markets (1988) Volume 5, *Journal of Islamic Banking and Finance* at p 34.

[175] "Sukuk represents the fractional, proportionate and undivided beneficial ownership of the underlying assets, usufructs, services, projects or investment activities with the corresponding rights to income stream generated from the underlying asset." Brain Kettle, *Islamic Capital Market* (2009) Harcourt Litho Swansea at p 213. Also see Razi Pahlavi Abdul and Anne-Sophie Gintz Burger, Equity Based. Equity based and Asset Backed Transactional structures in Sharia compliant Financing: Reflection sin Current Financial Crisis (2009) *The Economic Papers of Australia* at p 274.

[176] It has been criticised that its structure bears resemblance to the asset backed securities and securitisation. For an elaborate analysis see Asyraf Wajdi Dusuki, Challenges of Realising Maqasid-al-Shariah in Islamic Capital Market: Special Focus on Equity Based sukuk, Key Note Speaker at International Islamic Management Con-

underlying debt financed assets as opposed to pre-determined interest payment on conventional bonds.[177] Moreover, the contractual structure promotes transparency, stability and certainty by giving the sukuk holder an inherent right to obtain information about the invested funds.[178] Thus sukuk creates a superior discipline in creating natural equilibrium on return from debt based financing. These contractual structures also saved the Islamic financial institutions from financial crisis.

Pahlavi and Gintzburger also argued that the Shariah compliant contractual structure offer better consumer protection vis-à-vis Shariah compliant financing techniques and securitisation.[179] Moreover, if the Shariah compliant home financing contractual modes and products were adopted, the securitisation of the loan for investment purposes would have been substantially reduced and insulated the financial institutions from the risk of crisis. Thus the key theme of the Shariah complaint securitisation is that the performance of capital should be considered whilst rewarding the capital as opposed to a pre-determined rate of return (interest).[180]

6.7- Shariah Principles and Market Abuse through Derivative Products

6.7.1- Introduction

Derivative is a generic term. It refers to financial instruments whose value depends upon the underlying asset, equity, currency and commodities. Some of the common derivatives are futures, swaps, options etc.[181] The popular view is that derivative instruments are not

---

ferece on Islamic Capital Market, 28th, 29th October 2009. Downloaded from http://uaelaws.files.wordpress.com/2011/10/challenges_of_realizing_maqasid_as-shariah_in_islamic_capital_market_final.pdf. Accessed on 20th April 2012.

177 The difference lies in the fact that income from the bond is made regardless of the income generated from the projects or business whereas the sukuk payments are directly linked with the income from the underlying assets or business.

178 Once the SPV is formed, the assets are transferred from the originator and the assets come off the originator's balance sheet. On the other hand, the securitisation of subprime debt enabled the originators to pass on the entire risk of mortgage default to the ultimate purchasers who would have been reluctant to bear such risk. This is in contrast to the conventional bond holders who are unaware of the purpose the money raised

179 Also see Razi Pahlavi Abdul and Anne-Sophie Gintz burger, Equity Based and Asset Backed Transactional Structures in Shariah Compliant Financing: Reflections in Current Financial Crisis (2009) *The Economic Papers of Australia* at p 274.

180 For detailed discussion see Karmila Hanim Kamil, Marliana Abdullah and Shahida Shahimi, The Subprime Mortgage Crisis and Islamic Securitisation (2010) Volume 3, *International Journal of Islamic and Middle Eastern Studies and Management* at p 387.

181 Derivatives derive its value from its underlying instruments. It may also include corporate bonds, payment obligation under a payment agreement, shares, indexes and interest and this list is by no means exhaustive. It

permitted in Shariah however financial engineering has made it possible to devise Shariah compliant derivatives such as arboun, wa'ad and forward contracts based on salam.[182]

The contemporary derivatives are transacted in one of the two ways in the modern financial markets: exchange traded derivatives contracts and over the counter contracts (OTC). Exchange traded contracts have to comply with the rules of exchange. The clearinghouse acts as a counter party in transactions between the participants requiring them to deposit an initial margin to cushion losses. It displays some features, which are similar to bay-salam and is classed as Shariah compliant such as standardised weight, quality and specific time and place of delivery.[183] It is argued that the guarantee function of the clearinghouse minimises gharar (excessive uncertainty and risk) in derivatives to a Shariah compliant level.[184] This in turn, minimises the potential for market abuse and is therefore permissible in accordance with Shariah.

On the other hand, over the counter derivative are traded *without* the clearinghouse and organised markets. They are tailor made contracts separately negotiated in relation to the maturity date and volume in contrast to the standardised products on regulated exchanges. Products such as swaps, forward rate agreements and exotic options are often traded on OTC markets.[185] It is argued that the absence of the clearinghouse gives rise to gharar and falls foul of Shariah. Gharar (excessive uncertainity) camouflage insider trading and market manipulation and leads to distortion in the price mechanism in the underlying markets. It is also simply a financial contract far removed from the real economy which requires no possession or delivery. These features facilitate excessive speculation leading to the formation of bubbles. They are further analysed under subsequent headings.

The contractual structures of futures, option and swaps developed mainly from the forward contracts. Forward contracts were used to facilitate exchange of commodities in the

---

includes tradable assets such as stock and commodity and non-tradable assets such as weather, unemployment rate or any kind of economic index. It is important to note that derivatives are purely financial agreement.

182 Humayun Dar, Derivatives and Shariah, Business Asia, 6th December 2010.

183 Fahim Khan, "Islamic Futures and Their Markets: With Special Reference to their Role in Developing Rural Financial Market (1997) Research Paper No 32, Islamic Development Bank at p 12.

184 This is subject to the stipulation that it is not a completely future contract.

185 Ahmad Ali Ghouri, The Law and Regulation of OTC derivatives: An Anglo-American Comparison and Lesson for Developing Countries (2010) *Nordic Journal of Commercial Law* at p 1-6.

markets.[186] Exchange promoted an economic development which leads to prosperity in the society. Shariah's view is that the financial instruments are tools to propel this process of prosperity through the spot, forward and futures markets via mutually beneficially exchange.

It is contended that conventional derivatives do not perform this function any more in the futures markets. The derivative products conform to Adam's Smith *mutually beneficial exchange* when it is used to hedge pre-existing risk and falls foul of it when it is used to excessively speculate on too much risk.[187] The excessive and abusive speculation leads to exploitation and unfair appropriation in trasactions.[188] Shariah also approves of hedging in principle and regards it as an important economic objective however it disapproves of excessive and abusive speculation resulting from the misuse of derivative instruments. This excessive and abusive speculation can be curtailed by removing non-Shariah compliant elements from their *design and structure of the market.*

6.7.2- Non-Shariah Elements of Derivatives

Shariah scholars have extensively analysed the permissibility of derivatives in Islamic capital markets. From the extensive literature analysed, two approaches appear to emerge.[189] One group of scholars has taken a more flexible approach.[190] They argued that derivatives are new

---

[186] Fahim Khan, Islamic Futures and Their Markets: With Special Reference to their Role in Developing Rural Financial Market (1997) Islamic Development Bank at p 9.

[187] Lynn Stout, The Legal Origin of Credit Crisis, Downloaded from htt://ssrn.com/abstract=1770082. Accessed on 21st July 2011.

[188] Hashim Kamali, Prospects For an Islamic Derivative Market in Malaysia (1999) Volume 51, *Thunderbird International Business Review* at p 523-540.

[189] The two groups of scholars are divided in conservative Ulama's and modern reformers. Most of the articles consulted are listed here. Fahim Khan, Islamic Futures and their Markets: With Special Reference to Their Role in Developing Rural Financial Market (2000) Research Paper No 3, Islamic Research and Training Institute. Edward Swan, *Building the Global Market: A 4000-Year History of Derivatives* (2000) Kluwer Law International. Umer Chapra, The Role of Stock Exchanges in Islamic Economy: Comments (1985) Volume 3, *Journal of Research in Islamic Economy* at p 75. Mohammed Akram Khan, Commodity Exchange and Stock Exchange in Islamic Economy (1988) Volume 5, *American Journal of Islamic Social Sciences* at p 91-92. Mohammed Taqi Usmani, Future Options Swaps and Equity Instruments (1996) New Horizon. Mohammed Obaidullah, Financial Engineering with Islamic Options (1998) Volume 6, Islamic Economic Studies. OIC Islamic Fiqh Academy, Resolution and Recommendation of the Council of the Islamic Fiqh Academy (1985-2000) Available at http://www.islamibankbd.com/page/oicres.htm, Mohammed Al-Gari, Shariah Injunctions on Futures Contracts (2006) www.islamicfinancenews.com. Rodney Wilson, Global Islamic Capital Markets (2007) www.islamicfinancenews.com, Mohammed Kahf, Islamic Stance on Commodities or Futures Market (2002)Downloaded from http://www.islamonline.net/servlet/Satellite?cid=1119503544954&pagename=IslamOnline_English-Ask_Scholars52FfatwaE%PrintFatwaE;

phenomenon and new innovation and therefore it should be dealt with by Ijtihad.[191] The proponent of this approach have criticised that classic jurist attempted to apply rules of conventional sales to this new innovation. There is no clear prohibition of derivatives in Quran and Sunnah. The proponents have also invoked the principle of Ibahah as a defence, which articulates that in the absence of clear prohibition, there is a presumption in favour of permissibility of a transaction in Fiqh-ul-Muamlat.[192] Moreover, it is argued that derivatives comply with the requirements of "exchange with mutual consent" and therefore amount to lawful transaction.[193]

Conversely, the other group has taken a very strict interpretation and argued that any contract, structure or instrument that does not comply with the established modes of contracts in Shariah such as Istisna and Salam is forbidden.[194] They have also highlighted non-Shariah components in the contemporary structure of derivatives and non-Shariah elements in the overall structure of the derivative markets.[195] This is analysed below.

6.8- Does Non-Shariah Elements in Derivative Products Facilitate Market Abuse?

There are merits and demerits to the aforementioned approaches of Shariah scholars in analysing the permissibility of derivatives. It is *hypothesized*, that in evaluating the non-Shariah elements, both set of contemporary scholars aim to minimise and eliminate the

---

190 Bacha, Kamali, Smolarski, Malaysian Securities Exchange Shariah Advisory Council and other scholars have regarded the derivative to be permissible in shariah. Please see Obiyathulla Bacha, Derivative Instruments and Islamic Finance: Some thoughts for Reconsideration (1999) Downloaded from http://mpra.ub.uni-muenchen.de/12752. Accessed on 21ts July 2011. Hashim Kamali, Islamic Commercial Law: An Analysis of Futures, (1999) *American Journal of Islamic Social Sciences* at p 197. Hashim Kamali, Prospects for an Islamic Derivatives Market in Malaysia (1999) *Thunderbird International Business Review* at p 523.

191 First and foremost recourse is to Quran and Sunnah. This would be an effort to ascertain purpose and objective from the textual sources or wording. In the absence of unambiguous and authentic prohibition, principle of Ibahah is invoked, which states that all civil transactions are allowed in the absence of clear prohibition. It simply establishes that there is no clear prohibition and the matter would be decided by juristic Ijtihad. In reaching to Ijtihad, scholars tend to support it with the established views of Shariah School of law. Alternatively, scholars must adduce independent justification in taking a fresh perspective

192 Hashim Kamali, Islamic Commercial Law: An Analysis of Futures (1999) *American Journal of Islamic Social Sciences* at p 197. Hashim Kamali, Prospects for an Islamic Derivatives Market in Malaysia (1999) *Thunderbird International Business Review* at p 523.

193 Hashim Kamali, Prospects for an Islamic Derivatives Market in Malaysia (1999) *Thunderbird International Business Review* at p 523.

194 Most notable ones are Taqi Usmani and Umer Chapra.

195 For the historical development and analysis, See Fahim Khan, Islamic Futures and Their Markets: With Special Reference to their Role in Developing Rural Financial Market (1997) Islamic Development Bank. Lynn Stout, The legal Origin of the 2008 Credit Crisis, Down loaded from http://ssrn.comabstract=1770082 Accessed on 15th July 2011.

potential for exploitation, harm, distortion and abusive activities to the contemporary investors. This is alignment with Shariah's overall philosophy to create just, orderly and equitable markets.

I have attempted to *link the non-Shariah elements* in the contractual structure and design of conventional derivatives *with their potential to facilitate market abuse*. I have also attempted to evaluate the relevance of Shariah principles in the context of the derivative market in financial exchanges. The non-Shariah elements in the contractual structures of most conventional derivative products are set out as follows. [196]

1- Derivative products defer payment and delivery of goods
2- Parties lack ownership or possession of underlying items in derivative transactions
3- Futures, options, swaps facilitate excessive and abusive speculation (maisir)

6.8.1- Deferment of Payment and Delivery Creates Excessive Gharar Leading to Market Abuse

The genesis of the contemporary futures market originated from forward sale transactions a few centuries ago. The rationale behind forward sale was to remove financial hardship for the farmers and enable them to hedge against price uncertainties. On the other hand, Shariah's approval of Salam (forward sale) goes back fourteen centuries ago. It is argued that Salam was an exception to Shariah's general principle of sale of an item not in one's possession. The approval was based on the condition that the payment must be made in advance. It is argued that the payment in advance provided certainty and removed excessive risk taking leading to more stability, and confidence to the parties' involved in forward sale transactions. Stability of the market place and investor confidence is cited as one of the key rationales and objectives of prohibition of market abuse in conventional finance.

[196] Most of the scholars have given five reasons for disputing the permissibility of derivatives. In addition to the three set out above, elaborately analysed, further two are given here for the sake of completion, Options trading is merely the right to buy or sell, for which charging fee is impermissible, Futures trading amounts to illegal exchange of one debt for another and falls foul of Shariah. Sherin Kunhibava, Balachandran Shanmugam, Shariah and Conventional Law Objections to Derivatives: A Comparison (2010) *Arab Law Quarterly* at p 326. Hashim Kamali, *Islamic Commercial Law: An Analysis of Futures and Options* (2002) The Islamic Texts Society at p xx.

It is further argued that by requiring payment in advance and setting restriction on settlement without delivery, Shariah promoted production in the exchanges whilst redistributing risks from the farmers at the same time. Since it makes delivery of the goods obligatory, it is not merely a financial contract and cannot be used to promote abusive speculation in the financial exchanges. On the other hand, deferment of payment upon delivery in conventional derivatives enables the traders to use the instrument for speculation to intensify the seasonal fluctuations and create volatility in the prices.[197] It also adds to the excessive risk element in exchange of these commodities which defies the entire purpose of the instruments. This component of derivatives often facilitates artificial hyping up of the prices leading to asset bubbles. It also provides an ideal opportunity to the unscrupulous to perpetrate insider trading and manipulation.

It is argued that that sale of non-existent goods and non-payment of price creates counter party risk as well as a network of interdependencies leading to excessive risk and uncertainity in the markets. The excessive risk and uncertainty creates an atmosphere of doubt and lack of confidence resulting in in-efficient pricing of stocks. This results in distortion of pricing mechanism. This situation can be exploited by anyone with price sensitive information.

6.8.1.1- Shariah Principles Reduce Market Abuse

Gharar has preceded the bursting of most notorious bubbles and crisis in the history of stock exchanges. Gharar is equivalent to excessive uncertainty and risktaking in stock exchanges. It leads to doubt and ambiguity for traders, institutional investors and market makers in relation to accurate pricing of stocks and commodities. Since traders can enter into derivative transactions at a low margin without paying the full payment in advance and intending to settle by payment of difference of price, it provides an ideal tool to engage in speculation leading to excessive uncertainty in the price formation mechanism. The opaque structure of the OTC market exacerbates the excessive uncertainty and disrupts the natural equilibrium in the real markets. It causes distortion and provides optimal circumstances to trade on price sensitive information.

[197] Fahim Khan, Islamic Futures and Their Markets: With Special Reference to their Role in Developing Rural Financial Market (1997) Islamic Development Bank at p 10 and 17.

The above situation is further exacerbated in the absence of regular full, timely, accurate disclosure of information and a central clearing house in the OTC derivative market. Risk trading contracts aim to diminish excessive uncertainty (gharar) and therefore participants need relevant information.[198] Since most players are banks and financial institutions, the market has been left unregulated and lacks a clear structure.[199] There is no pre-contractual information and post trade data is also not available from the exchange. The entire operation is mysterious.[200] This is a classic example of *Jahlah*, an Islamic concept, which mean that parties lack the requisite information to engage in contracts. It leads to excessive gharar in the markets.

The lack of transparency also impairs the price formation mechanism and prevents efficient market hypothesis, which may results in more knowledgeable investors being able to exploit and abuse less knowledgeable investors.[201] This may leads to asymmetry of information and turbulent and uncertain markets which provide the circumstances and background to perpetrate insider trading or manipulation.

The design of forward sale and derivatives instruments has also enabled the participants to sell non-existent goods in commodity markets, which has resulted in an astonishing growth of trade in risk. According to Bank of International Settlement, the outstanding contracts increased from USD 3.45 trillion in 1990 to USD 11.5 trillion in 1994, USD 88.2 in 1999, USD 234 trillion in 2004 and USD 670 trillion presently.[202] Suwailum argued that the real market is subject to constraints in terms of growth, production and delivery as opposed to the abstract nature of risk. This growth is facilitated by deferment of payment and delivery and settlement on price differences and faciltate excessive and abusive speculation, volatility and

[198] Chau-Hung Christophe Cheng, Information Disclosure, Risk Trading and the Nature of Derivative Instruments: From common Law Perspective (2011) *National Taiwan University Law Review* at p 1 and 48.

[199] Marcin Kalinowski, Over the Counter Derivative Market in View of global Financial Crisis, at p 1125. Ahmed Ali Ghouri, The Law and Regulation of OTC Derivatives: An Anglo-American Comparison and Lessons For developing Countries, Nordic Journal of Commercial Law at p 1

[200] Testimony of Chairman Gary Gensler before the Financial Crisis Inquiry Commission, July 1, 2010.

[201] Ahmed Ali Ghouri, The Law and Regulation of OTC Derivatives: An Anglo-American Comparison and Lessons For developing Countries (2010) *Nordic Journal of Commercial Law* at p 1

[202] Lynn stout, The Legal Origin of 2008 Credit Crisis (2011) at p 23. Downloaded from http://ssrn.com/abstract=1770082 Accessed on 21st July 2011. Also see Bank for International Settlements, Semi-annual OTC Derivatives Statistics at End-June 2010, Table 19. Available at http://www.bis.org/statistics/derstats.htm

distortion.[203] It artificially distorts asset prices and creates opportunities for the unscrupulous participants to perpetrate market abuse.[204]

It is also argued that the design of the derivative instruments tempts the participants by offering large reward without delivery. They are probabilistic betting agreements (often referred to as wagers) for the difference of price or on future events. It redistributes existing wealth without "promoting any legitimate trade and discourage the disposition to engage in steady business or labour."[205] The derivative instruments connect the different markets in highly irregular ways, for example derivatives on stocks and bonds etc.[206] The widespread use of derivatives on other financial products without delivery is also a form of gambling which reverses the laws of supply and demand and facilitates manipulation.[207]

It is also argued that most derivatives contracts are a form of zero sum contracts. The term zero-sum indicates that the party's interests are directly opposite each other and the transaction results into net transfer of wealth from one party to another. Excessive uncertainty and risk is the essence of any zero sum game. Suwailum regards derivatives as a form of gambling and the purest form of gharar. In this context, gambling is a game of chance, which enables the parties to earn profit without any effort on their part and at each other's expense. It also makes the financial system highly vulnerable and risky**.** Allais, a Nobele Laureate regarded such markets and instruments as "casinos where gigantic games of poker are being played.[208] Similarly, Lawrence pointed out, the freeing of financial markets to pursue their casino instincts has heightened the odds of bubbles leading to crisis.

Shariah's position is also exactly similar to the decision in cases in UK and US courts in 18th century. The *contracts for difference with no delivery* intended were regarded as wagering

[203] Sami Ibrahim Al-Suwailum, *Hedging in Islamic Finance* (2006) Islamic Research Training Institute at 41.

[204] Insider trading, market manipulation and distortion while undoubtedly encouraged and made easier by the growth in scale, liquidity and complexity of financial markets pre-2008 are less a cause and more in the nature of a by-product.

[205] Justh v Holiday (1883) 13 D.C (2Mackay) 346,349 cited in Lynn stout, The Legal Origin of 2008 Credit Crisis 92011) at p 13. Downloaded from http://ssrn.com/abstract=1770082 Accessed on 21st July 2011 at p 12.

[206] Sami Ibrahim Al-Suwailem, *Hedging in Islamic Finance* (2006) Islamic Research Training Institute at p 44.

[207] Ibid at p 33.

[208] Ibid at p 44.

and gambling. These contracts were regarded as null and void and unenforceable.[209] One of the judges articulated:

> We are clearly of the opinion that dealing in futures and options, as they are commonly called, to be settled according to the fluctuations of the market, is void by common law; for among other reasons, it is contrary to public policy. It is a crime – a crime against the state, a crime against the welfare and happiness of the people, a crime against religion and morality and a crime against all legitimate trade and business.
>
> This species of gambling has become emphatically and pre-eminently the national sin. …Clothed in respectability, and entrenched behind wealth and power, it submits to no restraints and defies alike the laws of God and man. *…Through its instrumentality the laws of supply and demand have been reversed and the market is ruled by the amount of money its manipulators can bring upon it*.

Stout argued that the reasons for the recent financial crisis lie in the change in the legal framework of OTC derivative legal framework, rather than financial innovation, engineering or market failure.[210] She argued that the crisis which provided the ultimate economic circumstances (as described elaborately under the next heading) for short selling and trade based manipulation were direct and foreseeable consequences of the change in law. The change in the law occurred in Commodities and Futures Modernisation Act 2000 (CFMA). Previously, common law and subsequent codification of law in the form of Commodities Exchange Act acknowledged the *social welfare* of derivatives by enforcing the disparity

[209] Sherin Kunhibava, Balachandran Shanmugam, Shariah and Conventional Law Objections to Derivatives: A Comparison (2010) *Arab Law Quarterly* at p 351. Common law decided that in relation to the transactions entailing lack of delivery of goods and settlement by payment of difference between the strike price and spot price of underlying asset are wager and gambling. Please see Green v Dyer (1828), 6 Law J Reports Kings Bench at p 345. Morgan v Ferber (1837) 6 Law Journal Reports CP 75. Irwin v William, 110 U.S 499 (1883). Section 18 of Gaming Act 1845 in UK also rendered all contracts and agreements, which were wagered as null and void. Sami Ibrahim Al-Suwailum, *Hedging in Islamic Finance* (2006) Islamic Research Training Institute at p 44.

[210] "Financial Inquiry Commission established that CFMA was one of the main reasons, among others for the financial crisis. The report also analysed that if it wesn't for CFMA, the crisis would have been of much low intensity, less destructive and could possibly be averted. The crisis is perceived as an economic phenomenon is due to the fact that mostly economist, journalist and politicians analysed the causes of the crisis." Financial Crisis Inquiry Commission (January 2011) The Financial Crisis Inquiry Report XV.

between the difference contracts (derivative contracts) and contracts where the parties intended to take a delivery.[211]

The courts in the previous centuries[212] regarded the contracts for wagers unenforceable and a form of gambling and associated them with many social and economic ills.[213] One of the main reasons Courts disallowed the contracts for difference was because of the possibility that gamblers may go so far to manipulate the underlying asset or commodity in order to win their bets.[214] It is therefore possible to argue that the manipulation and possibility to destroy value was anticipated to pose one of the serious threats from the gambling-like instruments and gamblers state of mind. The causes of the financial crisis are a demonstration of these arguments.

The traditional legal restraints prevalent for centuries on derivative trading was slowly eliminated in 1980s and 1990s and finally obliterated in CFMA 2000.[215] CFMA granted legal certainty to OTC derivatives contracts – contracts without delivery.[216] At this time, US banking regulators had warned that *"uncertainties and unintended consequences"* associated with the lack of delivery on the OTC market may lead the global financial system to a disaster.[217] Post financial crisis deliberation leading to legislation is a *testament of the Shariah stance on obligation of payment or delivery in transactions.* Title VII of the Dodd-Frank Act aims to reverse the regulatory clock by making it obligatory upon the OTC financial derivatives to go through a Futures Trading Commission approved clearing house organisation. This will perform the same contract guarantee function as an exchange thus

---

[211] This is not suggest that these futures exchanges had a smooth sailing and did not pose any problems. Farmers, small investors and business always complained that futures traders were manipulating the market and there are many instances of manipulation and cornering the market. These cases have been discussed in detail in the first chapter. It is important to note that Common law approved of hedging, as an exception. This meant the contracts where the parties would make no delivery but had genuine economic risks to hedge. Lynn stout, The Legal Origin of 2008 Credit Crisis, Downloaded from http://ssrn.com/abstract=1770082 Accessed on 21st July 2011 at p 12.

[212] Ibid at p 9-10.

[213] The participants of the derivative industry devised their own mechanism in the form clearing house guarantee to enforce such contracts. The clearinghouse function managed to contain the social cost of derivatives.

[214] Lynn Stout, The Legal Origin of 2008 Financial Crisis (2011) Downloaded from http://ssrn.com/abstract=1770082. Accessed on 21st July 2011 at p 12.

[215] Lynn Stout The Legal Origin of 2008 Financial Crisis (2011) Downloaded from http://ssrn.com/abstract=1770082. Accessed on 21st July 2011 at p 19

[216] As soon as the CFMA granted legal certainty to the OTC derivative speculation, the market grew from $88 trillion to $670 trillion.

[217] House Report No. 106-711 (2000) Part 2 at 54, Lynn Stout The Legal Origin of 2008 Financial Crisis (2011) at p 19.

minimising gharar and the potential for market abuse.[218] This is further illustrated under the next headings.

6.8.2- Lack of Ownership and Possession Facilitate Market Abuse.

The contractual design of the conventional derivatives enable the participants of the stock exchanges to sell underlying assets without owning or having possession of the objects and resale of these underlying assets with out ever taking the delivery. It is quite a normal practice to settle these derivative contracts by reversing the transaction before delivery or to settle in price differences. It is evidenced by the fact that only 1% of the participants in the derivative market settle their transactions with actual delivery.[219] The aformentioned features also remove the futures markets from the real economy and make it simply a financial contract. These two features also facilitate excessive speculation, which, in turn, causes volatility and artificially hyped up prices leading to bubbles. The excessive volatility provides ideal circumstances to perpetrate market abuse activities resulting in financial crisis. Similarly, traders in other markets such stocks, bonds, commodities and financial indexes are also able to create derivative like effect through short sales and naked short sales. This is analysed under the subsequent heading.

As analysed in the fifth chapter, Shariah has a general principle which does not permit any transfer of risk without acquiring ownership in the real assets. It ensures that instruments and transactions are embedded in real economies. It is argued that lack of observance of this principle in innovation of new financial instrument creates gharar and facilitates gambling in the financial market. The prohibition behind gambling was meant to avoid unjust and unknown consequences.[220] It also ensures that markets are fair, just and able to distribute wealth equitably.[221]

Lack of ownership, possession and delivery serves speculative tendencies and leads to rapidly fluctuating stocks, commodities and gold prices. This is due to the fact that design of

---

[218] Kamali has taken this position in relation to permissibility of derivatives in commodities market. He has quoted Ibn Taimaiyyah, eminent scholars in 12th century. He argued that the presence of clearing houses in commodities derivatives minimised gharar to a shariah compliant level.

[219] Al- Suwailum *Hedging in Islamic Finance* (2006) Islamic Research Training Institute at p 27.

[220] Al-Quran 5:90, 5:91.

[221] Mohammed Obaidullah, Islamic Risk Management: Towards Greater Ethics and Efficiency (2002) *International Journal of Islamic Financial Services* at p 6.

derivatives enables the brokers to sell the underlying assets or commodities without putting any time or energy in real economic affairs. The transactions also enable the unscrupulous participants to create volatile intensity in fluctuating prices in using these features of the instruments. The ensuing volatile circumstances enable insiders with superior price sensitive information to take advantage of the uninformed traders at very nominal cost of trading in derivatives. This asymmetry of information is used to transfer wealth through derivatives rather than adding any real value to the society.

Merton argued that the design of conventional derivatives enable the conventional financiers to separate the risk from the ownership of the underlying assets and remove the obstacles from growth.[222] Moreover, it allocates risk to the agents in the economy making it more prosperous, efficient and agents more productive. He also argued that financial derivatives transfer the risk to speculators who are in a better position to manage it and are more suited to take such risks. Furthermore, theoretically, it transfers only the existing risk and does not create any new risks and improves the allocational efficiency of the market.[223]

Suwailum strongly criticised the above proposition and argued that commoditizing risk creates a separate market in risk. He further raised the question whether creating a market in risk would mitigate the risks in general or promote the risks. He described the market in risk as a bad commodity, undesirable and social waste. The segregation of risk from the underlying assets makes wealth creation and risk management move in opposite direction. Both compete for meagre resources and ultimately result in the transfer of wealth to fewer hands.[224] It often disrupts the natural equilibrium of demand and supply resulting in artificial hypes and bubbles. This may also lead to inefficient stock prices due to artificial price rises providing an opportunity for those with price sensitive information to exploit the uninformed traders.

---

[222] Robert C. Merton, Innovation and Authenticity: Keynote Speech Eighth Harvard University Forum on Islamic Finance (April 2008) at p 1. The author argues separation of risk enables the manager to deal with it as a separate matter from capital, trade, balance sheet and income flows. It allows them to deal with a larger risk with a lower cost. Also see Husam el-Khatib, Harvard – LSE Workshop: Islamic Economic and Islamic Ethico-Legal Perspectives on the Current Financial Crisis (26th February 2009) Short Report at p 7. Also see Mohammed Taqi Usmani, Future, Option Swaps and Equity Instruments (1996) *New Horizon*.

[223] Mohammed Obaidullah, *Islamic Financial Services* (2005) Scientific Publishing Centre (2005) at p 176.

[224] As derivatives are zero sum game, since every party who gains, the counter party looses. Sami Ibrahim Al-Suwailum, *Hedging in Islamic Finance* (2006) Islamic Research Training Institute at p 28.

It is also argued that consumers, farmers and general public are better served if the risk is minimized rather than compounded. Unbundling and repackaging of the risk enable market participants to bet on any type of risk in the free nature of the market.[225] It may be the rating of any company, takeovers, mergers or weather in the city of London. It also results in a large sum of money betted on derivatives, which adds no value to society and has no relevance with the real economy and ordinary consumers resulting in un-productivity and inefficiency. Betting leads to distortion in the price formation mechanism. This combined with the zero sum[226] nature of derivative products and speculative use creates excessive uncertainty in the markets. This in turn, affects the pricing in the stock exchanges. It provides ideal circumstances for the manipulators to take advantage of the uninformed traders.

It is also argued that there is no guarantee that the risk is transferred to those who are in a better position to bear it.[227] There is a further categorisation of those who can bear it and those who are in a better position to manage the risk. For example insurance companies who take on the risk of credit defaults (swap) are in a less advantageous position to manage it in comparison with to the banks. The current legal and regulatory infrastructure results in allocating risk to those who are more willing but not able to manage it, a classical example of an adverse selection problem.[228]

The above transactions allegedly take place on the assumption that that there is a perfect symmetry of information in the financial system, which enables the parties to analyse the gravity of risk they assume. Suwailum argued the assumption is inconsistent with the reality. He argued that the asymmetry of information makes it unproductive for the transferee to analyse and manage the risk, which leads to distortion in pricing mechanism and an ineffiecint economy. Thus traders often use derivatives as instruments to exploit the asymmetry of information for manipulative activities and it results in imbalanced and uneven proliferation of risk in the entire financial markets.

6.8.2.1- Do Short Sales Lead to Market Abuse?

[225] Ibid at p 41.

[226] Mohammed Obaid -Ullah, Islamic Risk Management: Towards Greater Ethics and Efficiency (2002) Volume 3, International Journal of Islamic Financial Services at p 6

[227] Sami Ibrahim Suwailum, *Hedging in Islamic Finance* (2006) Islamic Research Training Institute at p 38 -39.

[228] Husan-El-Khatib, Harvard – LSE Workshop: Islamic Economic and Islamic Ethico-Legal Perspectives on the Current Financial Crisis (26th February 2009) Short Report at p 4.

Investors also use short sales and naked short sales to manipulate stocks and commodities. The mechanics of the practice entail investors instructing the brokers or dealers to sell a volume of borrowed stocks, commodities and other assets without *owning or ever possessing* them.[229] Generally brokers borrow these stocks from custody banks, pension funds, mutual funds and other institutional investors who want to earn interest on the cash collateral.[230] Brokers can also borrow the stocks from other customer's accounts who have used margin facility.[231] The proceeds of sale are debited to dealer's account upon which they can earn interest.[232] The short seller hopes to profit from the decline of the prices and buys back the securities at a later stage from the market at a much lower price. The borrower is allocated three days after the completion to buy back the shares and return. It is called "covering the short" or "covering the position."

On the other hand, naked short selling is also a similar practice. It entails selling the securities without ever borrowing it, which means that seller often, fails to deliver.[233] In fact the seller is trading a promise to deliver the shares as opposed to real shares. The delivery is required by the third day of the settlement when the buyer pays the amount and becomes the beneficial owner.[234] The buyer becomes entitled to the dividend and voting rights. The lender of the stock is also entitled to dividend until the shares are purchased and returned. The equivalent of the dividend amount is deducted from the short seller and paid to the lender. It is called "shorting the dividend." Depository Trust and Clearing Corporation release no data on settlement failures.

---

[229] In US, investors often ask the brokers to find the stock shorted. This is referred to as locate. Brokers allow their retail customers to sell the stock short. Emilios Avgouleas, A New Framework for the Global Regulation of Short Sales: Why prohibition is Insufficient and Disclosure Insufficient (2010) *Stanford Journal of Law, Business & Finance* at p 3.

[230] The borrower generally puts up cash collateral of 102 % of the value of the stock, which is generally invested by the lender. Lenders often retain some interest as a compensation for lending the stocks.

[231] Generally margin agreement enables the brokers to lend their customers stocks without asking their permission. One of the SEC requirements is that customer has borrowed from the brokerage account however, in case of fully paid of accounts, brokers must have express permission of the customer.

[232] In the mean time, the lender does not lose the right to sell the security and in any such event, broker is able to transfer securities from a large supply of securities.

[233] There can be number of reasons for failure of delivery. It can be routine failure, long failures, economic failure and manipulative failure. James Angel, Douglas McCabe, The Business Ethics of Sort Selling and Naked Short selling (2009) Volume 85, *Journal of Business Ethics* at p 242.

[234] In most cases there is no hard and fast rule which states that share have to be delivered by certain date. SEC Rule 242.203 gives the seller up to 35 calendar days to deliver the shares before requiring the brokers to buy in.

The practice is often used as a conduit for trading on inside price sensitive information, which if made public would have adverse effect on the price of the securities. It is also used as tools to depress the stocks and commodities prices.[235] The short sales overpower the buying interest in the market and push the prices artificially down. Theoretically, if they have access to a large supply of credit they can crash the price to zero. Similarly, manipulators often use naked short sales to trade phantom shares without ever borrowing them and pushing the prices falsely down. The freedom to sell large quantity of shares by deferring the intention to deliver can be used as a potent tool to exploit the uninformed traders. They also overwhelm the buying interest by continuing to short the infinite number of stocks and completely manipulate the market.[236] Thus large quantity and speed of execution can be used as a tool for manipulating prices downward.[237]

Seasoned equity offerings (SEO) present an ideal opportunity for short sellers to manipulate the share price. SEO is a new equity issuance by an already trading company and generally the price of the stock is set at a discount of 3% to the trading stocks.[238] The existing shareholders have the right to buy a certain number of shares at a certain price. Short sellers take advantage of this price difference and sell short with out any fear of the market moving against them. They buy at a lower price at a later stage and exploit the ordinary traders in the market. It results in lower offer price and lower capital generated from the SEO.[239] Therefore it presents a serious risk to market stability.

---

[235] IOSCO, Technical Committee, Regulation of Short Selling – Consultation Report, Appendix III 24rth March 2009 at p 22.

[236] James Angel, Douglas McCabe, The Business Ethics of Sort Selling and Naked Short Selling (2009) Volume 85, *Journal of Business Ethics* at p 242.

[237] Emilios Avgouleas, Short Sales Regulation in Seasoned Equity Offerings, *Corporate Law and Finance in the UK and EU* (2011) Oxford University Press at p 127.

[238] Shiva Kumar hypothesized that firms overstate their earnings prior to SEO. Lakshmanan Shiva Kumar, Do Firms Misleads Investors by Overstating Earnings By Seasoned Equity Offerings, Down loaded from

http://faculty.london.edu/lshivakumar/ernmgmt.pdf Downloaded Accessed on 11th July 2011. Also see Michael Gombola, Hei Wai Lee, Feng-Ying Lui, Evidence of Short selling by Managers after Seasoned Equity Offerings (1997) Downloaded from http://www.jstor.org/stable/pdfplus/3666212.pdf?acceptTC=true Accessed on 11th July 2011.

[239] Emilios Avgouleas, Short Sales Regulation in Seasoned Equity Offerings, *Corporate Law and Finance in the UK and EU* (2011) Oxford University Press at p 118 and 131,

Several studies carried out also substantiated the existence of insider trading associated with short selling.[240] Christopher, Ferri and Angel proved in their test that there is a massive increase in short selling before a negative earning announcement which proves that short sellers are better informed then the ordinary investors and have access to price sensitive information. Moreover, more recent studies of Henry and Koski also proved that short sellers make a profit as a result of price sensitive information or manipulative trading and SEC Rule 105 is not fully effective in prohibiting this practice.[241]

It is also argued that manipulators often use active smear campaigns in conjunction with the short sales, which is intended to spread negative information about the company.[242] The proponents argue that price rebounds when the short sellers buy it back to cover the short position. Besides this, the other investors may also notice it and start purchasing the depressed stocks, which enable the market to discover the true value of the stocks. The ability to sell an infinite number of shares enable them to engage in "short and distort" campaigns, which are often accompanied with false and misleading information about the company. It is also regarded as an abuse of a legal loophole in the settlement system.[243] Therefore it is argued that banning such short selling would eliminate the incentive to perpetrate market abuse.

Avgouleas analysed how the practice can be used as a tool to destabilise the orderly market by putting a downward pressure on stock prices.[244] Long investors are unwilling to take a position due to continuous decline and often close their position, which often intensifies the

---

[240] Stephen Christopher, Michael Ferri, James Angel, Short Selling Prior to Prior to Earning Announcement (2004) Volume 59, *Journal of Finance* at p 1845. Michael Gombola, Hei Wai Lee, Feng-Ying Lui, Evidence of Short selling by Managers after Seasoned Equity Offerings (1997) Downloaded from http://www.jstor.org/stable/pdfplus/3666212.pdf?acceptTC=true Accessed on 11th July 2011 at p 1. Also see Emilios Avgouleas, A New Framework for the Global regulation of Short Sales: Why Prohibition is insufficient and Disclosure insufficient (2010) *Stanford Journal of Law, Business and Finance* at p 43.

[241] Emilios Avgouleas, Short Sales Regulation in Seasoned Equity Offerings, *Corporate Law and Finance in the UK and EU* (2011) Oxford University Press at p 131. Also see James Angel, Douglas McCabe, The Business Ethics of Sort Selling and Naked Short selling (2009) Volume 85, *Journal of Business Ethics* at p 246.

[242] Ibid t p 131.

[243]James Angel, Douglas McCabe, The Business Ethics of Sort Selling and Naked Short Selling (2009) Volume 85, *Journal of Business Ethics* at p 239 and 246.

[244] One such example is 2008 financial crisis when this perception was strengthened that short sales result in precipitous decline in the share price. Emilios Avgouleas, A New Framework for the Global regulation of Short Sales: Why Prohibition is insufficient and Disclosure insufficient (2010) *Stanford Journal of Law, Business and Finance* at p 37. Auto Bris, William Goetzmann & Ning Zhu, Efficiency and the Bear: Short Sales and Markets Around the World (2007) Volume 62, *Journal of Finance* at 1029.

situation. It may have a contagious affect on the specific sector and affect the investor confidence in the general market.[245] SEC has received numerous complaints about practices connected with short selling and naked short selling. The Chairman has stated: "Generally, this abusive practice which involves short selling while knowingly and intentionally failing to have stocks available for delivery with in the standard three days settlement period, is a fraud that the commission is bound to prevent and punish."[246]

It is also argued that short selling increases the unethical activities and adds to the misery and loss of contemporary traders. Insiders use this tactics to trade on price sensitive information and cause the price to decline. It also harms the corporation and indirectly the shareholders, managers and employees. It has strong resemblance to gambling as the short sellers cannot possibly have legitimate expectation to profit as the market may move against them. One's gains at the other trader's expense makes it a zero sum-based practice. It often results in a transfer of wealth from less informed investors to wealthy investors with price sensitive information. In most cases, it is a conduit for insiders to trade on price sensitive inside information.

Short sellers also serve to exacerbate the fluctuation in the price of the stocks and this leads to volatility.[247] It is strongly connected with market performance. Volatility increases when the stock prices falls and declines when the stock prices rise.[248] Risk increases with the volatility and return drops. It also increases the bid-ask spread and decreases the trading volume.[249] It may also give wrong signals to the investors and results in allocational inefficiency in the Islamic Capital market[250]

---

[245] Emilios Avgouleas, Short sales Regulation in Seasoned Equity Offerings, *Corporate Law and Finance in the UK and EU,* (2011) Oxford University Press at p 127.

[246] Congressional Record, Senate, 20th July 2007 at p S9646.

[247] Auto Bris, William Goetzmann & Ning Zhu, Efficiency and the Bear: Short Sales and Markets around the World (2007) Volume 62, *Journal of Finance* at 1029.

[248] James Angel, Douglas McCabe, The Business Ethics of Sort Selling and Naked Short Selling (2009) Volume 85, *Journal of Business Ethics* at p 245.

[249] Steven Lecce, Andrew Lepone & Reuben Segara, The Impact of Naked Short sales on Returns, Volatility and Liquidity: Evidence from the Australian Securities Exchange (2008) Presented at 21st Australasian Finance and

Banking Conference 2008. Downloaded from http://papers.ssrn.com/sso13/papers.cfm?abstract_id=1253176. Accessed on 15th July 2011.

[250] Lynn Stout, Betting the Bank: How the Derivatives Trading under condition of Uncertainty Can Increase Risk and Erode Returns in Financial Markets (1995-1996) Volume 21, *Journal of Corporation Law* at p 53.

6.8.2.2- Is there a Shariah Approach to Short Sales which Can Reduce Market Abuse?

Shariah's stance of requiring possession before resale of the securities, assets and commodities would automatically prohibit the short selling in Shariah compliant secondary markets and associated market abuse. This view is based on a number of hadiths.[251] There is a general juristic consensus on the rationale behind the hadith however views differ as to its applicability to foodstuff and non-foodstuffs.[252] The rationale is based on the fact that the market may become so illiquid in the asset sold short that trader may not be able to fulfil his obligations. On the other hand, the market may move against the short seller making it impossible for him to deliver. This situation becomes worse if the trader has taken a very large short position. It disrupts the market, resulting in defaults leading to bankruptcies of leveraged investors. It is a classic example of gharar leading to market abuse.

In this context, it is further argued that Shariah's requirement to have possession before sale or resale of the commodities market would also put a stop to market abuse activities associated with short selling. It would end the unethical practice of raising profit from the decline of a company's stocks. It is an immoral and corrupt practice for pension and funds managers to loan shares for a fee, which facilitates short selling and causes decline in the value of the same shares. Critics have drawn analogies of short sales with Salam and Istisna, however Shariah scholars distinguished Salam on the premise that the payment is fully made in the above contractual modes compared to margin payment in short sales.[253]

Naughten and Naughten argued that the sale of assets, commodities and securities without owning them or without any intention of ever delivering does not comply with Maslahah, an important rationale of Shariah. Chapra has also disapproved of the permissibility of short selling and regarded the lack of possession component as non-Shariah compliant. "Maslahah" and "Sad-al-dhari" provide criteria for approval of financial practices and financial

[251] Sherin Kunhibava, Balachandran Shanmugam, Shariah and Conventional Law Objections to derivatives: A Comparison (2010) *Arab law Quarterly* at p 328- 332.

[252] Imam Malik has interpreted the hadith to apply to foodstuff only.[252] Ibn Rushd also reiterated this stance by articulating that only foodstuffs cannot be resold without taking possession which means non-foodstuff may be sold without taking possession. Imam Shaafi has interpreted the hadiths more strictly and argued that it applies to foodstuffs as well as land and garden etc. Critics have argued that real estate does not pose any gharar and therefore there is no need for possession before resale. Ibn Taimaiyyah has dissented from the majority view above. On the other hand, Hanafi school of thought does not regard it as an essential requirement for the sale at all.

[253] Shahnaz Naughten and Tony Naughten, Religion, Ethics and Stock trading: The Case of an Islamic Equities Market (2000) *Journal of Business Ethics* at p 153

instruments. Maslahah refers to social utility and legitimate benefit from the practice or transaction whereas Sad-al dhari refers to obstructing the practice that may cause social harm and degradation. It is argued that the benefits of short selling are outweighed by the harm it entails to the contemporary investors and society.[254]

Shariah takes a strict approach in prohibiting harm and unfairness and it took measures to ban such practices fourteen centuries ago. Proponents of short sellers argue that it complies with Maslahah when the investors incorporate negative information in their trades. They perform a socially useful activity by carrying out research to figure out that stock is overvalued.[255] It prevents the less informed investors from having to purchase the overpriced securities and reflects the intrinsic value of the security. In addition to this, short sellers are the first line of defence against "pump and dump" manipulative schemes.[256] Moreover, proponents also argued that short sellers also provide liquidity[257] and dampen volatility.[258] This practice also keeps the derivative prices in alignment with the underlying assets.

Classical Shariah Scholar's have argued that the essence of all this hadith prohibiting transactions lacking possession is based on "sell not what is not with you."[259] The rationale behind this hadith is to avoid gharar in the markets. Moreover, the markets in Medina were small in those times and bearing in mind the perishable nature of the food products, there was a genuine reason for excessive uncertainty due to lack of delivery. This is not the situation in

---

[254] James Angel, Douglas McCabe, The Business Ethics of Sort Selling and Naked Short selling (2009) Volume 85, *Journal of Business Ethics* at p 242.

[255] Ibid at p 239. Also see Emilios Avgouleas, Short Sales Regulation in Seasoned Equity Offerings, in Dan Prentice & Arad Reinsberg, *Corporate Law and Finance in the UK and EU* (2011) Oxford University Press at p 125. Boehmer, Jones and Zhang analysed the data from Jan 2000- April 2004 for NYSE short sales. They articulate that short sellers, as a group, are more aware investors about the fundamentals.

[256] James Angel, Douglas McCabe, The Business Ethics of Sort Selling and Naked Short selling (2009) Volume 85, *Journal of Business Ethics* at p 241.

[257] Emilios Avgouleas, Short sales Regulation in Seasoned Equity Offerings, *Corporate Law and Finance in the UK and EU* (2011) Oxford University Press at p 118. International Organisation for Securities Regulations also acknowledged that short selling brings about efficient price discovers, mitigation of bubbles, increase market liquidity and ensure hedging. IOSCO, Technical committee, Regulation of Short Selling – Consultation Report, Appendix III 24rth March 2009 at p 5 and 22. US Office of Economic Analysis has carried out studies that impact on price is very minimal. Office of Economic Analysis, Analysis of short sales price test using intraday quote and trade data" 17 December 2008.

[258] Emilios Avgouleas, Short Sales Regulation in Seasoned Equity Offerings, *Corporate Law and Finance in the UK and EU* (2011) Oxford University Press at p 125

[259] Sherin Kunhibava, Balachandran Shanmugam, Shariah and Conventional Law Objections to derivatives: A Comparison (2010) *Arab law Quarterly* at p 322.

the current markets and therefore there is no reason for hatred, animosity and injustice in the market place and society.[260]

On the other hand, another group of Shariah scholars[261] argued that lack of possession (or Qabd) in the commodities derivatives market does not lead to gharar in the current regulatory environment. They criticised that most scholars have applied the above hadith superficially and failed to take it to its logical conclusion. The hadith on requirement of possession before sale has been interpreted in three ways.

Firstly, the scholars interpret that the basic purpose of the sale is to transfer ownership. It transpires that if traders are not in a position to sell anything that is not in their possession, it amounts to gharar and is not a valid sale. This literal interpretation would prohibit Salam and Istisna as well. Secondly, the hadith does not apply to fungibles and commodities markets since they are easily replaceable. It only applies to the subject of sales, which are difficult to obtain. The third interpretation analyses its applicability to the derivatives in the commodities market. They argued that the hadith was intended to apply to the normal sales mechanism rather then the mechanics of derivatives markets.

Kamali supported the third interpretation in the context of the commodities market. He also endorsed Ibn Tamayah's view, which articulates that qabd (possession) is a flexible requirement and linked to prevailing commercial reality and custom and norms. He articulates that derivatives are a new phenomenon and classical jurist are attempting to apply rule of conventional sale to the new innovation. Futures trading in the commodities market takes place in standardised quantity, quality and *the requirement of qabd is fulfilled by the guarantee function of the clearinghouse.* It eliminates any gharar over fulfilment of contracts due to vagaries of climate, politics, and chance.

Moreover, the brokers, registered with the centralised exchange, *establish their financial ability and their legal capacity to fulfil the contract*. In addition to this, the availability of data providing equality of information, margining and marking to market diminish excessive

[260] Al-Quran 5:90, 5:91**.**

[261] Mohammed Hashim Kamali, Islamic Commercial law: An analysis of Futures (1997) Volume 13, American Journal of Islamic Social sciences at p 197. Mohammed Hashim Kamali, Prospect for an Islamic Derivative Markets (1999) Volume 41, *Thunderbird International Business Review* at p 528. Mohammed Hashim Kamali, *Islamic Commercial Law: An analysis of Futures and Options* (2002) Islamic Text Society.

uncertainty from lack of possession of subject matter to ensure that no distortion of market take place. Furthermore, the technological improvement may bring forward a more innovative way of taking possession, which may become a customary norm in conventional finance and also find approval in Shariah subject to the requirement that it is devoid of gross uncertainty and risk.[262]

It is also argued that the recent ban on short sales pursuant to the onset of the financial crisis is a testament to Shariah's stance of transactions involving lack of ownership leading to excessive gharar and market abuse.[263] UK regulators issued a ban on short selling in financial stocks and disclosure obligation of short sales position in excess of 0.25%. FSA described it important for stability of the markets and orderly operation and to avoid the crisis of confidence. The ban expired after a month and disclosure obligation remained in place for 7 months.[264] FSA cited market abuse as one of the main reason for the ban in the uncertain economic circumstances. SEC also banned short selling in 799 financial companies.[265]

In this context, it is important to notice that FSA ban also applied to short sales through derivatives whereas SEC did not.[266] EU Parliament has also voted to ban short selling and naked short selling in March 2011, pursuant to the Greek bond crisis.[267] In addition to this, Commis-

---

262 Hashim Kamali, *Islamic Commercial Law: An Analysis of Futures and Options* (2002) The Islamic Text Society at p 211.

263 The practice has been controversial from the beginning of equities trading in 1610 in Amsterdam. The fist ban came along in 1610 at the request of East India Company. Subsequently, the Dutch Government imposed a tax to discourage the short selling. Throughout the history, there has been number of bans on the practice with the most recent one in 2007 in UK and US. The financial crisis, pursuant to collapse of Lehman Brother and financial troubles of AIG in September 2008, was the turning point in view in favour of regulating short sales around the globe.

264 UK Ban on Short Selling, downloaded from http://news.bbc.co.uk/1/hi/business/7812816.stm, Accessed on 11th July 2011, Short Selling Ban to be Lifted. Downloaded from http://news.bbc.co.uk/1/hi/business/7812816.stm. Accessed on 11th July 2011. Peter Thal Larson, UK Ban of short Selling of Financials (September 2008) Downloaded from http://www.ft.com/cms/s/0/3652c4d8-85e3-11dd-a1ac-0000779fd18c.html#axzz1RuJlxVZ5. Accessed on 11th July 2011. FSA Confirms the Extension of Short Selling disclosure Regime (14th June 2009) Downloaded from http://www.fsa.gov.uk/pages/Library/Communication/PR/2009/009.shtml. Accessed on 11th July 2011.

265 After the collapse of Lehman Brother, Merry Lynch rescue of AIG, SEC and FSA and EU regulators came under enormous pressure.

266 Emilios Avgouleas, A New Framework for the Global Regulation of Short Sales: Why prohibition is Insufficient and Disclosure Insufficient (2010) *Stanford Journal of Law, Business & Finance* at p 5.

267 EU Votes to Ban Short Selling (8th March 2011) Downloaded from http://www.securitieslendingtimes.com/securitieslendingnews/article.php?article_id=21707, Accessed on 11th July 2011. For a detailed discussion of the effect of short sales on liquidity and the market in general, pursuant to 2008 crisis, Please see Emilios Avgouleas, A New Framework for the Global Regulation of Short Sales: Why prohibition is Insufficient and Disclosure Insufficient (2010) *Stanford Journal of Law, Business & Finance* at p 5.

sion of European Securities Regulators (CESR)[268] and the International Organisation of Securities Commission (IOSCO) also consulted on the most suitable way of regulating short sales. Avgouleas differs with Shariah's view of banning short sales and endorses the IOSCO proposal that disclosure and the strict settlement regime with penalties would be more appropriate rather than a total ban.[269]

Shariah has taken a more conservative and fairer approach to ban this practice, even in normal economic circumstances to ensure certainty and prevent market abuse. It regards the practice as paying homage to naked greed and is the equivalent of exploiting and transferring wealth from ordinary investors by hedge funds.[270] Moreover, the so-called practice is used to squeeze every drop from the productive economy.[271]

It is also argued that pursuant to financial crisis, attempts have been made to cut back on excessive risk taking to introduce certainty by stringent regulation in the OTC derivative markets. In this context, one of the lynchpins of Dodd-Frank Wall Street Reforms and Consumer Protection Act 2011 is to introduce a concept of on exchange for OTC derivatives.[272] Central Counter Party (CCP) will comply with the core principles of eligibility, risk management (credit exposure, margin requirement, monitoring of members), default resolution, settlement procedure, reporting, record keeping, disclosure and sharing of information etc. CCP will also play its part in the product design, provide information about prices of the trades and more importantly, trading venue for the authorised parties.[273] They in turn, will comply with the rules of risk management, record keeping, monitoring and surveillance by the exchange to put a stop to insider trading and manipulation.[274] This view coincides with the Kamali's view of the clearing house diminishing gharar to a Shariah compliant level.

[268] CESR, Call for Evidence–Regulation of Short Selling by CESR Members, December (2008) CESR/08 -1010

[269] Emilios Avgouleas, A New Framework for the Global Regulation of Short Sales: Why prohibition is Insufficient and Disclosure Insufficient (2010) *Stanford Journal of Law, Business & Finance* at p 45.

[270] Emilios Avgouleas, Short sales Regulation in Seasoned Equity Offerings, *Corporate Law and Finance in the UK and EU* (2011) Oxford University Press at p 118.

[271] George Monbiot, Downloaded from http://www.guardian.co.uk/commentisfree/2011/feb/15/condemns-naked-short-selling-not-treasury Accessed on 11th July 2011.

[272] Hal Scot, A General Evaluation of the Dodd-Frank US Financial Reform Legislation (2010) *Journal of International Banking Law and Regulation* at p 1.

[273] Christopher Culp, OTC Derivatives: Benefits, Costs, and Implication of the Dodd-Frank Wall street Reform and Consumer Protection (2010) Volume 2, *Journal of Applied Finance* at p 21.

[274] Ibid at p 3

On the other hand, Exchange traded derivatives also comply with the requirements of contract expiration dates, minimum price, quantity, quality, deliverable grade of underlying etc. These are the same requirements prescribed for Shariah products such as Salam and Istisna. They aim to remove prevailing legal and regulatory uncertainty in the OTC market and which also contributed to the financial crisis. These are sweeping changes. The OTC market may not be fully Shariah compliant because of sale of underlying assets based on debt. However, the over all approach to regulate this markets is not too far from the Shariah principles interpretation of Ibn Taimaiyyah which emphasises reducing gharar, which often leads to market abuse and unknown consequences.[275]

6.8.3- Derivatives Speculation Contravenes Shariah and Facilitate Market Abuse.

Speculation reflects a mental activity where traders formulate their judgement about the future direction and prospects of their investment in analysing risk involved in buying and selling. Cootner defined it as "the purchase and sale of an asset in the expectation of gain from changes in the price of that asset."[276] Speculators are not interested in the goods, underlying assets or variables and are simply interested to maximise profit from the fluctuation in the price on the stock exchanges. Gains for small speculators often depends on price sensitive information, experience, study, luck, chance, rumours or coincidence whereas the big speculators often use these instruments to corner, squeeze, manipulate and exploit the rest of the market.

Speculators do not abide by any religion or ethics and may resort to monopoly, deceit, rumours, misleading information and abusive activities to maximise their gains.[277] This philosophy accompanied with derivative instruments often transforms selling into betting and is regarded as Maisir[278] which facilitates manipulation.[279] Speculation is not an unlawful or

[275] Excessive risk and uncertainty often leads to enmity, injustice and hatred. Al-Quran, Al-Maeda 5-90-91

[276] Cootner, Speculation, Hedging and Arbitrage (1968) Modern Encyclopaedia of Social Sciences For a detailed discussion of the definition of speculation, Please see Rafic Yunus-al-Masri, Speculation Between Proponents and Opponents (2007) *Journal of King Abdul-Aziz University* at p 44. John Kenneth Galbraith, *A Short History of Financial Euphoria* (1993) *Penguin Books at p 4.*

[277] Rafic Yunus-al-Masri, Speculation between Proponents and Opponents (2007) *Journal of King Abdul-Aziz University* at p 51.

[278] Obaidullah argued that "the provision of hedging facility is hardly any rationale for tolerating Qimar and Maisir." Sami Ibrahim Al-Suwailum, *Hedging in Islamic Finance* (2006) Islamic Research Training Institute at p 52.

objectionable activity per se and it is difficult to enforce any law against the intention to undertake risk in buying.[280]

The difficulty arises in distinguishing between the investments, speculation and gambling.[281] The intention to speculate from the intention to invest becomes evident when the trader sells the stocks, commodity or assets after exploiting the short-term price difference.[282] The commitment in terms of time often distinguishes the investors from the speculators however the difference between speculations and gambling is regarded as very subtle.[283] Shariah has drawn analogies between the motivation behind derivative speculation and the intention behind gambling.[284]

As analysed in the fourth chapter, gambling leads to numerous social ills and serves no useful purpose for society.[285] Gamblers seek to make profit through wagering or betting on socially non-productive risk.[286] There are many features of derivative speculation which are analogous

---

[279] Rafic Yunus-al-Masri, Speculation between Proponents and Opponents (2007) *Journal of King Abdul-Aziz University* at p 48.

[280] The intention of the speculator is to simply maximise their profit without any loyalty. Hizt-ul-Tahrir, *The Turbulence of the Stock Markets: their causes and Shariah Rule pertaining to these causes.* Deluxe Publications at p 11.

[281] For a detailed discussion, please see Al-Suwailum, *Hedging in Islamic Finance* (2006) Islamic Research Training Institute at p 61.

[282] Mohammed Hashim Kamali, *Islamic Commercial Law: An Analysis of Futures and Options* (2002) The Islamic Text Society at p 147-149. Mohammed Akram Khan, Commodity Exchange and Stock Exchange in Islamic Economy (1988) Volume 5, *The American Journal of Islamic Social Science* at p 101. It is also argued that speculation on prices is the most important part of stock exchanges as is interest of commercial banks.

[283] The investor buys shares to reap dividend and in times make profit from capital gains however the speculator simply intend to make capital gain from the fluctuation in prices. For a detailed discussion, please see. Rafic Yunus –al-Masri, Speculation between Proponents and Opponents (2007) *Journal of King Abdul-Aziz University* at p 45, 46 and 47.

[284] Quran states: they ask you concerning wine and Maisir, in them is great sin and benefit to the people but the sin and ham is greater than benefits. Al-Quran 2:219.

[285] One of the reason the common law Courts articulate for not enforcing the derivative contracts was the “it promotes no legitimate trade and discourage the disposition to engage in steady business or labour” Justh v Hollidaz, 13 D.C (2Mackay) 346 349. It has also been argued that derivative contracts are socially detrimentally and grave welfare consequences. It is regarded as rent seeking activity, which drains the skills, human ingenuity and money. It often becomes negative sum game and diminishes the social welfare. Derivatives speculation increased risk and often leads to bankruptcies. Lynn Stout, How Deregulating Derivatives Led to Disaster, and why Re-Regulating Them Can Prevent Another, Lombard Street at p 5. Lynn Stout, The Legal Origin of Credit Crisis (2011) at p 11. Downloaded from http://ssrn.com/abstract=1432654. Accessed ón 21st July 2011.

[286] Kamali have disagreed with this view in the context of commodities market. He argued the derivatives speculation in commodities is not gambling. Mohammed Hashim Kamali, *Islamic Commercial Law: An Analysis of Futures and Options* (2002) The Islamic Text Society at p ix-xxi and 147-155. Also see Hashim Kamali, Prospects for an Islamic Derivatives market in Malaysia, and (1999) *Thunderbird international Business Review* at p 523-540. Thomas Lee Hazen, Rational Investment, Speculation, Or Gambling – Derivative

to a gambling. Both intend to take on large risk in the hope of making large rewards upon a chance without making much effort, excitement of winning the game, gross uncertainty and misappropriation of other's properties in the form of the zero-sum nature of the winnings leading to potential for greater financial losses.[287] In this context, Suwailum argued that derivatives are a perfect tool for gambling.[288]

Ibn Taimiyah has argued that any instrument or sale structure that deals in excessive risk (gharar) and also involves appropriation of other's property becomes indistinguishable from gambling.[289] Obaidullah also articulated that unfettered (excessive and abusive) speculation is actually gambling.[290] In this context, the current derivative structure exhibis strong similarities with the above features. It predominantly deals in excessive risk and is zero-sum in nature.[291] Opposing parties in the derivative transactions transfer wealth from each other by betting on the direction of the market.[292] Similar to this, manipulation is also a zero-sum activity where the manipulator exploits less informed traders by transferring wealth. The conventional market abuse legal and regulatory framework prohibits manipulation per se however excessive and abusive speculation through derivatives which entail exactly the same mechanics remain unregulated.

Shariah regards abusive and excessive speculation as a form of gambling and attribute to it the root of "social disharmony and discord."[293] The gambling nature of derivative speculation is obvious in the OTC market which makes the entire financial system zero-sum.[294] Large

---

Securities and Financial futures and their Effect on Capital Markets (1991-1992) *North Western University Law Review* at 1002.

[287] Mohammed Hashim Kamali, *Islamic Commercial Law: An Analysis of Futures and Options* (2002) The Islamic Text Society at 151.

[288] Al-Suwailum, *Hedging in Islamic Finance* (2006) Islamic Research Training Institute at p 52.

[289] Ibid at p 55-56. Mohammed Hashim Kamali, *Islamic Commercial Law: An Analysis of Futures and Options* (2002) The Islamic Text Society at 154.

[290] Mohammed Obaidullah, Islamic Risk management: Towards Greater Ethics and Efficiency (2002) Volume 3, *International Journal of Islamic Financial Services* at p 84. Downloaded from http://islamic-finance.net/journals/journal10/obaidvol3no2.pdf.

[291] Alan Greenspan argued that derivatives are zero sum game between the two parties. It is pure transfer of wealth with no counter value. Sami Ibrahim Al-Suwailum, *Hedging in Islamic Finance* (2006) Islamic Research Training Institute at p 27.

[292]Sherin Kunhibava, Balachandran Shanmugam, Shariah and Conventional Law Objections to derivatives: A Comparison (2010) *Arab law Quarterly* at p 377.

[293] Sami Ibrahim Al-Suwailum, *Hedging in Islamic Finance* (2006) Islamic Research Training Institute at p 57.

[294] Ibid at p 75- 76 and 84.

institutional investors and hedge funds bet in socially non-productive risk[295] purely for profit maximisation at the expense of less well of and less informed investors. They trade from their own accounts and make profit from the contemporary traders. This also makes derivatives highly dangerous and instrumental in perpetrating manipulation and abusive fraudulent activities.

Harm and distortion to the economy may originate from either the "*abuse of derivatives*" or "*negative consequences*" of misuse of derivatives. Both start from the speculative use of the derivative instruments. The former refers to the deliberate attempt to manipulate, commit fraud, evade tax, distort information and price formation mechanism. It entails speculative use of derivatives which is regarded as a gateway to unethical activities.[296] The counterparties located in different parts of the world have disparity of information and rely upon fictitious trading, false sales and front running in order to make a profit. This is such a major concern that CFTC spends 30% and SEC spends 40%[297] of its funds on policing.[298] The negative consequences from misuse of derivatives create systmic risk for global financial system.[299] It

---

[295] By simply profiting from stock price differences, it does not contribute to any social good, prosperity or productivity. Popular opinion regards it as socially harmful, on the other hand economist regard it as promoting the economic goals of allocation efficiency. Increasing allocational efficiency increases social welfare. Lynn Stout, Irrational Expectations, Legal Theory (1997) at p. Downloaded from http://ssrn.com/abstract=1432654. Rafic Yunus-al-Masri, Speculation Between Proponents and Opponents (2007) *Journal of King Abdul-Aziz University* at p 43.

[296] Randall Dodd, Consequences of Liberalising Derivative Markets (2002) Financial Policy Forum at p 2, 8-9. Downloaded from http://www.financialpolicy.org/fpfspr10.pdf. Accessed on 11th September 2011.

[297] Knowledge@Wharton, U.S Securities Laws: Does High Density Enforcement Pay off (2007) at p 1. Downloaded from http://knowledge.wharton.upenn.edu/article.cfm?articleid=1746.

[298] Ibid at p 9.

[299] Sami Ibrahim Al-Suwailum, *Hedging in Islamic Finance* (2006) Islamic Research Training Institute at p 45. Bank of International Report - Lamfalussy Report defines it as "the risk that the illiquidity or failure of one institution, and its resulting inability to meet its obligations when due, will lead to the illiquidity or failure of other institutions." Bank for International Settlements. 1990. Report of the Committee on Interbank Netting Schemes of the Central Banks of the Group of Ten Countries. Basle, Switzerland. A French Noble laureate – Maurice Allais holds derivative speculation as one of the factor that is making the world financial system unstable. He argued that whilst it is possible to justify the forward trading in commodities by referring to its price discovery and risk hedging mechanism, however it is difficult to explain the social utility of futures trading on stocks and bonds. Fahim Khan, Islamic Futures and Their Markets: With Special reference to their Role in Developing Rural Financial Market (1997) Research Paper No 32, Islamic Research and Trading Institute at p 26

leads to sequence of defaults resulting in failure of financial institutions,[300] unemployment and decline in the prosperity of society.[301]

In this context, Shariah regards collective social welfare and development over and above the interests of corporations and shareholders. It pays great emphasis on a smooth price formation mechanism devoid of any malignant unnatural forces.[302] The potential for grand scale harm to society and less informed investors from derivative speculation amounts to gharar. Gharar may be interpreted as a measure of stability and just transactions devoid of artificial distortion in the Shariah compliant securities markets.

Shariah has also regarded the "unearned nature of income" from derivative speculation as maisir (games of chance).[303] It promotes greed among the traders urging them to undertake excessive risks.[304] Maisir and qimar are both used interchangeably and are a form of gambling. Gamblingwith derivative products lead to non-equilibrium prices, distortion and ideal circumstances for manipulation. Thus derivatives are an ideal tool to perpetrate manipulation of the underlying assets in order to win their bets in the absence of regulatory measures to counter it. The UK and US Courts also endorsed this as one of the key reasons for not enforcing wagering contracts in the past.[305]

---

300 One example of such incident is financial crisis of 2007-08. Derivative speculation also resulted in demise of Enron, proctor and gamble, Long term Capital Management, Bear Stern, merry Lynch and AIG most recently.

301 A French Noble laureate – Maurice Allais holds derivative speculation as one of the factor that is making the world financial system unstable. He argued that whilst it is possible to justify the forward trading in commodities by referring to its price discovery and risk hedging mechanism, however it is difficult to explain the social utility of futures trading on stocks and bonds. Fahim Khan, Islamic Futures and Their Markets: With Special reference to their Role in Developing Rural Financial Market (1997) Research Paper No 32, Islamic Research and Trading Institute at p 26

302 Randall Dodd, Consequences of Liberalising Derivative Markets (2002) Financial Policy Forum at p 8. Downloaded from http://www.financialpolicy.org/fpfspr10.pdf. Accessed on 11th September 2011.

303 See previous chapter for detailed evaluation of Maisir and Qimar.

304 Ibn Taimaiyyah also identified several common denominators in futures speculation and gambling. It includes intention to make a gain upon chance without making any effort, which crystallises when derivatives results in net transfer of wealth from one participant to another. Moreover, if any sale contract or structure of instrument entails excessive risk, excessive uncertainty and has an element of appropriating other's properties in the form of zero sum nature, it meets all the characteristics of gambling and becomes very difficult to differentiate from it. Mohammed Hashim Kamali, *Islamic Commercial Law: An Analysis of Futures and Options* (2001) the Islamic Text Society at 151.

305 The general trend of the Courts in 19th century was that these products are tools of gambling. Lynn argued that common law judges had also introduced a requirement of valid economic interest to hedge against the difference of contracts. Similar requirement applied under the doctrine of insurable interest in insurance. UK disregarded this rule when it modernised the financial services under FSA 1986 and regarded financial derivatives enforceable. Similarly US followed the same wholesale deregulation by implementing Commodities Trading Modernizing Act 2000. For a detailed discussion see Lynn Stout, The Legal Origin of 2008 Financial

Shariah propounds that the rationale for prohibition of gambling like instrument is based on being unethical practice which destabilize the markets. The Quranic Ayah articulates "Devour not each others properties unlawfully unless it is through trading by mutual consent."[306] Devouring refers to acquisition of wealth through fraud, riba, usurpations, profit made from unlawful transaction, zero-sum based products, insider trading and market manipulation.[307] Shariah takes an overly strict view of fairness in transactions to spread falah through markets. It regards just exchange via mutual consent as a fair method of distribution of resources and prosperity. Thus any instrument that misappropriates other's properties by indirectly transfering unfair and disproprotionate transfer of wealth is a form of exploitation and strictly prohibited.

Shariah regards commercial speculation with physical assets and expertise as legitimate as opposed to speculation on paper.[308] However, speculating in risk alone with the help of futures, options and swaps simply for the sake of profit on the stock exchanges, when it's not incidental to socially beneficial economic activity is prohibited.[309] The emerging Islamic capital exchanges will be following this economic approach in devising the legal and regulatory framework which is also affirmed by the Quranic Ayah below.[310]

Crisis, http://ssrn.com/abstract=1770082 at p 11. Sami Ibrahim Al-Suwailum, *Hedging in Islamic Finance* (2006) Islamic Research Training Institute at p 33. Sherin Kunhibava, Balachandran Shanmugam, Shariah and Conventional Law Objections to derivatives: A Comparison (2010) *Arab law Quarterly* at p 377.

306 Al-Quran, Al-Nisa 4:29. Another hadith sets out a very grave punishment for those who do not fulfil their obligations or takes advantage of others. It states "you shall return the rights to their rightful owners on the day of judgement, even the ewe with no horns will get even with the ewe with horns by butting it back."

307 Although Kamali disagrees that derivative speculator in commodities market would be devourers or gamblers. Mohammed Hashim Kamali, *Islamic Commercial Law: An Analysis of Futures and Options* (2001) The Islamic Text Society at 151-155

308 In speculation, selling or buying is not real as the underlying product is never needed. Samuelson argued "the speculators are simply middlemen who buy cheap and sell dear. The last thing they want to see the wheat or hog truck roll up outside their doors. They never touch a kernel of corn or bag of cocoa, nor need to know anything about storage, warehouse or delivery. They merely sell bits of paper." Samuel Armstrong Nelson, "*The ABC of Speculation*" (2007) Market Place Books at p 214-215. Rafic Yunus –al-Masri, Speculation between Proponents and Opponents (2007) *Journal of King Abdul-Aziz University* at p 44.

309 Mohammed Hashim Kamali, *Islamic Commercial Law: An Analysis of Futures and Options* (2001) The Islamic Text Society at p 155

310 Al-Quran 2:275. Financial futures which was introduced only thirty years ago accounts for 50 per cent of all trading. Fahim Khan, Islamic Futures and Their Markets: With Special reference to their Role in Developing Rural Financial Market (1995) Research Paper No 32, Islamic Research and Trading Institute at p 24-25.

"God has allowed trade (*to profit from transactions in goods and services*) and prohibited riba (*to profit from pure financial and monetary transactions*)"

Shariah prohibited gambling like instruments in order to avoid injustice to the contemporary traders, enmity and unknown consequences in the market places.[311] This reference to enmity and hatred could be interpretd as decline in investor's confidence. Moreover the avoidance of harm and loss to society is given a priority over the need to maximize profit.[312] Promotion of investor's confidence through smooth price formation mechanism and avoidance of injustice to contemporary traders through distortion in forces of demand and supply are the same objectives, UK and US law aimed to achieve by prohibiting insider trading and manipulation in the secondary exchanges.

Shariah compliant structures of forward sales curb speculation and ultimately discourage manipulation and distortion. The conventional futures market developed from the forward sales. The rationale behind forward sale was to promote exchange and production, enhance output, hedge and redistribute risk and provide liquidity to the farmers and producers. Shariah also recognised the usefulness of this concept fourteen centuries ago however it made "*payment in advance and delivery as two essential features"* of Salam and Istisna. They served the same purpose of redistributing risk but additionally did not allow professional speculators to thrive and engage in abusive practices.[313]

In contrast, the development of conventional futures, options and swaps from forward sales completely stripped these two essential features.[314] It promoted abusive speculation and makes it easier to manipulate the price as opposed to trading in commerce.[315] The parties

[311] Al-Quran 5:90, 5-91. Hashim Kamali, Prospects for an Islamic derivative Market in Malaysia (July-October) Volume 41, Thunderbird *International Review* at p 529. Abdul-Rahim Al-Saati, The Permissible Gharar in Classical Islamic Jurisprudence (2003) Volume 16, *Islamic Economics* at p 12-13.

[312] Maslahah is a juridical concept in Islamic finance. It is invoked to permit or prohibit something on the basis of whether it serves public interest.

[313] Mohammed Akram Khan, Commodity Exchange and Stock Exchange in Islamic Economy (1988) *The American Journal of Islamic Social Sciences* at p 91. Also see Sami Ibrahim Al-Suwailum, *Hedging in Islamic Finance* (2006) Islamic Research Training Institute at p 30

[314] Futures markets now operate independently and traders speculate in risk with no concern in the real markets and economies

[315] Rafic Yunus – al-Masri, Speculation between Proponents and Opponents (2007) *Journal of King Abdul-Aziz University* at p 44.

engaged in contracts without any regard to the underlying markets.[316] Moreover, it does not serve the rationales of stability, prevention of harm, smooth operation of markets and leads to massive fluctuation providing opportunities to the unscrupulous to distort the markets. The deferment of payment and delivery through contractual structures of derivative instruments provided tools to the traders to manipulate the underlying markets to their advantage.[317]

Futures, options and swaps are also referred to as capital efficient investments tools which enable the traders to have high exposure to the market for a smaller outlay. This high leverage and lower transaction cost enable the traders to carry out a high degree of speculative trading without buying the underlying assets, securities or commodities.[318] This is facilitated by the low margin requirements with high liquidity and the possibility of instantaneous offsetting in derivative market which is not available in the normal securities market.[319] Options perform a similar and even more flexible function. It also enables traders to take a highly speculative and leveraged position at a fixed potential smaller cost. Similarly, Interest rate Swaps on OTC also do not cost any money to the parties at least until the interest rate actually changes and bets actually become due.[320]

The above instruments facilitate speculation without investing in the spot markets such as physical commodities, securities, interest rate and gold etc. For example, a synthetic collaterised debt obligation (CDO) makes it extremely easy to speculate on the default rate of mortgagors.[321] It obviates the need for speculators to buy the houses. This highly leveraged

[316] Noble Laureate questions the forward and futures on securities stocks and bonds. Furthermore “speculation on securities indices must be eliminated” Sami Ibrahim Al-Suwailum, *Hedging in Islamic Finance* (2006) Islamic Research Training Institute at p35-36.

[317] Ibid at p 43.

[318] IMF report stated “the growing use of OTC derivatives is increasing the ability of institutions to leverage up capital positions. The high levels of leverage may be creating financial systems that are capable of making costlier mistakes during periods of euphoria (exacerbating the boom) and that can magnify the adverse consequences of a negative shock or a reappraisal of risk." Randall Dodd, Consequences of Liberalising Derivative Markets (2002) Financial Policy Forum at p 17. Downloaded from http://www.financialpolicy.org/fpfspr10.pdf. Accessed on 11th September 2011.

[319] Mohammed Hashim Kamali, *Islamic Commercial Law: An Analysis of Futures and Options* (2001) the Islamic Text Society at p 150.

[320] This is based on the assumption that the parties deal directly with each other on OTC derivative market however if they decide to use the swap dealer, they may incur transaction charges. Randall Dodd, Consequences of Liberalising Derivative Markets (2002) Financial Policy Forum at p 18. Downloaded from http://www.financialpolicy.org/fpfspr10.pdf. Accessed on 11th September 2011.

[321] Lynn Stout, The Legal Origin of Credit Crisis, Downloaded from http://ssrn.com/abstract=1432654 at p 6. Accessed ón 21st July 2011.

position magnifies the losses and gains in the real market. One example of such occurrence is 2007 financial crisis when these instruments amplified the risk from the £1.3 trillion subprime mortgage market to substantial financial crisis which required £3.3 trillion government bail out not to mention the harm to the society.[322] The regulators in the Islamic Capital Market would be better of avoiding such a situation by either prohibiting or toning down the speculative element of these instruments through its contractual structures to avoid undue distortions in the markets.

The embedded leveraging and speculative nature of futures, options and swaps also facilitate trade based manipulation, action based manipulation and information based manipulation. In trade based manipulation, derivatives enable the traders to take a large position in the futures market with the help of futures and swaps. At the same time, manipulators can buy a large inventory of underlying assets in the spot market.[323] This enables the manipulator to offset his long position profitably in the futures market. It is also argued that if these transactions are carried out in the OTC market, it makes it difficult for the manipulators to get detected by the market competitors or regulatory organisations. It results in massive demand in the underlying securities or commodities market. It also enables the traders to create excessive heat in the markets without any relevance to the real performance of stock issuing companies.[324] As Chapra argued it leads to "superficial expansion and contraction in the volume of transaction in the commodities market."[325]

Similarly, in information based manipulation, derivative products enable insiders to capture a bigger profit by exploiting price sensitive information.[326] It takes place when an insider or manager shorts the shares followed by an announcement of negative news about the corporation which drives the price further down. It enables them to cover the short at a lower

[322] Speculators were attempting to make money by buying credit default swap on company's bonds. The real value of company's bond was around 15 trillion dollar whereas the notional value of CDS had reached 67 trillion dollars. Bank for International Settlements, quarterly Review statistical annex at A103 table 19 (Amounts outstanding of OTC derivatives) (Dec 2008).

[323] Randall Dodd, Consequences of Liberalising Derivative Markets, Financial Policy Forum at p 10. Downloaded from http://www.financialpolicy.org/fpfspr10.pdf. Accessed on 11th September 2011.

[324] Rafic Yunus -al-Masri, Speculation between Proponents and Opponents (2007) *Journal of King Abdul-Aziz University* at p 45, 47 and 49.

[325] Umer Chapra, *Towards a Just Monetary System* (1985) The Islamic Foundation at 96. Rafic Yunus –al-Masri, Speculation between Proponents and Opponents (2007) *Journal of King Abdul-Aziz University* at p 47.

[326] One such example was Enron managers and executives who cashed out their stock option and sold their shares being aware of the accounting discrepancies.

price at a later stage. Professional speculators can take advantage of this position and manipulate those who are less informed and reap profit before the prices decline. The manipulators often use these instruments to increase prices and before the ordinary investors come to know, they sell their large holdings and leave the markets.

The role of speculation has also been distinctly apparent as a trigger, catalyst and accelerator to the financial crisis throughout the history. Historians and researchers have identified speculation as one of the major causes of the Great depression 1929.[327] It was facilitated by highly speculative device of margin trading resulting in the highly leveraged position of the investors. The margin requirements were loose and the leverage rates were somewhere near 90 per cent. Approximately 1 million investors were using billions of dollars of margin[328] facility despite the high interest rate of 20 percent a few days before the crash.[329]

During the crisis, the market loses contact with its fundamental factors[330] and is based on the perception of the buyers and seller in the markets. Speculative bubbles often function like a Ponzi scheme where early investors manage to reap their profit from those joining afterwards and they make their profit from late comers. This mechanism does not distribute profit according to the natural forces of demand and supply but is based on early price sensitive inside information.[331] The informed speculators exploit the market and offload at the right

[327] Manipulation in the stocks and shares caused major economic depression which is referred by the historians as the Great Depression. It lasted for a decade and caused poverty, starvation and misery. Similar occurrence took place in October 1987 and October 1997 with lesser intensity. Hizb-ul-Tahrir, *The Turbulence of the Stock Markets: Their Causes and Shariah Rule Pertaining to these Causes (1998)* Delux Publications at p 3.

[328] When the stock prices went down, traders could not meet their margin call requirement and broker sold the shares without consulting their clients. This put further downward pressure on the shares which further triggered the market decline. Karen Blumenthal, *Six Days in October: the Stock Market Crash of 1929* (2002) Anthem Books at 56, 59, 61-65. Please also see. Hizb-ul-Tahrir, *The Turbulence of the Stock Markets: their causes and Shariah Rule pertaining to these causes* (1988) Deluxe Publications at p 13.

[329] The money provided on margin enabled the traders to buy more shares by putting in small amount of their own. This raises the price and continues to raise it at an exaggerated level, however, if for any reason the share price goes down, the banks withdraw the lending facility, in the absence of sufficient margin requirement. This increases the supply of shares in the market and lowers their price. Hizb-ul-Tahrir, *The Turbulence of the Stock Markets: Their Causes and Shariah Rule Pertaining to These Causes* (1988) Deluxe Publications at p 9. Just before the financial Crisis of 1929, the money lent for margin to speculate would have gone to useful causes in the society such building or improving business etc. Karen Blumenthal, *Six Days in October: the Stock Market Crash of 1929* (2002) Anthem Books at p 59.

[330] Valuation of the company is based on its fundamental factors such as profit earned, earning potential, debt-equity ratio, real assets, previous and expected future performance. On the other hand, its valuation can be based on the psychology of the market. Mohammed Qureshi, The Role of Stock Exchange in the Islamic Financial System (1988) Volume 5, *Journal of Islamic Banking and Finance* at p 9-10.

[331] Sami Ibrahim Al-Suwailum, *Hedging in Islamic Finance* (2006) Islamic Research Training Institute at p 60.

time for others to bear the loss before the financial crisis is triggered. Thus speculation played a major role in both crises, either with the help of margin or with the help of derivative products.

Large financial institutions and hedge funds have also used *derivative products* to speculate in the food prices and create artificial food shortage to hype up the prices.[332] In normal circumstances, farmers and operators follow the price signals in the futures market to plan their plantation and use derivative products to get a guaranteed price in the future.[333] However the impact of hedge funds and other financial institution derivative speculation distort these signals and make it difficult to interpret.[334] As Joseph Stieglitz argued "the increased use of derivatives is increasingly making the full disclosure of relevant information, or at least the full interpretation of the disclosed information, even more difficult."[335]

Furthermore, it disrupts the markets and makes it dysfunctional with no relevance to forces of demand and supply.[336] The hedge funds treat it like any other asset class and by speculating, raises price which manipulate people around the world out of their disposable income.[337] It resulted in the food crisis in 2007-2008 and had a drastic effect on the world's poor people.[338] It also caused food riots in Tunisia, Algeria, Sudan, Jordan, Egypt and Yemen.[339]

---

[332] This is despite the fact that harvest of 2010 was among the best in the last five years. The prices then feel rapidly in next month. Tim Jones, The Great Hunger Lottery: How Banking Speculation Caused Food Crisis, The World Development Movement Report, at p 7. Download from http://www.wdm.org.uk/food-speculation/great-hunger-lottery. Accessed on 7th August 2011.

[333] Excessive speculation in commodities index makes it difficult for the derivative markets to achieve its essential purposes of price discovery mechanism and manage price risk. Gary Gensler, head of the US government commodity regulator, says: "I believe that increased speculation in energy and agricultural products has hurt farmers and consumers." Tim Jones, The Great Hunger Lottery: How Banking Speculation Caused Food Crisis (July 2010) The World Development Movement Report at p 8 and 24. Download from http://www.wdm.org.uk/food-speculation/great-hunger-lottery. Accessed on 7th August 2011.

[334] "One of the hedge fund manager told the financial times "There is so much investment money coming into commodity markets right now that it almost does not matter what the fundamentals are doing. The common theme for why all these commodity prices are higher is the substantial increase in fund flow into these markets, which are not big enough to withstand the increase in funds without pushing up prices." Tim Jones, The Great Hunger Lottery: How Banking Speculation Caused Food Crisis (July 2010) The World Development Movement Report at p 10. Downloaded from http://www.wdm.org.uk/food-speculation/great-hunger-lottery. Accessed on 7th August 2011.

[335] Randall Dodd, Consequences of Liberalising Derivative Markets (2002) Financial Policy Forum at p 14. Downloaded from http://www.financialpolicy.org/fpfspr10.pdf. Accessed on 11th September 2011.

[335] Knowledge@wharton, U.S Securities Laws: Does High Density Enforcement Pay off (May 2007) Downloaded from http://knowledge.wharton.upenn.edu/article.cfm?articleid=1746.

[336] Tim Jones, The Great Hunger Lottery: How Banking Speculation Caused Food Crisis (July 2010) The World Development Movement Report at p 27. Commodities index funds and derivative products move huge amounts of money in and out of this market which has no relevance with the underlying demand and supply.

Goldman Sach innovated the Food Index Fund to enable the financial institutions to profit from the price fluctuation in staple food. The World Development Movement (WDM) has used Goldman Sach's annual reports to estimate that the bank made profits of 1 billion from derivative speculation in food prices.[340] Most of the trading took place on the OTC market which is opaque and non-transparent. Parties' buying the contract has little information whereas investment banks such as Goldman Sach have complete information. They used the disparity of information to manipulate the market.[341] Moreover, lack of data on transactions on the OTC market and lack of transparency makes it difficult for regulators to eradicate manipulation in the related markets.[342] It is analogous to speculating on starvation and pushed 40 million people into hunger and malnutrition.[343] The WDM has dubbed it as the *hunger lottery* and regarded the abusive use of the derivative products as unsustainable.[344] The derivative instruments amplified financial speculators ability to bet on the direction of prices of the most fundamental human necessity causing destabilisation in food prices.[345]

---

337 Ibid at 29.

338 Ibid at 4-5. High food prices increased the chronically malnourished people to 75 million in 2007-2008. Derivative speculation resulted in phenomenal rise in the staple food prices. According to IMF food price index, the food price rose by 80% between the start of 2007 and 2008. In 2007-2008, a record number of food futures contracts were entered leading to a bubble.

339 Tim Jones, The Great Hunger Lottery: How Banking Speculation Caused Food Crisis (July 2010) The World Development Movement Report, at p 10. Downloaded from http://www.wdm.org.uk/food-speculation/great-hunger-lottery. Accessed on 7th August 2011.

340 Extracts from the interview of Olivier DeShuttier, UN Special Rapporteur on GT World News. Downloaded from http://www.youtube.com/watch?v=NbARnnTXI-s. Accessed on 7th August 2011.

341 Tim Jones, The Great Hunger Lottery: How Banking Speculation Caused Food Crisis (July 2010) The World Development Movement Report, at p 25. Download from http://www.wdm.org.uk/food-speculation/great-hunger-lottery. Accessed on 7th August 2011.

342 Randall Dodd, Consequences of Liberalising Derivative Markets (2002) Financial Policy Forum at p 14. Downloaded from http://www.financialpolicy.org/fpfspr10.pdf. Accessed on 11th September 2011.

343 Olivier De Shutier, Food Commodities Speculation and Food Price Crisis: Regulations to Reduce the Risk of Price Volatility, Sep 2010. Accenture, The Influence of Financial Derivatives in Global Commodity Market, Downloaded from http://www.accenture.com/SiteCollectionDocuments/PDF/Accenture_The_Influence_of_Financial_Derivatives_in_Global_Commodity_Markets.pdf. Accessed on 21st August 2011. Pedro Paez, former Minister for Economic Policy Coordination of Ecuador, said: "international financial markets are distorting the markets in food and energy. This is increasing vulnerability day-by-day. In one-and a-half years, the number of people in hunger has increased from 900 million to over 1 billion … The lives of millions of people come to depend on the activities of a handful of financial speculators."

344 Tim Jones, The Great Hunger Lottery: How Banking Speculation Caused Food Crisis (July 2010) The World Development Movement Report at p 10. Download from http://www.wdm.org.uk/food-speculation/great-hunger-lottery. Accessed on 7th August 2011.

345 Ibid at 4, please also see Food Ethics Council, The Ethics of Speculating on Food at p 4-7. Downloaded from www.foodethicscouncil.org. Accessed on 21st July 2011.

Enron is another classic example where the firm lost substantial amount in derivative speculation in the energy market and attempted to cover up by manipulating its share price and accounting fraud.[346] The essence of accounting rules determines tax liabilities, apportion profit from losses and assign assets and liabilities. However a recent survey indicates that "42% use of derivatives is primarily to manage reported earnings by moving income from one period to another."[347] This in turn, affects the shares and creates distortion in the market leading to inefficiency.

Shariah prescribes risk to be tolerable in any instrument of investment and the likelihood of success has to be more than failure. Suwailum also adduced evidence that derivatives are not only zero-sum but they also result in failure of more than seventy per cent.[348] They only appear attractive to the participants because of the size of the prize. This is also evident from huge losses caused by Proctor and Gamble, Orange County Pension Fund, Baring Bank, Long Term Capital Management,[349] the Enron, Bear Stern, Merrill lynch and AIG.[350] Prior to 1986, Sumitomo Bank of Japan used derivatives to manipulate the global copper market.[351] Greece used derivatives to take on more debt which resulted in default on the sovereign bond market.[352] Most recently, UBS suffered losses of $2.3 billion in derivative trading.

It is argued that the aforementioned occurrences caused non-equilibrium prices on a wider scale and provide support to Shariah's theoretical stance that excessive and abusive

[346] Mark Jickling, *CRS Report for Congress: The Enron Collapse*: *An overview of Financial Issues*, CRS-4 (2002) Downloaded from http://fpc.state.gov/documents. Accessed on 21st august 2011.

[347] Randall Dodd, Consequences of Liberalising Derivative Markets (2002) Financial Policy Forum at p 14. Downloaded from http://www.financialpolicy.org/fpfspr10.pdf. Accessed on 11th September 2011.

[348] Al-Suwailum, *Hedging in Islamic Finance* (2006) Islamic Research Training Institute at p 60-61.

[349] In 1998, when the Long Term Capital Management was near collapse, it had £100 billion in assets and $1trillion in derivatives. The Federal Reserve had to intervene to prevent a collapse. Sami Ibrahim Al-Suwailum, *Hedging in Islamic Finance* (2006) Islamic Research Training Institute at p 46.

[350] There are number of firms who lost billions by derivative speculation on OTC market. Proctor and Gamble lost $157 billion in 1994. Lon-term capital management was a privately held hedge fund which lost $2.5 billion in 1998 and required $4 billion bailout. In 2008, Bear stern incurred huge losses and became insolvent. Similarly, Merry Lynch became victim of derivative speculation and was sold off to Bank of America. In the case of AIG, the Federal Reserve was forced to act as the lender of last resort.

[351] Brief Overview of derivatives and their Marketplace, Dowloaded from http://faircontracts.org/issues/derivatives at p 4. Accessed on 21ts August 2011.

[352] Ibid at p 4. Also see Joe Nocera, Hearings that aren't just thereafter (2nd July 2010) The New York Times. http://www.nytime.com/2010/07/03business/03nocera.html?_r=1&ref=todays

speculation is the gateway to market abuse. This is regarded as oppressive, exploitative and against Maslahah. In this context, Shariah has made it obligatory to take appropriate measures to reduce uncertainty, likelihood of failure and abuse in the markets.[353] This would diminish the possibility of any financial crisis and occurrences of market abuse. As Lawrence has articulated that "The freeing of financial markets to pursue their casino instinct has heightened the odd of crisis"[354]

It is also argued that the structure of the conventional derivative instruments segregates futures markets from the underlying real economy.[355] It facilitates formulation of an abstract nature of futures market in risk which is unnatural and does not conform with the operation of the economy. It transforms the risk into a more dangerous form which leads to distortion.[356] Suwailum argued that it is artificial to remove risk from economic activity and a Shariah compliant structure should be based on positive sum rather than zero-sum. It is also argued that zero-sum based instruments are "pareto inferior" comparatively. [357]

Data also proves that the segregation of risk from the real economy promotes the speculative usage[358] and results in expansion of the derivative market dis-proportionately.[359] The growth in the real market is constrained by production capacity, demand and supply, delivery, marketing and regulations etc.[360] Scholars have argued that the Shariah compliant design of instruments would combine the risk with ownership of the real assets or real economic

---

353 Sami Ibrahim Al-Suwailum, *Hedging in Islamic Finance* (2006) Islamic Research Training Institute at p 59.

354 Ibid at 42. Stieglitz has also argued that in case of crisis "the profits are privatised and losses were nationalised."

355 The capitalist system is divided in two economies: the first one represent the real economy where production and marketing takes place and the second one is financial economy. Hizb-ul-Tahrir, *The Turbulence of the Stock Markets: their causes and Shariah Rule Pertaining to these causes* (1988) Deluxe Publications at p 9.

356 Suwailum, *Hedging in Islamic Finance* (2006) Islamic Research Training Institute at p 59 and 72.

357 The capitalist system is divided in two economies: the first one represent the real economy where production and marketing takes place and the second one is financial economy. Hizb-ul-Tahrir, *The Turbulence of the Stock Markets: their causes and Shariah Rule Pertaining to these causes* (1988) Deluxe Publications at p 9.

358 97 per cent of the participants of this market are speculators as opposed to 3 per cent of hedgers. Similarly 10 per cent of the OTC transactions are carried outside the financial sector with the end users. Sami Ibrahim Al-Suwailum, *Hedging in Islamic Finance* (2006) Islamic Research Training Institute at p 43.

359 The total worth of conventional derivative market stands at $480 trillion, almost 30 times the size of US economy and 12 times the size of entire world economy Dr Abul Hassan, "The Global Financial Crisis and Islamic Banking" http://www.islamic-foundation.org.uk/IslamicEconomicsPDF/Hassan-financialcrisis-if.pdf Accessed on 22nd April 2010.

360 Suwailum, *Hedging in Islamic Finance* (2006) Islamic Research Training Institute at p 41.

activities. This will ensure that risk is mitigated by creating value which is tied to the real assets leading to productivity as opposed to volatility by mere transfer of risk.[361] Thus Shariah compliant hedging instruments would curb disproportionate growth through derivative speculation and in turn any distortions in the real markets and diminish the possibility of circumstances which may lead to manipulation.[362]

Disproportionate growth has also fuelled speculative euphoria, violent swings and volatility leading to fluctuations in the underlying assets, commodities and securities in the past. Fluctuation in the economy often limits the availability of credit for trade and enterprise and also effects valuation of collateral for banking loans and tax purposes.[363] It is also accompanied by manipulative and abusive practices distorting the markets. The inefficient markets with non-equilibrium prices affect the entire resource generating process and send the wrong signal to investors who may channel the much valued liquidity in pursuit of worthless economic activities leading to allocational inefficiency.[364]

Speculation is also perceived with moral disdain in the commodities market because it enriches the speculator at the expense of the hard working farmer in the commodities market.[365] The commodities[366] futures market has forecasting properties and acts as a price discovery

---

361 Husam el-Khatib, Harvard – LSE Workshop: Islamic Economic and Islamic Ethico-Legal Perspectives on the current Financial Crisis (26th February 2009) at p 17. Majority of Islamic scholars are in support of devising an instrument which does not promote speculation. See Michael Mahlknecht, *Islamic Capital Market and Risk Management* (2009) Risk Books at p 19.

362 Proponents argue that derivatives redistribute the risk in the system according to the ability of parties and therefore enhance efficiency however George Akerlof, Michael Spencer and Joseph Stieglitz, (who were awarded noble prize for their work on information economic) argued that information changes the way the agents operate and affects the market equilibrium. In the presence of asymmetric information in financial system, the structure of derivative instruments which allegedly is supposed to redistribute risk from those who cannot to those who can assume risk, does not promote efficiency in the market. In fact, the argument supports the Shariah scholars' stance that unpacking and decomposition of risk from the underlying asset compounds the risk and often become gharar. The production of artificial risk crate arbitrage opportunities and promotes speculation which is not related with the real economy and often leads to manipulation or distortion in the market. Moreover the capital committed is not exposed to the real economic activities, distort prices and result in inefficiency in the economy. Suwailum, *Hedging in Islamic Finance* (2006) Islamic Research Training Institute at p 38 - 42.

363 Section 2 (3) (a) of Securities Exchange Act 1934 (SEA hereafter), Section 2(3) (b) and (c) and Section 2(4) respectively.

364 Umer Chapra, Towards a Just Monetary System (1985) The Islamic Foundation at p 98 and 176.

365 Thomas Lee Hazen, Rational Investment, Speculation, Or Gambling – Derivative Securities and Financial Futures and Their Effect on the Capital Markets (1991-92) *North-western University Law Review* at p 1005.

366 The commodities may include wheat corn, soya bean, energy sector like crude oil, natural gas and metals like iron, copper, zinc, and lead etc.

mechanism.[367] The manipulators use the derivative instruments to give a wrong signal to the spot market. In this fashion, farmers end up competing with professional speculators and are cornered, controlled, squeezed and exploited.[368] There have been many notable cases of manipulation in the commodities market.[369] Hazen equates the speculation with legalised gambling and argues that regulators need to decide whether the markets are going to provide opportunities for wealth transfer through legalised gambling or wealth generation through legitimate risk hedging activities for the farmers, producers and manufacturers. Speculation through derivative instruments can artificially fuel the securities market thus is a case of tail waging the dog.

Delorenzo[370] argued that traders use futures, options, swaps, margin trading and short selling to speculate on the future direction of the price of assets, stocks, bonds, commodities, indexes and anything else.[371] It causes volatile price movements which destroy price discovery mechanism resulting in an inefficient market hypothesis and irrational exuberance.[372] The prices established in derivative markets are relied upon by consumers and producers and play a very important role in the efficiency of the overall economy. The abusive speculation or manipulative use of derivatives not only results in harm to the contemporary traders but also grossly affects the integrity of the market. Moreover, it has the potential to turn into speculative euphoria which does not reflect the true underlying forces of demand and supply

---

[367] Price discovery refers to a benchmark price inferred after the interaction of forces of demand and supply and used more broadly in the economy. Randall Dodd, Consequences of Liberalising Derivative Markets (2002) Financial Policy Forum at p 1. Downloaded from http://www.financialpolicy.org/fpfspr10.pdf. Accessed on 11th September 2011.

[368] Fahim Khan, Islamic Futures and Their Markets: With Special Reference to their Role in Developing Rural Financial Market (1995) Islamic Development Bank at p 22. Also see Geoffrey Poitras, *Risk Management, Speculation and Derivative Securities* (2002) Academic Press at p 27.

[369] In 1950, traders cornered the underlying onion spot market by using futures which resulted in passage of Onions futures Act. In addition to this, in 1970, the Hunt brothers cornered the underlying silver market by using futures instruments.

[370] DeLorenzo, Covered Options: Scholars Answer, Downloaded fromhttp://muslim-investor.com/answers/covered-option.html. DeLorenzo also support the above proposition and argued that options and futures are mode of betting to determine the direction of the market. It produces nothing of value in the market and the society and the ethics of its structure would not be acceptable from Shariah. Also see Sherin Kunhibava, Balachandran Shanmugam, Shariah and Conventional law Objections to Derivatives: A Comparison (2010) Volume 24, *Arab Law Quarterly* at p 322.

[371] Sami Ibrahim Al-Suwailum, *Hedging in Islamic Finance* (2006) Islamic Research Training Institute at p 41. Lynn stout, How Deregulating Derivatives Led to Disaster, and why Re-Regulating Them Can prevents Another, Lombard Street at p 6.

[372] Charles Kindleberger, *Manias, Panics and Crashes*, Wiley & Sons (2005) at p 41-50. John Kenneth Galbraith, A Short History of Financial Euphoria (1993) Penguin Books at p 1-5. Edward Chancellor, *Devil Takes the Hindmost* (2007) Plume Books at p 3-10.

and causes distortions. This has the potential to play havoc in the predominantly equity based Shariah compliant stock exchanges.[373]

Speculation with derivative instrument enables the traders to facilitate, amplify and exacerbate the irrationality. When it moves the price upward, irrationality may overcome rational investors and generally decent investors also turn into speculators. Speculation combined with manipulative practices facilitates initiation of bubble. Continued frenzied speculation together with manipulative practices can turn the asset prices into bubbles and leads them to crashes.[374] It provides an opportunity for those with the price sensitive information to maximise their profit by using derivatives. Moreover, the bubbles make early identification of fraud, insider trading and manipulation by the regulatory bodies much more difficult thereby prolonging, exacerbating and intensifying the devastation caused.[375] The resulting losses may diminish investor's confidence and destroy the integrity of the Islamic capital markets resulting in a flight of capital.

Derivatives also interlink the different types of markets in a highly irregular fashion. The widespread use of derivatives in a random attempt to profit upon a chance in opaque OTC derivative markets disrupts the natural equilibrium, price formation mechanism and orderly function of the market.[376] In this context, integrity of pricing is important for the smooth functioning of exchanges as well as economies. Derivative speculation can reverse the natural laws of supply and demand and replace it with chaotic situations in the market.[377] It also makes the financial system highly vulnerable, excessively uncertain and prone to fluctuations, which enable the manipulators to take advantage of the situation. Moreover, excessive usage of these instruments for betting turns the entire financial system into gambling like a casino and the regulatory measures fail to counter its effects.

---

[373] Suwailum argued that since the speculators are indispensable for the derivative market, there is a possibility that some may commit large sums of money in pursuit of profit. This may create a tendency to speculate and tendency to undertake unnecessary risks. In this context, Stieglitz have argued that in the case of financial crisis "the profits are privatised and the losses are nationalised." This leads to ordinary people and government bearing the cost of derivative speculation.

[374] Charles Mackay, Extraordinary Popular Delusions and the Madness of the Crowd (1995) Wadsworth Edition at p.

[375] Emilios Avgouleas, The Mechanics and Regulation of Market Abuse (2005) Oxford University Press at p 89.

[376] Sami Ibrahim Al-Suwailum, *Hedging in Islamic Finance* (2006) Islamic Research Training Institute at p 44**.**

[377] Ibid at p 36

Keynes also disapproved of gambling like financial instruments, which may become tools of manipulation in the markets often leading to bubbles. He argued that “Speculator may do no harm as bubbles on a steady stream of enterprise but the position is serious when the enterprise becomes the bubble in a whirlpool of speculation. When the capital development of the country becomes the by product of the casino, the job is likely to be ill done.” [378] Moreover, Warren Buffet also argued that “derivatives are time bombs both for the parties that deal in them and for the economic system.” Furthermore, he argued that “derivatives are weapons of mass destruction that are potentially lethal” Noble laureate Allais described “such markets as casinos where gigantic games of pokers are being played.” [379]

As Gordon Gecko in the Hollywood film articulates, “Speculation is the mother of all evils”[380] Shariah Scholars appear to take similar approach for excessive and abusive speculation. Galbraith regards free market enterprise characterised by the episodes of speculation which also entails unethical and abusive practices.[381] Al-Masri has argued that once speculation is permitted, it is very difficult to limit it to a reasonable or an acceptable level. He further argued prohibition of derivative speculation is the only way to ensure a fair and just stock exchange for a predominantly equity based Islamic stock exchange.[382] Moreover, if the status quo is allowed to prevail in the emerging Islamic stock exchanges this may result in loss of contact with economic reality.

---

[378] Ibid at p 35.

[379] Ibid at p36

[380] Oliver Stone, Wall Street: Money Never Sleeps (2010) Hollywood, Sequel to “Wall Street” (1987).

[381] John Kenneth Galbraith, *A Short History of Financial Euphoria* (1993) Penguin Books at p 1.

[382] Rafic Yunus -al-Masri, Speculation between Proponents and Opponents (2007) *Journal of King Abdul-Aziz University* at p 50.

7- Critical Evaluation and Conclusion

Corruption has appeared on land and sea because of what the hands *of men have earned (by oppression and evil deeds). Ar-Rum*[1]

7.1- Introduction

The chapter addresses the third hypothesis set out in the introduction. It critically analyses, compares and contrasts the rationales and theories of prohibition underpinning the UK and US legal framework with the principles of Shariah's for investor protection. It will also investigate the possibility of harmonised interface, common grounds and divergences.

7.2- Comparison of Rationales of Prohibition of Insider Trading in UK and US with Shariah Principles

The UK and US law defines market abuse as insider trading, market manipulation and distortion of market forces. The second chapter analysed pros and cons of regulating insider trading in the conventional securities market of the UK and US. The debate about desirability of regulation of insider trading has been divided in two groups for the last six decades. Both groups have advocated regulation and deregulations of insider trading based on their benefit and harm analysis to the investor, corporations and market participants. Professor Manne was the first economist to advocate the deregulation of insider trading based on his economic analysis. He argued that insider trading is a form of compensation for entrepreneurs and an inexpensive alternative to disclosure. It reflects the information more accurately, reduces volatility and overall increases the informational, allocational and operational efficiency of the market.

He also contended that the current legislation prohibiting insider trading is based on the concept of fairness and equality of access to information. He criticised that fairness is a high sounding but an empty concept and when formulating public policy, morals are sham and a refuge for the intellectually bankrupt.[2] He concluded from his theoretical examples that insider trading does not lead to any harm to the outsiders and therefore the current legislation does not have any coherent theoretical underpinning. Although many eminent scholars such as Milton Freidman, Dennis Carlton, Thomas Sowel, Daniel Fischel and Frank Easterbrook

[1] Al-Quran 30:41.

[2] Please refer to the second chapter for detailed analysis.

has supported Mann's assertion, it has remained empirically unsubstantiated after several decades.[3]

On the other hand, Scotland, Bainbridge, Krawiece, Moore, Brudney, Machan, Strudler, Schepple, Avgouleas and many other eminent scholars have robustly countered it. They have based their arguments predominantly on morality and ethics in favour of prohibition of insider trading. They have highlighted a number of rationales in the second chapter such as *fair dealing, right to equal access to information in the impersonal securities markets, orderly and transparent markets leading to just reward, uninterrupted natural equilibrium, maintaining a level playing field for equitable distribution of wealth, prohibition of unjust enrichment, prohibition of breach of fiduciary duty, freedom from misrepresentation, freedom from exploitation*, *respect for the autonomy of the individual investors and avoidance of harm to the contemporaneous investors*.[4]

In addition to the above rationales, several *ethical theories* have been propagated to justify the coherence of theoretical framework of prohibition of insider trading. They include the *deontological theory of ethics, consequentialist theory, contractarian theory and social norm theory.* The moral and ethical approach has been accorded overriding status by the US Congress, UK and EU parliament and since 1966 most of the countries have adopted the regulation of insider trading. It has also been endorsed by the US Supreme Court in O'Hagan.

Shariah appears to supplement the above rationales and theories and have taken a strict stance in favour of prohibition of insider trading. The Prophet expressly prohibited traders with market knowledge[5] from meeting caravans out in the deserts bringing the commodities to the markets and approaching poor farmers in the remote areas. The rationale behind his prohibition was that the traders with the inside knowledge of the markets should be prohibited from taking advantage of the discrepancy between the potential value and the prevailing prices of the commodities in the markets. They would negotiate lower prices with the trading caravans and the poor farmers. They would also subsequently trade in the open market in Medina to capture the value of information they possessed about the demand and

---

[3] For detailed citation, please refer to the second chapter under the heading of "Prohibition of Insider Trading."

[4] Please refer to the second chapter for a detailed analysis.

[5] Please refer to sixth chapter under the heading of "Shariah's Prohibition of Insider Trading" for a detailed analysis.

supply of a particular commodity. This would put the contemporary traders in an unequal bargaining position and hinder the market bargaining process.

The rationale behind the prohibition of the above is similar to the economic analysis of insider trading advocated by Goshen and Parchomvsky in the context of the modern securities market. They described insider trading as "a situation where insiders detect discrepancies between the value and the price of securities, based on undisclosed information they possess and trade in order to capture the value of informational advantage."[6]

In addition to the above, Quranic Ayah also articulated *exchange with mutual consent* as a *pre-condition* for shariah compliance of just transactions. It is regarded as a *tool to promote falah and prosperity* in the society.[7] It also discourages any potential for dispute and harm to the contemporary participants of the market. Trading on inside information undermines the *willingness* and *mutual consent* element highlighted in the Quran. In comparison, as analysed in the second chapter, conventional academics argued that trading based on price sensitive information amounts to coercion which undermines willingness, overrides mutual consent, autonomy of the individual traders and violates the right to engage in trade freely. It is also similar to Adam Smith's famous formulation for the rule of capitalism that every trade must occur "by mutual consent and to mutual advantage."[8] Thus it may be argued *that exchange by the mutual consent (voluntary exchange in conventional economics) appears to be common denominator in prohibiting insider trading in conventional finance and Shariah.*

The conventional academics further argued that the aggregate or cumulative effect of *exchanges with mutual consent*, in turn, leads to a *fair price formation mechanism* in the securities market. It represents a natural equilibrium of the forces of demand and supply which *distributes wealth equitably in the society*. Congress also relied upon the *fair price formation mechanism as a rationale* for prohibition of market abuse.[9] In comparison, Naqvi

[6] Zohar Goshen, Gideon Parchomvsky, On Insider Trading, Markets and Negative Property Rights in information (2001) Volume 87, *Virginia Law Review* at p 1238-1239.

[7] Shariah also presents various other mechanisms for distribution and redistribution of wealth in the society. Mabid Ali Al-Jarhi and Mohammed Anas Zarqa, Redistributive Justice in a Developed Economy: An Islamic Perspective, http://www.iefpedia.com/english/wp-content/uploads/2009/10/Advances-in-Islamic-Economics-and-Finance-Volume-1by-Munawar-Iqbal-Salman-Syed-Ali-Dadang-Muljawan.pdf#page=56. Accessed on 23rd March 2012.

[8] Robert Tracinski, The Moral Basis of Capitalism, Downloaded from http://www.capitalismcenter.org/Philosophy/Essays/The_Moral_Basis_of_Capitalism.htm. Accessed on 28th Oct 2011.

[9] This is set out in the section 2 (1) (2) (3) (4) of the Securities Exchange Act 1934.

argued that Shariah goes beyond simply establishing natural equilibrium and advocates *quality of natural equilibrium*. He equated natural equilibrium with justice and regarded it as a fair method of distributing resources. Thus preservation of natural equilibrium and equitable distribution of wealth is another common economic objective between Shariah and conventional securities markets.

As analysed in the sixth chapter, Shariah regards transactions based on asymmetry of information and dis-equilibrium as leading to *invalid prices*. The Quran also articulated that any profit earned from such a transaction would be classed as *devouring*.[10] The prohibition of insider trading is also supported by other concepts in Shariah such as *Jahlah* (provision of inadequate information), *ghish* (prohibition of withholding information in transactions), *alleviating hardship for public good* (Maslahah), *khiyanah* (breach of fiduciary duty), *avoiding dharar* (harm to the contemporaneous traders), *respect for autonomy of the individual traders, un-interrupted price formation mechanism leading to natural equilibrium, promotion of falah via exchange with mutual consent, avoidance of injury, corruption, exploitation, sad-al-dhari, transgression and abuse*. These are similar rationales to the ones analysed above by the conventional academics in the context of securities markets.

In addition to above rationales, Scheppele also developed on the *doctrine of utilitarianism* (a form of consequentlist theory) to justify the coherence of a theoretical framework of prohibition of insider trading. The theory compared the economic data from different legal rules to ascertain which one contributes to the greatest aggregate good of society.[11] Although, the theory may not be conclusive in the presence of difficulty of obtaining accurate economic data from insiders, this may be compared with the Islamic concept of *Maslahah*.

Maslahah literally means seeking benefit, interest or welfare and repelling harm. It is a juristic legal device in Islamic legal theory which aims to promote similar objectives to the doctrine of utilitarianism namely the greatest public good and prevention of harm. This ultimately achieves falah in society, one of the cherished principles behind Shariah. Kamali described Maslahah as the sum of objectives of Shariah (Maqasid-al-shariah) which safeguards and promotes faith, life, intellect, posterity and wealth. The modern economic data

[10] Al-Quran 4:29

[11] Kim Lane Scheppele, It's Just Not right: The Ethics of Insider Trading, Volume 56, *Law and Contemporary Problems* at p 150-155.

may be presented to the Shariah Advisory Board who pursuant to Ijtihad may decide as to the suitability of regulation or deregulation.

Schepple has also employed *contractarian theory* analysed in the second chapter to formulate a coherent theoretical underpinning for the prohibition of insider trading. It originates from the Rawl's theory of justice[12] which is parallel to the Islamic concept of Justice. He sees justice as fairness and is ingrained in the idea that well-being of the society is based in co-operation. The contractarian theory proposes the requirement of prior consent of people affected. In this context, the popular opinion is that the prohibition of insider trading is legitimised after its approval by the legislature. Shariah uses a similar tool or procedural approach in developing law in novel situations through its *concept of Ijtihad*.

It is also argued that Shariah's approach contravenes Professor Mann's analysis based on the economic rationale of efficiency. He argued that general objective of finance is to promote economic growth by equitable distribution of resources. The current stock exchanges make this possible by allocating scarce resources optimally. The optimality of allocation is measured by the efficiency of the stock markets. He argued that insider trading increases the speed with which the shares price responds to the changing information or data. It facilitates the movement of capital in pursuit of projects which are more profitable. This leads to increased informational, allocational and the greater operational efficiency of the market.

In comparison, the Islamic concept of efficiency differs from Mann's assertion. It does not endorse the concept of efficiency which hinges on the speed with which capital chases profit maximisation. Shariah's concept of efficiency adds a social dimension; the joint responsibility towards society to the concept of efficiency. It dictates that capital should be invested in profitable projects which also lead to social prosperity as well. Although Professor Manne makes a prima facie case that insider trading may benefit the investors, the stock market and in turn society, however it is unsupported by the empirical analysis. In the absence of empirical evidence, Shariah scholars are unlikely to approve of it as an efficiency enhancing practice which may lead to prosperity. Moreover, trading based upon privileged information when Islam promotes equality would not meet the ethical criteria of the Shariah compliant securities exchanges.

---

[12] John Rawl, *The theory of Justice* (1991) Harvard University Press

7.3-Comparison of Rationales of Prohibition of Manipulation in UK and US with Shariah Principles

The corporations raise capital by listing on the primary markets through initial public offering. The capital raised facilitates projects and contributes to the economic growth and development in the country. The shareholders contribute money towards these projects and are able to recover their money by buying and selling stocks on the secondary markets. The aggregate buying and selling reflects the market forces of demand and supply which determine the price formation mechanism. It also facilitates resource allocation process. The occurrences of manipulative practices cause price anomalies which affect the *fair* price formation mechanism which in turn also effect the *efficient* resource allocation. It also undermines the integrity of the markets and investors depart in search of safer heavens. This reduces liquidity and makes it difficult for the companies to raise further capital which effect economic growth in the long term and reduce the *prosperity* of the society.

The second chapter analysed the rationales for prohibition of market manipulation and distortion of markets in UK and US. They are set out as an *uninterrupted price formation mechanism leading to resource allocation and equitable distribution of wealth, freedom from contraction of volume which in turn affects the trade, transport, industry and evaluation of collateral bank loans,*[13] *freedom from misrepresentation and deceit, freedom from dissemination of false information, equal access to flow of information, equal opportunities and risk for investors on impersonal stock exchanges, respect for the autonomy of the individual investors, unjust enrichment, fair, honest, level playing markets, promotion of investors' confidence and preserving integrity of the markets.*[14]

The above rationales, as analysed in the second chapter, underpins the theoretical foundation of the current law prohibiting manipulation in the UK and US. It is enforced by regulatory organisations such as SEC and FSA which monitor and keep under surveillance the markets through technological advanced computer system to detect the slightest anomalies in the price formation mechanism. Shariah endorses the above rationales into conventional securities markets which attempt to introduce norms of ethics in the secular markets to achieve its normative objective. In contrast to this, the Islamic markets and products in the 7th century

[13] Section 2 of Securities Exchange Act 1934.

[14] Please refer to the second chapter under the heading of "Prohibition of Manipulation" for a detailed analysis.

were not very advanced therefore the Islamic concepts prohibiting manipulation were also simplified.

There was no stock exchange fourteen centuries ago, however there was a buoyant market place in Mecca, Medina and other parts. Islam does not claim to have invented the market based system. However it took such measures to enhance and improve its spirit and its efficiency with its ethical approach. In setting the foundation of thefirst Islamic market structure, the Prophet banned all *form of gambling, taxes, levies, fees on merchants, buyers, sellers and merchandise in order to ensure that markets were free and devoid of artificial interference*. He strictly prohibited *any propaganda, rumours, false information, collusion, hoarding, abusive practices of artificially raising prices, exaggerating the quality of the products and exchange without mutual consent to ensure fairness, elimination of abuse and exploitation* in the ancient markets. These rationales are similar to the rationales of prohibition of manipulation.

The purpose of this prohibition was to avoid enmity, injustice, loss of social prosperity, harm and unknown consequences resulting from unfair exchange in the markets. By eliminating manipulation from the markets, the aim was to promote the higher objectives of Shariah. Shariah's higher objectives articulated that all financial transactions and economic projects should ultimately serve the objectives of promoting and enhancing human well-being, intellect, posterity and wealth. It is argued from the analysis in the sixth chapter that this approach will form the religious underpinning for Shariah's prohibition of manipulation and is comparable to the purpose of economic prosperity in the conventional securities markets.

It is also argued that Shariah has taken a significantly more profound approach in deterring manipulation. This approach originates from its general economic philosophy which articulates that markets do not simply provide a platform for exchange.[15] They must enable participants to *maximise profit* subject to *promoting falah* and *collective social welfare*.[16] This is contrary to the conventional economic approach of *profit maximisation in pursuit of self-interest* in a free enterprise system. The capitalistic philosophy has led to non-sustainable economic growth and failure to protect the investors.

---

[15] Abdus Samad, Market Analysis from an Islamic Perspective and the Contribution of Muslim Scholars, Downloaded from http://www.ibtra.com/pdf/journal/v4_n3_article4.pdf. Accessed on 24rth November 2011 at 54-56.

[16] Ibid at p 57

In this context, Shariah's has taken a two pronged approach in curbing manipulation in the markets. Firstly, it aims to ensure *equitable distribution of wealth, falah (prosperity), socio-economic justice throughout the markets by eliminating all form of exploitation, abuse and oppression.* It equates justices with *maintaining a level playing field and the natural equilibrium of market forces*. These Shariah principles are comparable to the normative objectives of conventional economics. Shariah makes it mandatory to incorporate the above principle of "no injury" or Maslahah (benefit to the society)[17] in its financial engineering philosophy.

Secondly, Shariah regulates financial engineering to curb volatility, excessive and abusive speculation, high leveraging, short selling, naked short selling and gambling in the financial system. It aims to devise products which facilitate fair exchange[18] in the markets.[19] In this context, the seventh chapter illustrated that Shariah's conservative contractual structures have an inbuilt safety mechanism which promote stability and minimises the possibility of manipulation.[20] These contractual structures are incorporated in devising new products and Shariah Advisory scholars monitor the process to ensure that the ultimate products do not provide undue advantage, unequal bargaining positions, gambling and are instrumental in creating distortion in the markets via its mechanics.[21]

In comparison, the conventional financial engineering philosophy prefers to attain efficiency by devising easy to execute, highly leveraged financial products. Such products are often tools for betting, causing fluctuation, volatility, loss of contact with the real economy which creates optimal circumstances to perpetrate manipulation. At the same time, the legal framework and regulatory organisations police the markets with a view to curbing

---

[17] Mohammad Lawal Ahmed Bashar, Price Control in Islamic Economy (1997*) Islamic Economics* at p 30

[18] Exchange is a fundamental concept both in Islamic Economics and conventional Economics. The Quran specifies the trade with mutual consent as a best form of distribution of resources. Adam smith also subscribed to "trade by mutual consent and mutual advantage." Shariah regards that all financial instruments are tools to facilitate exchange and therefore should be fair and free from exploitation and oppression.

[19] Shariah has specifications in respect of structure and mechanics of the products as analysed in the previous chapter. This is to ensure that parties are treated with fairness and oppression is eliminated.

[20] It is also argued that equity based products are more efficient that debt based products. Moreover they have inbuilt mechanism for consumer protection and reducing market abuse. Mohammed Shahid Ebrahim, Akram Safadi, Behavioural Norms in The Islamic Doctrine of Economics: A Comment (1995) Volume 27, *Journal of Economic behaviour and Organisation* at p 154. Also see Mohammed Anas Zarqa, Stability in an interest free Islamic Economy: A Note (1983) *Pakistan Journal of Applied Economics* at p 182.

[21] Conventional Finance follows a different approach in innovation of financial products. Their weakness or harmful effects on the society are highlighted after the crisis and no attempt is made to identify such harmful effects in advance whereas Islamic finance attempts to ensure at the financial engineering stage whether the products meet the criteria of collective social benefit.

manipulation and achieving its objectives of maintaining fair, transparent and orderly stock exchanges. This highlights an anomaly in the normative objectives of the conventional legal and regulatory market abuse frame work and its financial engineering philosophy.

It is also argued that the conventional financial system does not have any mechanism to anticipate or attempt to restrain the harmful effects of its products. Its weakness or the harmful effects on society are highlighted after the occurrences of manipulation or financial crisis. The conventional approach attributes more importance to the flexibility and has devised no rules to regulate innovation. Thus unsupervised financial engineering creates products which undermine the effectiveness of the legal framework of market abuse and regulatory organisations in practice. In comparison, Islamic finance pursues a much safer approach of financial engineering which is in alignment with its normative objective of *collective social benefit* (Maslahah).

It is further argued that the market abuse framework in the UK and US attempt to complement its general economics philosophy of trade with mutual consent which leads to fair price formation mechanism.[22] In line with this approach, the market abuse framework prohibits all such practices and tactics which disrupt trade with mutual consent and distort the price formation mechanism. Similarly, Shariah also subscribe to "exchange with mutual consent" as the most basic denominator in any transaction[23] and an equitable form of distribution of wealth in society. Shariah also prohibits any interference in *trade with mutual consent* and regards it as invalid exchange. This is a remarkably similar stance to prohibiting manipulation in the markets.

In this context, the Quran has also endorsed this stance. It has referred to transactions *without* mutual consent as "*devouring.*" Since the consent of the counterparty is over ridden in manipulative transactions, any profit earned from fraud, artificial transaction based manipulation, trade based manipulation, information based manipulation, misleading behaviour and distortion usurpation, fraudulent, abusive practices, deception and cheating would amount to *devouring* in the markets. These practices may also be compared with analogous terminologies in the ancient Islamic markets. For example, the modern practice of

[22] Adam smith based his capitalistic philosophy on "trade by mutual consent and mutual advantage."

[23] "Eat not up your property amongst yourselves by vanities: but let there be trade with *mutual consent*" Al-Quran 4:29.

cornering may be compared with Ikhtikar, pump and dump schemes with Najsh, insider trading with Talaqqi-al-Rukban and manipulation with Tatfif in the ancient markets.

It is obvious from the preceding analysis that Shariah has a much more comprehensive approach in dealing with abuse, exploitation, manipulation and distortion in comparison with the UK and US market abuse framework. It is also argued that the Islamic approach may result in complete elimination of market abuse. However it may also affect the liquidity and efficiency of the stock exchanges to some extent.

7.4- Conclusion

It is evident from the preceding analysis that the concepts, notions, maxims, rationales and theoretical underpinning for prohibition of market abuse in the UK, US and Shariah principles for investor protection are remarkably similar. Both aim to achieve the same objectives of orderly, fair markets with a level playing field devoid of abuse and exploitation. However Shariah's philosophical underpinning is much wider. It encompasses Quranic proscriptions, Prophetic commandments (6.4 and 6.5), mandatory economic principles, specific restrictions, ethical norms, rationales and requirements of fair balance in the contractual structures of the products. This complements Shariah's overall philosophy that the secondary securities markets are not simply a platform for exchange mechanism but also are a source of falah and prosperity for the society.

Despite the convergence of rationales for prohibition of market abuse of Shariah, UK and the US law, their actual approach of implementation vastly differs in practice. *UK and US legal and regulatory system discourage participants from engaging in undesirable behaviour by detecting and punishing them after market abuse has taken place*. The regulatory organisations scrutinise the markets with technologically advanced computer system to detect any anomaly in the price formation mechanism and the legal framework attempts to create a deterrence by providing for civil and criminal sanctions.[24]

In comparison, Shariah takes a *pre-emptive and very comprehensive approach* in curbing market abuse. *The higher objectives of Shariah set the overriding and holistic regulatory approach.*[25] It implements this approach in two key stages. Firstly, it is argued that strict

[24] Richard Pierce Jr, Market Manipulation and Market Flaws (2003) The Electricity Journal at p 2-3.

[25] The objective (Maqasid) of Shariah propounds for preservation of religion, life, intellect, property and family. Anything that affects the above five would be prohibited. Ali Adnan Ibrahim, The Rise of Customary Business

adherence with Shariah's compulsory ethical principles serves to curb market abuse in practice. They prohibit interest, gambling (Maisir) and excessive risk taking and uncertainty (gharar) in the financial system. These are regarded as exploitative, abusive and inconsistent with the notion of protecting the weak from the strong. Their prohibition serves to ensure socio-economic justice, a level playing field, equitable distribution of wealth, falah, social prosperity and egalitarianism in the securities markets. Shariah attempts to incorporate them in the design of the market which makes abuse and exploitation difficult to perpetrate.

The applicability of the aforementioned ethical principles is illustrated in the seventh chapter. For example, lending on interest for stock trading provides excessive leverage and unnecessary heat in transactions, volatility and leads to distortion and facilitates manipulation.[26] Similarly gambling (maisir) and excessive risk taking (gharar) is zero-sum in nature and leads to excessive and abusive speculation. It is a form of non-equilibrium prices and does not reflect "mutually beneficial exchange." Shariah believes that it leads to enmity, injustice, harm, loss of social prosperity and unknown consequences.[27] The seventh chapter also illustrate that maisir and qimar creates the optimal circumstances for perpetration of market abuse.

Secondly, Shariah also advocates contractual structures with an inbuilt safety mechanism and features in the context of securities markets. It regards financial products as instrumental in ensuring fair exchange which also curb exploitation and abuse. It also makes it an important condition of its *financial engineering philosophy* that mechanics (contractual structures) of equity, debt and derivative products must be balanced to be Shariah compliant and must not be used as tools for the perpetration of harm to the contemporary participants.

Some of the intrinsic features of ancient Shariah compliant contractual structures are profit and loss sharing, shirkah, asset based structures in equity based products, non-saleability and other pre-requisites in debt based products, requirements of payment, possession, delivery in derivative products and many other features highlighted in this thesis. As the preceding

in International Financial Market: An Introduction to Islamic Finance and Challenges of International Integration (2008) Volume 23, *American University International Law Review* at p 4.

[26] This was one of the reasons that commercial banks were prohibited from investing in securities (proprietary trading - Speculating with their own capital) pursuant to the Glass Steagal Act (Banking At 1933). Ioannis Glinavos, Regulation and the Role of Law in Economic Crisis, (2009) Presented at W G Hart Legal Workshop – Institute of Legal Studies at p 4. Downloaded from http://ssrn.com/abstract=1425782. Accessed on 25th June 2012.

[27] Al-Quran - Surah- Maeda: 5-90-91

analysis indicates, they aim to ensure certainty in the exchange mechanism by rooting out market abuse and exploitation. The design and structure illustrate the principles of mutual dependence, socio-economic justice, balance of power, stability in the financial system, equitability, fairness, and public welfare.

Shariah scholars also *pre-emptively supervise the process of financial innovation* in every financial institution in order to eliminate exploitation and harm for society. They detect and disallow non-Shariah compliant products which the unscrupulous may exploit to harm society regardless of their efficiency and profit maximisation. This approach is similar to regulation of the pharmaceutical products in the UK and US. It is further argued that these Shariah scholars follow fixed parameters of ethical principles to regulate any financial innovation.

On the other hand, conventional ethics is transient and changes as the financial system develops over time. Scholars argued that greed, pursuit of self-interest, maximization of profit and efficiency are the key building blocks of the capitalistic financial engineering philosophy.[28] It is criticized that greed and pursuit of self-interest are the lowest motives of the human being.[29] In comparison, *the higher objectives of Shariah which set Shariah's overriding* financial engineering philosophy are embedded in maximisation of falah. This is a much wider concept than maximisation of profit or efficiency and imparts utility, service and benefit to society.

It is also highlighted from the preceding analysis that the objectives underlying legal and regulatory market abuse framework in the UK and US and conventional philosophy of unbridled financial innovation (a key part of free market capitalism) clash and creates an anomaly. On one side, the rationales behind prohibition is to promote fair, transparent and orderly transactions however on the other hand, any new innovation may equip the participants with tools to perpetrate market abuse. It is therefore recommended that adopting an approach similar to Islamic finance of supervising financial innovation by the financial experts who must ensure products are safe or alternatively have proportionate regulatory

---

[28] Lawrence Mitchell argued that smith's theory of invisible hands was embedded in the "behaviour of self-interested but morally sensitive economic man." Lawrence Mitchell, Financialism: A (Very) Brief History, (2010) downloaded from at p 2 Accessed on 20th November 2011.

[29] Beginning with New Deal to the current financial crisis, western regulators have learned that to have a sustainable economic growth and prosperity, they need to put restraints on pursuit of self-interest.

measures in place to counter their misuse is the way forward.[30] On the other hand, Shariah may learn how to establish institutions and regulatory organisations to keep surveillance on the markets.

Based on the above analysis, it may be argued that the key feature of capitalistic philosophy of non-interference in trade operationalized through prohibition of market abuse in securities markets has strong and comprehensive parallels in the form of the ethical principles in Shariah. However, Shariah treats ethics and finance together to work for the betterment of society whereas conventional finance has been divorced from religious ethics since the nineteenth century.[31] Mitchell argued that lack of ethical control has resulted in a shift from capitalism to financialism.[32] This often provides ample opportunities for market abuse ad leads to financial crisis.

---

[30] A similar approach has been propagated by Dr Ioannis Glinavos. He proposed the review of receding role of state to market relationship in the context of financial innovation and regulation. He argued that this may lead to "ethically acceptable version of capitalism." This approach is similar to Islamic finance. Ioannis Glinavos, Regulation and the Role of Law in Economic Crisis, (2009) Presented at W G Hart Legal Workshop – Institute of Legal Studies. Downloaded from http://ssrn.com/abstract=1425782. Accessed on 25th June 2012.

[31] Pre-classical economist treated the economics and ethics as one. Adam Smith also classed himself as moral philosopher and Political economist and his major work was theory of Moral Sentiments. However, by the nineteenth century moral judgements were regarded as scientifically unsound. Theories which could stand the test of empirical analysis were regarded as sound and acceptable as opposed to theories which were morally well founded. Rodney Wilson, *Economics, Ethics and Religion* (1997) New York University Press at p 3.

[32] Mitchell argued that the capitalism pushes for economic growth by providing funds for the production of goods and trade whereas financialism raises money not to trade in the real economy but trade in the financial paper. He described it as a "market unto themselves." These financial institutions are not prepared to share any social or economic responsibility. They often transfer wealth as opposed to facilitate creation of wealth through market misconduct. Financialism has none of the features of capitalism. The recent legislation of "Volcker rule" and "Lincoln amendment" seeks to undo these trends. For a more comprehensive analysis see Lawrence Mitchell, Financialism: A (Very) Brief History" downloaded from http://ssrnn.com/abstract=1655739 at p 1, 2,3,14. Accessed on 20th November 2011,

Bibliography

Books

Ahmed, Habib, *Theoretical Foundation of Islamic Economics* (2002) Islamic Research and Training Institute.

Al-Ghamal, Mahmoud, *Islamic Finance-Law, Economics and Practice* (2006) Cambridge University Press.

Al-Quran: Al-Baqarah - 278 -290.

Askari, Hossein & Zamir, Iqbal & Krichene, Noureddine & Mirakhor, Abbas, *The Stability of Islamic Finance: Creating a Resilient Financial Environment for Secure Future* (2010) John Wiley.

Avgouleas, Emilios, *The Mechanics and Regulation of Market Abuse: A Legal and Economic Analysis* (2005) Oxford University Press at p 88-92.

Ayub, Muhammad, *Understanding Islamic Finance* (2007) John Wiley.

Bainbridge, Stephen, *Securities Law: Insider Trading* (1999) Foundation Press.

Beekun, Issa Rafiq, *Islamic Business Ethics* (1996) International Institute of Islamic Thought.

Bernstein, Peter, *Against the Gods: The Remarkable Story of Risks* (1996) John Wiley.

Brandies, Louise, *Other People's Money- and How the Bankers Use It* (1914) Accessed online: http://library.louisville.edu/law/brandeis/opm-toc.html.

Bukhari, Mohammed Imam, *Sahih Al-Bukhari: A Book of Hadiths*.

Chancellor, Edward, *Devil Takes the Hindmost*, (2000) Plume Books at p ix.

Chapra, Umer, *Towards a Just Monetary System* (1985) The Islamic Foundation.

Chapra, Umer, *What is Islamic Economics* (1996) Islamic Research and Training Institute.

Chapra, Umer, *The Islamic Welfare State and its Role in the Economy* (1979) The Islamic Foundation.

Chapra, Umer, Challenges Facing the Islamic Financial Industry, Chapter 21 in Kabir Hassan, and Marvyn King, *Handbook of Islamic Banking* (2007) Edward Elgar.

Chapra, Umer, *Islam and the Economic Challenge* (1992) Islamic Foundation - Leicester.

Chaudhary, Mohammed Sharif, *Fundamentals of Islamic Economic* (1999) Burhan Education and Welfare Trust.

Chapman, Colin, How *the Stock Markets Work* (2002) Random House Business Books.

Cootner, *Speculation, Hedging and Arbitrage (1968)* Modern Encyclopaedia of Social Sciences.

Davidson, Paul, *Money and Real World* (1978) Palgrave Macmillan Press.

Easterbrook, Frank, Insider trading as an agency Problem published in John Pratt and Richard Zeckhauser, *In Principals and the Agents: The Structure of Business. (*1985) Harvard Business School Press.

Easterbrook, Frank & Fischel, Daniel, *The Economic Structure of Corporate Law* (1991) Harvard University Press.

Fabian, Ann, *Card Sharps, Dream Books & Bucket Shops*: *Gambling in the 19th century America (1990) Routledge.*

Fabozzi, Frank & Modigliani, Franco, *Capitals Market: Institutions and Instruments* (1992) Prentice Hall.

Fisher, Jonathan & Bewsey, Jane & Waters, Malcolm & Ovey, Elizabeth, *The Law of Investor Protection* (2003) Sweet Maxwell.

Galbraith, John Kenneth, *A Short History of Financial Euphoria* (1993) Penguin Books.

Gambling, Trevor & Karim, Rifaat Ahmed Abdel, *Business and Accounting Ethics* (1991) Mansel.

Gordon, Barry, *Economic Analysis before Adam Smith* (1979) Lewes Reprint Ltd.

Hansel, John & Cohen, Mark, *Risk and Gambling: The Study of Subjective Probability* (1956) Longmans.

Kamali, Hashim Mohammed, *Islamic Commercial Law: An Analysis of Futures and Option* (2001) The Islamic Text Society.

Huang, Hui, *International Securities Markets in China: Insider Trading Law in China* (2007) Kluwer International.

Taimiyah, Ibn, Al-ubaidiyah fi al-Islam (1967) Al-Matba'ah al-Salafiyyah - Cairo at p 17.

Iqbal, Munawar & Llewellyn, David, *Islamic Banking and Finance* (2002) Elgar Publishing Ltd.

Iqbal, Zamir & Mirakhor, Abbas, *An Introduction to Finance - Theory and Practice* (2007) John Wiley.

Iqbal, Munawar & Wilson, Rodney, *Islamic Perspective on Wealth Creation* (2005) Edinburgh University Press.

Kababji, Maher, *Islamic Capitalism: Presentation of an alternative Economic System* (2010) Word Clay.

Kamali, Hashim, *Islamic Commercial Law: An Analysis of Futures and Options* (2002) The Islamic Text Society.

Kamali, Hashim, *Shariah Law: An Introduction* (2008) One World Oxford at p 33.

Karen, Blumenthal, *Six Days in October: the Stock Market Crash of 1929* (2002) Anthem Books.

Keane, Simon, *Stock Market Efficiency: Theory, Evidence, Implications* (1983) Phillip Allan Publishers.

Kettle, Brian, *Islamic Capital Market* (2009) Harcourt Litho Swansea.

Khadmein, Ann, *The SEC and the Capital Market Regulations (*1992) University of Pittsburgh Press.

Khan, Akram Mohammed, *Issues in Islamic Economic* (1983) Islamic Publications.

Khan, Fahim, *Islamic Futures and Their Markets: With Special Reference to their Role in Developing Rural Financial Market* (1997) Islamic Development Bank at p 9.

Kindleberger, Charles, *Manias, Panics and Crashes* (2005) John Wiley.

Lose, Louis Joel Seligman, *Fundamental of Securities Regulation* (1999) Aspen Publishers.

Macey, Jonathan, *Insider trading: Economics, Politics, and Policy* (1991) Washington: AEI Press

Mahlknecht, Michael, *Islamic Capital Market and Risk Management* (2009) Risk Books.

Mandelbrot, Benoit & Hudson, Richard, *The Misbehaviour of Markets* (2008) Profile Books.

Mannan, Mohammed, *Understanding Islamic finance: A Study of Securities Market in an Islamic Framework* (1993) Islamic Research and Training Institution.

Manne, Henry, *Insider Trading and the Stock Market* (1966) New York: The Free Press.

McGosh, Andrew, *Financial Ethics* (1999) Kluwer Academic Publishers.

Muslim, Kitab al-Masqat, Bab al-Sarf wa Bai al-Dhahab bi al-Waraq Naqdan.

Naqvi, Haider Nawab Syed, *Islam, Economics and Society* (1994) Kegan Paul International.
Naqvi, Haider Nawab Syed, *Ethics and Economics* (1981) The Islamic Foundation.

Nelson, Armstrong Samuel, *The ABC Stock Speculation* (2007) Market Place Books.

Obaidullah, Mohammed, *Islamic Financial Services* (2005) Scientific Publishing Centre.

Parrish, Michael, *Securities Regulation and the New Deal* (1970) Yale University Press.

Poitras, Geoffrey, *Risk Management, Speculation and Derivative Securities* (2002) Academic Press.

Ramadan, Tariq, *Radical Reform: Islamic Ethics and Liberation* (2009) Oxford University Press.

Rawl, John, *The Theory of Justice* (1991) Harvard University Press.

Rider, Barry & Abrams, Charles & Ferran, Ellis, *Guide to the Financial Services Act 1986* (1989) Bicester: Oxon at p 7.

Rosley, Azhar Saiful, *Critical Issues on Islamic Banking and Financial Markets* (2005) Author House.

Muslim, Ibn-al-Hajjaj, *Sahih Muslim - A Book of Hadiths*.

Saleh Nabil, *Unlawful Gain and Legitimate Profit in Islamic law* (1986) Cambridge University Press.

Saleem, Mohammed, *Islamic Banking - A $300Billion Deception* (2005) Xlibris Corporation.

Samuelson, Paul, *Economics: An Introductory Analysis* (1967) McGraw Hill.

Sardehi, Nangi, *Islamic Capital Markets* (2008) VDM Verlag Dr. Muller Aktiengesellschaft & Co. KG.

Schiller, John, *Financial Fraud* (2010) Create Space Publishing at p 17.

Sedgwick, Romney, *The History of Parliament: The House of Commons 1715-1754* (1970) The Stationary House - London at p 435-7.

Harris, Larry, *Trading and Exchanges* (2003) Oxford University Press.

Smith, Mark, *A History of Global Stock Market: From Ancient Rome to Silicone Valley* (2003) The University of Chicago Press.

Smith, Frank, *Management Trading*: *Stock Market Prices and Profits* (1941) Yale University Press.

Suleiman, Abu Dawud, *Sunan Abu Dawud- A book of Hadiths*

Suwailum, Sami Ibrahim, *Hedging in Islamic Finance* (2006) Islamic Research Training Institute at p 38 -39.

Swan, Edward, *Building the Global Market: A 4000-Year History of Derivatives* (2000) Kluwer Law International.

Tahrir, Hizb-ut, *The turbulence of the Stock markets: Their Causes & the Shariah rule pertaining to these causes* (1998) Al Khilafah Publications.

Kababji, Maher, *Islamic Capitalism: Presentation of Alternative Economic System* (2010) Word clay at p 20

Khan, Tariqullah & Ahmed, Habib, *Risk Management; An Analysis of Issues in Islamic Financial Industry* (2001) Islamic Research Training Institute at p 26.

Khan, Tariqullah & Dadang, Muljawan, *Islamic Financial Architecture: Risk Management and Financial stability* (2006) Islamic Research Institute at p 377.

Kurran, Taimur, The Economic System in Contemporary Islamic Thought" in K.S (Jomo) *Islamic Economic Alternatives* (1992) Macmillan.

Iraj, Toutounchian, *Islamic Money and Banking: Integrating in Money in Capital Theory* (2009) John Wiley.

Usmani, Taqi, *Future Options Swaps and Equity Instruments* (1996) New Horizon.

Usmani, Taqi, *An Introduction to Islamic Finance* (2007) Maktaba Ma'Ariful Quran.

Vaughan, Emmett, *Fundamentals of Risk and Insurance* (1999) John Wiley at p 3.

Vogel, Frank & Hayes, Samuel *Islamic law and Finance* (1998) Kluwer International.

William, Jeffrey, *Manipulation on Trial – Economic Analysis and Hunt Silver Case* (1995) Cambridge University Press.

Wilson, Rodney, *Economics, Ethics and Religion,* (1997) New York University Press.

Articles, Essays, Discussion and Conference Papers.

Abdul, Pahlavi Razi & Anne-Sophie, Gintz burger, Equity Based, Assed Based and Asset Backed Transactional Structures in Sharia compliant Financing: Reflection in Current Financial Crisis (2009) *The Economic Papers of Australia* at p 274.

Abdererrazak, Farid, The performance of Islamic Equity Funds (May 2008) Unpublished MSc Thesis in the University of Maastricht at p 13.

Alcock, Alistair, Misappropriation Restored (1997) *Journal of Business Law* at p 562.

Alcock, Alistair, Market Abuse (2002) Volume 23, *Company Lawyer* at p 142.

Alexakis, Chrisos & Tsikouras, Alexandros, Islamic Finance: Regulatory Framework – Challenges Lying Ahead (2009) Volume 2, *International Journal of Islamic and Middle Eastern Finance and Management* at p 90-95.

Allen, Franklin & Gale, Douglas, Stock Price Manipulation (1992) Volume 5, *Review of Financial studies* at 503-505.

Alhabshi, Syed Othman, Development of Capital market Under Islamic Principles (1994) at p 4. Presented in Conference on Managing and Implementing Interest Free Banking/Financial system. Downloaded from http://www.kantakji.com/fiqh/Files/Markets/y102.pdf.

Al-Masri, Rafic Yunus, Speculation between Proponents and Opponents (2007) *Journal of King Abdul-Aziz University* at p 45.

Al-Bashir, Mohammed & Al-Amine, Mohammed, Sukuk Market: Innovation and Challenges (2008) Volume 15, *Islamic Economic Studies* at p 1-2.

Al-Saati, Abdul-Rahim, The Permissible Gharar in Classical Islamic Jurisprudence (2003) Volume 16, *Islamic Economics* at p 12-13.

Alsayyed, Nidal, Shariah Parameters of Islamic Derivatives in Islamic Banking and Finance (2011) International Shariah Research Academy for Islamic Finance (ISRA) at p 1. Downloaded from http://www.kantakji.com/fiqh/Files/Finance/N362.pdf.

Ahmad, Abdel-Rehman Yousri, Islamic Modes of Finance and the Role of Sukuk at p 3. Downloaded from http://www.qfinance.com.

Anas, El-Melki, Ethical Investment and Social Responsibilities of the Islamic Banks (2009) Volume 2, International *Business Research* at p123-124.

Anas, Zarqa Mohammed, Stability in an Interest Free Islamic Economy: A Note (1983) *Pakistan Journal of Applied Economics* at p 182.

Anas, Zarqa Mohammed, Rules of Exchange in Islamic Jurisprudence: An Introduction for Economist, Islamic Research and raining and Institute.

Angel, James & McCabe, Douglas, The Business Ethics of Sort Selling and Naked Short selling (2009) Volume 85, *Journal of Business Ethics* at p 242.

Anwar, Muhammad, An Islamic Perspective on Capital markets and Islamic Securities in Malaysia (1995) *The Pakistan Development Review* at p 867.

Avgouleas, Emilios, The Global Financial Crisis and the Disclosure paradigm in European Financial Regulation: The Case for Reform (2009) Volume 6, *European Company and Financial Law Review* at p 1.

Avgouleas, Emilios, The Thorny and Multi-Faceted Issue of OTC Derivatives Regulation and the Obama Administration Proposal (2009) Downloaded from http://www.finreg21.com/home.

Avgouleas, Emilios, Financial Innovation versus Systemic Stability: The Unresolved Dilemma of Derivative Regulations (2009) Downloaded from http://www.finreg21.com/home.

Avgouleas, Emilios, A New Framework for the Global Regulation of Short Sales: Why Prohibition is Insufficient and Disclosure Insufficient (2010) *Stanford Journal of Law, Business & Finance* at p 37.

Avgouleas, Emilios, Short Sales Regulation in Seasoned Equity Offerings, *Corporate Law and Finance in the UK and EU* (2011) Oxford University Press at p127.

Bacha, Obiyathulla, Derivative Instruments and Islamic Finance: Some thoughts for Reconsideration (1999) Downloaded from http://mpra.ub.uni-muenchen.de/12752.

Bagby, John, The Evolving Controversy over Insider Trading (1986) Volume 24, *American Business Law Journal* at p 580.

Bagehot, Walter, *The Only Game in the Town* (1971*) Financial Analyst Journal* at p 12.

Barry, John, The Economics of outside information and Rule 10b-5 (1981) Volume 129, *University of Pennsylvania Law Review* at p1307.

Bashar, Mohammed, Two Aspects of Exchange in Islam Jurisprudence: Rejoinder (1994) Volume 4, No 1 *Review of Islamic Economics* at p 18-19.

Bashar, Mohammad Lawal Ahmed, Price Control in Islamic Economy (1997*) Islamic Economics* at p 30-33.

Berle, Adolf, Publicity of Accounts and Directors Purchases of Stocks (1927) Volume 25, *Michigan Law Review* at p 827.

Benny, Laura**,** Insider Trading Laws and the Stock Market around the World (2006) *The John M Olin Centre for Law and Economics Working Paper Series*, Paper No 35.

Bierman, Harold, The Stock Market Crash of 1929 (2010) Volume 51 *Florida Law Review*

Bhide, Amar, The Hidden cost of Stock Market Liquidity, (1993) Volume34, *Journal of Financial Economics* at p 31-51.

Bainbridge, Stephen, The Law and Economics of Insider Trading - A Comprehensive Primer (2001). Downloaded from http://papers .ssrn.com/paper.taf?abstrat_id=261277.

Bainbridge, Stephen, the Insider Trading Prohibition: A Legal and Economic Enigma (1986)

Wang, Trading on Material Non-public Information of Impersonal Stock Markets (1986) Volume 54 *South California Law Review* at p1226.

Brenner, Gabriel, *Gambling and Speculation* (1990) Cambridge University Press at p 19-27.

Blume, Marshal & Jermy Siegel, The theory of Security Pricing and Market Structure (1992) Volume 1, *Financial Markets, Institution and Instruments* at p3.

Boyle, James, A Theory of Law and Information: Copyright, Spleens Blackmail and Insider trading (1992) Volume 80, *California Law Review* at p 1508.

Bris, Auto & Goetzmann, William & Ning Zhu, Efficiency and the Bear: Short Sales and Markets around the World (2007) Volume 62, *Journal of Finance* at p1029.

Brudney, Victor, Insiders, Outsiders and Informational Advantages under the Federal Securities Law, Volume 93, *Harvard Law Review* at p 339-340.

Brudney & Clark, A New Look at the Corporate Opportunities (1981) Volume 94, *Harvard Law Review*.

Burghardt, Ian and Caroline Ful, Islamic Banking Credit Products in Germany and in the United Kingdom (October 2004) Department of Finance Working Paper Series at p 14.

Carlton Dennis & Daniel Fischel, The Regulation of Insider Trading (1983) 35 *Stanford Law Review* at p 857.

Carlton, Dennis & Fischel, Daniel, The Regulation of Insider Trading (1983) Volume 35, *Stanford Law Review* at p 408.

Cary, William, Corporate Standards and Legal Rules (1962) Volume *50, California Law Review at p* 408.

Cary, William, The Direction of Management Responsibility (1962) Volume *18, Business Law Review* at p 29.

Cary, William, Recent Developments in Securities Regulation (1963) Volume *63, Columbia Law Review* at p856.

Chakarvarty, Sugato & McConnell, John, Does Insider Trading Really Move Prices (1999) Volume 34, *Journal of Financial Quantative Analysis* at p 191-193.

Chapra, Umer, The Role of Stock Exchanges in Islamic Economy: Comments (1985) Volume 3, *Journal of Research in Islamic Economy* at p 75.

Chapra, Umer, Mechanics and Operation of Islamic financial Market (1988) Volume 5, *Journal of Banking and Finance* at p 31.

Chapra, Umer, The Nature of Riba in Islam (2006) Volume 2, *The Journal of Islamic Economic and Finance.*

Chapra, Umer, Challenges Facing the Islamic Financial Industry, Chapter 21 in Kabir Hassan, and Marvyn King, *Handbook of Islamic Banking* (2007) Edward Elgar.

Chapra, Umer, The Global Financial Crisis: Can Islamic Finance Help (2008) *International Journal of Economics and Management* at p 119.

Chatterjee, Arkedov, Joseph Cherian, Robert Jarrow, Market Manipulation and Corporate Governance: A Perspective (1993) Volume 1, *Financial Management* at p 200-209.

Christopher, Stephen, & Ferri, Michael & Angel, James, Short Selling Prior to Prior to Earning Announcement (2004) Volume 59, *Journal of Finance* at p 1845.

Chong, Beng Soon & Ming-Hang Liu, Islamic Banking: Interest Free or Interest Based (2009) Volume 17, *Pacific-Basin Finance Journal* at p126.

Culp, Christopher, OTC Derivatives: Benefits, Costs, and Implication of the Dodd-Frank Wall street Reform and Consumer Protection (2010) Volume 2, Journal of Applied Finance at p 21.

Coffee, John Junior, Understanding Enron, It's about the Gatekeeper, Stupid, *Columbia Law and Working Paper No 207* (2007) http://ssrn.com/abstract_id=325240.

Cox, Charles & Fogarty, Kevin, Bases of Insider Trading Law (1998) 49 *Ohio State Law Journals at p 353, 366.*

Dallas, Mark, United States v. O' Hagan: A failed Attempt to Protect Public Policies underlying the Securities Laws (1999) Volume 32, *University of California Davis Law Review* at p 1107.

DeLorenzo, Shaykh Yusuf Talal, Shariah Compliance Risk, (2007) Volume 7, *Chicago Journal of International Law* at p 2.

DeLorenzo, Shaykh Yusuf Talal, Covered Options: Scholars Answer, Down loaded fromhttp://muslim-investor.com/answers/covered-option.html.

Demsetz, Harold, Corporate Control, Insider Trading, and Rate of Return (1986) Volume 76, *American Economic Review* at p 313.

Dennert, Jurgen, Insider Trading (1991) Volume 44, *International Review for Social Sciences* at p193-195. Downloaded from http://onlinelibrary.wiley.com/doi/10.1111/j.1467-6435.1991.tb02096.x/pdf.

Dodd, Randall, Consequences of Liberalising Derivative Markets (2002) Financial Policy Forum at p 2, 8-9. Downloaded from http://www.financialpolicy.org/fpfspr10.pdf.

Dogarawa, Ahmad Bello, Achieving Equitable Distribution through the Institution of Zakah, (June 2010) Downloaded from SSRN http://ssrn.com/abstract=1625230) at p 3.

Dusuki, Asyraf Wajdi, Challenges of Realising Maqasid-al-Shariah in Islamic Capital Market: Special Focus on Equity Based sukuk, Key Note Speaker at International Islamic Management Conference on Islamic Capital Market, 28th, 29th October 2009. Downloaded from http://uaelaws.files.wordpress.com/2011/10/challenges_of_realizing_maqasid_as-shariah_in_islamic_capital_market_final.pdf.

Dusuki, Asyruf Wajid & Nurdianwati Irwani Abdullah, Maqasid al-Shariah, Maslahah and Corporate Social Responsibility (2009) *The American Journal for Social Sciences* at p 30.

Dykstra, Clarence, Blue Sky Legislation (1913) Volume 7, *The American Political Science Review* at p 230-234.

Easterbrook, Frank, Insider Trading, Secret Agents, Evidentiary Privileges and the Production of Information. (1981) *Supreme Court Review* at p 333-334.

Easterbrook, Frank, Monopoly, Manipulation and the Regulations of Futures Markets (1986*)* Volume 59, *Journal of Business* 106.

Ebrahim, Mohammed Shahid & Akram Safadi, Behavioural Norms in The Islamic Doctrine of Economics: A Comment (1995) Volume 27, *Journal of Economic behaviour and Organisation* at p 154.

El-Askar, Ahmad Abdel Fattah, Towards an Islamic Stock Exchange in Transitional Stage (1995) *Islamic Economic Studies* at p 3.

El-Din, Seif, Taj-el-Din, Towards an Islamic Model of Stock Market, (2002) Volume 14, *Journal of King Abdul-Aziz University* at p 3-4.

El-Din, Seif, Capital and Money Market of the Muslims: The Emerging Experience in theory and Practice, (2007) *Kyoto Bulletin of Islamic Areas studies* at p 58.

El-Gari, Mohammed Ali, Stock Exchange Transactions: Shariah Viewpoints (1991) *Journal of Objectives Studies* at p 133.

El-Gari, Mohammed Ali, Shariah Injunctions on Futures Contracts (2006) www.islamicfinancenews.com.

Mohammed Kahf, Islamic Stance on Commodities or Futures http://www.islamonline.net/servlet/Satellite?cid=1119503544954&pagename=IslamOnline_English-Ask_Scholars52FfatwaE%PrintFatwaE;

Falkner, Robert & Jon, Gerty, Regulation of Market Misconduct in the United Kingdom (2005) *Journal of Investment Compliance* at p 35-53.

Fama, Eugene, Random Walks in the Stock market Prices (1965) Volume 21, *Financial Analysts Journal* at p 55.

Fama, Eugene, Efficient Capital Markets: A Review of Theory and Empirical work (1970) Volume 25, *Journal of Finance* 383.

Farooq, Abu Umar & Hassan, Kabir, Riba and Islamic Banking (June 2007) Volume 3, *Journal of Islamic Economics, Banking and Finance* at p 2-5.

Farooqi, Riyaz, Global financial Crisis Unthinkable under Islamic Banking Principles, (1st March 2009) Sunday Observer at p 1.

Ferber, David, The Case Against Insider Trading: A Response to the Professor Manne (1970) Volume 23, *Vanderbilt Law Review* at p 621.

Figlewski, Stephen, Market Efficiency in a Market with Heterogeneous Information (1978) Volume 86, *Journal of Political Economy 581*.

Figlewski, Stephen, Information Diversity and Price Behaviour (1982) Volume 37, *Journal of Finance at* p 88.

Fischel, David & David Ross, Should the Law Prohibit Manipulation in Financial Markets (1991*)* Volume 105, *Harvard Law Review* at p 510- 511.

Fleming, Rick, 100 Years of Securities Law: Examining a Foundation laid in Blue Sky (2011) Volume 50 *Washburn Law Review* at p 585.

Foster, Nicolas, Islamic Perspectives on the Law of Business Organisation1: An Overview of the Classical Sharia and Brief Comparison of the Shariah Regimes with Western-Style Law (2010) *European Business Organisation Law Review* at p 9.

Ghouri, Ahmed Ali, The Law and Regulation of OTC Derivatives: An Anglo-American Comparison and Lessons For developing Countries, *Nordic Journal of Commercial Law* at p 1.

Glinavos, Ioannis, Regulation and the Role of Law in Economic Crisis (2009) Presented at W G Hart Legal Workshop – Institute of Legal Studies at p 4. Downloaded from http://ssrn.com/abstract=1425782.

Ghazali, Imam, *Revival of Religious Learning: Ihyaa Ulum-Id-Din* (Late 10th century) Volume II, Dar-ul-Ishat. Translated by Fazl-ul-Karim (1993) at p 46.

Gilligan, George, Historical Touchstones in the Regulation of the Financial Services Sector: the Evolution of Financial Services Regulations (1992) *The International Journal of Law and Regulatory Practice* at p 65.

Gilligan, George, The origins of UK Financial Services Regulation (1997) Volume 18(6) *Company Lawyer* p 167-176.

Gilson, Ronald & Reinier, Kraakman, The Mechanisms of Market Efficiency, Volume 70, *Virginia Law Review* at p 629.

Givoly, Dan & Palmon, Dan, Insider Trading and the Exploitation of inside Information: Some Empirical Evidence (1985) Volume 58, *Journal of Business Review* at p 69.

Goldwasser, Vivien, Regulating Manipulation in Securities Markets: Historical Perspectives and Policy Rationales (1999) Volume 5, *Australian Journal of Legal History* at p 151.

Gombola, Michael & Hei Wai Lee & Feng-Ying Lui, Evidence of Short selling by Managers after Seasoned Equity Offerings (1997) at p 1. Downloaded from http://www.jstor.org/stable/pdfplus/3666212.pdf?acceptTC=true Accessed on 11th July 2011

Goshen, Zohar & Parchomvsky, Gideon, On Insider Trading, Markets and Negative Property Rights in information (2001) Volume 87, *Virginia Law Review* at p 1238-1239.

Gower, Lawrence Cecil, *Big Bang and City Regulation* (1988) Volume 51, *Modern Law Review* at 8.

Haft, Robert, The Effect of Insider Trading Rules on the Internal Efficiency of the Large Corporation (1981- 82) Volume 80, *Michigan Law Review* at p 1058.

Hanware, Khalil, Global Platform Needed for Islamic Finance (27th July 2009) *Arab News*.

Hartman, Joerg, Insider Trading: An Economic and Legal Problem (1997-1998) Volume 1, *Gonzaga Journal of International Law* at p 46-99.

Hashim, Kamali, Islamic Commercial Law: An Analysis of Futures (1996) *The American Journal of Social Sciences* at p 209.

Hashim, Kamali, Prospects for Islamic Derivatives in Malaysia (July-October 1999) Volume 41, *Thunderbird International Business Review* at p 523-540.

Hashim, Kamali, Prospects of An Islamic Derivatives in Malaysia (July-October 1999) Volume 41, *Thunderbird International Law Review* at p 523-540.

Hashim, Kamali, Tasir (Price Control) in Islamic Law (1994) Volume 2, *The America Journal of Islamic Social Sciences* at 27.

Hassan, Abdul & Antoniou, Antonios *Equity Fund's Islamic Screening: Effects on its Financial Performance* (2007) Research Papers, Islamic Development Bank at p 1.

Hassan, Abdul, The Global Financial Crisis and Islamic Banking. http://www.islamic-foundation.org.uk/IslamicEconomicsPDF/Hassan-financialcrisis-if.pdf.

Hetherington, John, Insider Trading and the Logic of the Law (1967) Wisconsin *Law Rev*iew at p 727.

Herberk, Wendell, Forestalling, Regrating and Engrossing (1929) *Michigan Law Review* at p 365-368.

Herwan, Mohammed & Sukri, Mohammed, Insider Trading from Malaysian Law and Islamic Law Perspective (2008) Downloaded from http://www.azmilaw.com/archives/Article_10_Insider_Trading-Islamic_Law_view_00102077_.pdf

Hussein, Kazi, Hedging Market Risk in Islamic Finance at p 1. Downloaded from http://www.worldcommercereview.com/publications/article_pdf/105.

Ibrahim, Ali Adnan, The Rise of Customary Business in International Financial Market, An Introduction to Islamic Finance and Challenges of International Integration, (2007) Volume 23, *American University Law Review* .

Iqbal, Muhammad Mazhar, Prohibition of Interest and Economic Rationality (2010) *Arab Law Quarterly* at p 1.

Iqbal, Zamir, Emerging Islamic Capital Markets – A Quickening Pace and New Potential, *Islamic Finance* at p 1. Downloaded from http://www.iefpedia.com/english/wp-content/uploads/2009/09/Emerging-Islamic-Capital-Markets.pdf.

Issa, Beekun Rafiq, *Islamic Business Ethics*, (1996) *International Institute of Islamic Thought* at p 5.

Jabber, Siti Farida Abdul, Financial Crimes: Prohibition in Islam and Prevention by the Shariah Supervisory Board of Islamic Financial Institutions (2010) Volume 17, *Journal of Financial Crime*, at p 288.

Jones, Tim, The Great Hunger Lottery: How Banking Speculation Caused Food Crisis, The World Development Movement Report, at p 7. Download from http://www.wdm.org.uk/food-speculation/great-hunger-lottery.

Kahf, Monzer, Market and Prices in Islamic Perspective (1993) *Journal of Objective Studies* at p 1-3.

Kahf, Monzer, Market and Prices, (1996) at p 6. Downloaded from http://monzer.kahf.com/papers/english/market_and_prices.pdf.

Kalinowski, Marcin, Over the Counter Derivative Market in View of global Financial Crisis of 2007 – 2009 (2011) at p 1125.

Kamali, Hashim, Islamic Commercial Law: An Analysis of Futures (1996) *The American Journal of Social Sciences* at p 209.

Kamali, Hashim, Prospects for an Islamic Derivatives Market in Malaysia (1999) Volume 51, *Thunderbird International Business Review* at p 523.

Kamil, Hanim Karmila & Marliana Abdullah & Shahida Shahimi, The Subprime Mortgage Crisis and Islamic Securitisation (2010) Volume 3, *International Journal of Islamic and Middle Eastern Finance and Management* at p 387.

Kammel, Armin, The Dilemma of Blind Spots in Capital Markets- How to Make Efficient Use of Regulatory Loopholes? (2009) Volume 10, *German Law Journal* at p 605.

Khans, Adnan, There are alternatives to Free Market Capitalism, http://www.khilafah.com/index.php/the-khilafah/economy/3919-there-are-alternatives-to-free-market-capitalism at p 10

Lynn, Stout, The legal Origin of the 2008 Credit Crisis, Down loaded from http://ssrn.comabstract=1770082.

Khan, Habibullah & Omar, Bashar, Islamic Finance: Growth and Prospects in Singapore (2008) U21Global Working Paper Series. Downloaded from http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1589796.

Khan, Mohammad Akbar, Consumer Protection and Islamic Law of Contract (2011) Volume 2, *Islamabad Law Review* at p 1. Downloaded from http://ssrn.com/abstract=19619192.

Khan, Mohammed Akram, Commodity Exchange and Stock Exchange in Islamic Economy (1988) Volume 5, *The American Journal of Islamic Social Sciences* at p 91-92.

Khan Mohammed, Stock Market in Islamic Framework, (1999) *International Journal of Islamic Financial Services* at p 4.

Knowledge@Wharton, U.S Securities Laws: Does High Density Enforcement Pay off (2007) at p 1. Downloaded from http://knowledge.wharton.upenn.edu/article.cfm?articleid=1746.

Krawiece, Kimberly, Fairness, Efficiency, and Insider Trading: Deconstructing the Coin of the Realm in the Information Age (2001) Volume 95*, North-western University Law Review* at p 502

Kumar, Lakshmanan Shiva, Do Firms Misleads Investors by Overstating Earnings before Seasoned Equity Offerings, Downloaded from http://faculty.london.edu/lshivakumar/ernmgmt.pdf.

Kunhibava, Sherin & Balachandran, Shanmugam, Shariah and Conventional Law Objections to Derivatives: A Comparison (2010) Volume 24, *Arab Law Quarterly* at p 319-32.

Laby, Arthur, Models of Securities Regulations in the United States (1999) Volume 23, *Fordham International Law Journal at p 24-26*

Latif, Qudeer & Susi Crawford, Introduction to Islamic Financial Risk Management Products at p 1. Downloaded from www.qfinance.com.

Larson, Peter Thal, UK Ban of Short Selling of Financials (2008) Downloaded from http://www.ft.com/cms/s/0/3652c4d8-85e3-11dd-a1ac-0000779fd18c.html#axzz1RuJlxVZ5.

Lee, Hazen Thomas, Rational Investment, Speculation, or Gambling – Derivative Securities and Financial Futures and Their Effect on the Capital Markets, *North-Western University Law Review* (1991-92) at p 1002.

Lecce, Steven & Andrew Lepone & Reuben Segara, The Impact of Naked Short sales on Returns, Volatility and Liquidity: Evidence from the Australian Securities Exchange (2008) Presented at 21st Australasian Finance and Banking Conference 2008. Downloaded from http://papers.ssrn.com/sso13/papers.cfm?abstract_id=1253176.

Levmore, Saul, Securities and Secrets: Insider Trading and the Law of Contract (1982) Volume 68, *Virginia Law Review* at p 117

Lewis, Morgan, A Summary of Market Abuse Regime in UK (2006) www.morganlewis.com at p 2-8.

Little, Arthur, Islamic Finance: Opportunities and Challenges (December 2008) Volume 1, Research Bulletin No 12 of Gulf One Investment Bank at p 6.

Macey, Haddock, A Co-Asian Model of Insider Trading (1980) Volume 80, *North-western University Law Review* at p1449.

Macey, Jonathan, From Fairness to Contract: The New Direction of the Rules against Insider Trading (1984) Volume 13, *Hofstra Law Review* at p 9-64.

Macey, Jonathan, The Origin of Blue Sky Law (1991) Faculty Scholarship Series, Paper 1641, http//digitalcommon.law.yale.edu.fss_paper/1641 at p 348-350.

Machan, Tibor, What is Morally Right with Insider trading, (2007) Volume 10, *Public Affairs Quarterly* at p 137.

McDermott, Edward, Defining Manipulation in Commodities Future Trading: The Future Squeeze (1979) Volume 74, *North-Western University Law Review* at p 202.

Mahlknecht, Michael, Contractual Enforceability Issues: Sukuk and Capital Market Development (2007) Volume 8, *The Chicago Journal of International Law* at p 428

Marsh, Jonathan, UK Legal and Regulatory Development (2005) *Journal of Derivatives and Hedge Funds* at p 164-172.

Manne, Henry, In Defence of Insider Trading (1966) Volume 44, *Harvard Business Review* at 114-115.

Manne, Henry, Insider Trading and the Law Professors (1970) Volume 23, *Vanderbilt Law Review* at p 547.

Manne, Henry, Economic Mysteries in Insider Trading (1991) Discussion Paper, Saarbrucken: Europa-Institute at p 4.

Manne, Henry, Insider Trading: Hayek, Virtual Markets and the Dog that did not bark (2005) Volume 31, *Journal of Corporation Law* at p 167-185.

Meulbroek, Lisa, An Empirical Analysis of Illegal Insider Trading (1992) Volume 47, *Journal of Finance* at p 1661.

Mirakhor, Abbas, Noureddine Krichene, Recent Crisis: Lessons for Islamic Finance (2009) Volume 5, *Journal of Islamic Economics, Banking and Finance* at p 68.

Mirakhor, Abbas, The Islamic Financial System and Lessons of the Financial Recent Crisis at p 2, Downloaded from http://www.islamonline.net/English/index.shtml.

Mirakhor, Abbas, The Islamic Financial System and Lessons of the Recent Financial Crisis (2010) Islamonline.net at p 3.

Mitchell, Lawrence, Financialism: A (Very) Brief History (2010) Downloaded from Accessed on 20th November 2011.

Mohammed, Anzal, Understanding Islamic Finance at p 2. Downloaded from http:// www.allenovery.com/AOWEB**.**

Mohammed, Arif, Islamic Banking (1988) Volume 2, *Asian-Pacific Economic Literature* at p 46-62.

Monbiot, George, Almost Every One Condemns Naked Short Selling but Not British Treasury, Downloaded from http://www.guardian.co.uk/commentisfree/2011/feb/15/condemns-naked-short-selling-not-treasury.

Moore, Jennifer, What Is Really Unethical about Insider Trading (1990) Volume 9, *Journal of Business Ethics* at p171-182.

Mulvey, Thomas, Blue Sky Law (1919) Volume 36 *Canadian Legal Times* at p 27.

Murray, Bryan, After Market Purchaser standing Under Section 11 of the Securities Act of 1933 (1999) Volume 73, *St. John Law Review* at p 633.

Naqvi, Haider, Ethics and Economic: An Islamic Synthesis (1981) The Islamic Foundation at p 37.

Naughten, Shahnaz & Tony Naughten, Religion, Ethics and Stock trading: The Case of an Islamic Equities Market (2000) *Journal of Business Ethics* at p 153.

Nocera, Joe, Hearings that aren't just thereafter (2nd July 2010) The New York Times. Downloaded http://www.nytime.com/2010/07/03business/03nocera.html?_r=1&ref=todays

Obaidullah, Mohammed, Financial Engineering with Islamic Options (1998) Volume 6, *Islamic Economic Studies* at p 1-10.

Obaidullah, Mohammed, Ethics and Efficiency in Islamic Stock Market (2001) Volume 3, *International Journal of Islamic Financial Services* at p 1-10

Obaidullah, Mohammed, Islamic Risk Management: Towards Greater Ethics and Efficiency (2002) *International Journal of Islamic Financial Services* at p 3.

Obaidullah, Mohammed, Islamic Financial Services (2005) Downloaded from www.islamiccenter.kau.edu.sa/english/publications/Obaidullah/ifs/ifs.html at p 57.

Omar, Farooq Mohammed, Partnership, Equity-Financing and Islamic Finance: Whither Profit-Loss-Sharing, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1415239 at p 1.

Osmani, Noor Mohammed & Abdullah, Mohammed Farukh, Towards an Islamic stock Exchange: A Review of Classical and Modern Literatures (2009) Volume 5, *International Review of Business Research Paper* at p 121-130.

Padilla, Alexander, The Regulation of Insider Trading as an Agency Problem (2005) *Beperess Legal Services* at p 6.

Paxford, Beata, Derivative – An Islamic Finance Perspective (2010) Downloaded from http://www.sailanmuslim.com/news/derivatives-an-islamic-finance-perspective-by-beata-m-paxford.

Pirrong, Craig, Commodity Market Manipulation Law: A Critical Analysis and Proposed Alternatives (1994) Volume 51, *Washington and Lee Law Review* at p 949.

Pirrong, Craig, The Self-Regulation of Commodity Exchanges: The Case of Market Manipulation (1995) Volume 38, *Journal of Law and Economics* at 141-142.

Pitluck, Aaron, Moral Behaviour in Stock Markets: Islamic Finance and Socially Responsible Investment, (2008) Published in Katherine Browne, Barbara Milgram, Economics and Morality: Anthropological Approaches (2008) The Rowmann and Littlefield Publishing Group at p 235.

Purdue, Wendy, Manipulation of Futures Market: Redefining the offence (1987) Volume 56, *Fordham Law Review 345*.

Qureshi, Mohammed, The Role of Stock Exchange in the Islamic Financial System (1988) Volume 5, *Journal of Islamic Banking and Finance* at p 9-10.

Rice, Gillian, Islamic Ethics and Implication for Business (1999) *Journal of Business Ethics* at p 345-358.

Rehman, Aamir, The Relevance of Islamic Finance Principles to the Global Financial Crisis, (16th March 2009) Discussion Papers on Islamic Finance Project –Harvard Law School.

Salahi, Abdul Azim, Ibn Taimiyah Concept of Market Mechanism, (1985) Volume 2, *Journal of Research I Islamic Economic*, at p 55.

Samad, Abdus, Market Analysis from an Islamic Perspective and the Contribution of Muslim Scholars (2008) Volume 4, Journal of Islamic Banking, Economics and Finance at 56-68.

Samad, Abdus & Gardener, Norman, & Cook, Bradley, Islamic Banking and Finance in Theory and Practices: the Experience of Malaysia and Bahrain (2005) *The American Journal of Social Sciences* at p 74.

Seligman, Joel, The United States federal- States Model for Securities Regulations (2003) Research Study Prepared for Wise person Committee at p 81-83.

Scot, Hal, A General Evaluation of the Dodd-Frank US Financial Reform Legislation (2010) *Journal of International Banking Law and Regulation* at p 1.

Schepple, Kim Lane, It’s Just Not Right: The Ethics of Insider Trading Law, Volume 56, *Law and Contemporary Problems* at p 128.

Schotland, Roy, Unsafe at Any Price: A Reply to Manne, Insider Trading and the Stock Market (1967) Volume 53, *Virginia Law Review* at p 1425.

Shafi, Mufti Mohammed, Translated by Mohammed Hassan Askari, Karrar Husain, *Distribution of Wealth in Islam*, Downloaded from http://ccm-inc.org/oldsite/iqra/articles/

Shefrin, Hersh & Statman, Meir, Ethics, Fairness and Efficiency in Financial Market (1993) Financial Analyst Journal at p 21.

Shutier Oliver De, Food Commodities Speculation and Food Price Crisis: Regulations to reduce the Risk of Price Volatility, Sep 2010. Accenture, The Influence of Financial

Derivatives in Global Commodity Market, Downloaded from http://www.accenture.com/SiteCollectionDocuments/PDF/Accenture_The_Influence_of_Financial_Derivatives_in_Global_Commodity_Markets.pdf.

Steiner, Robert, Heard on the Street (May 1991) *Wall Street Journal*, at p C1, C2.

Stout, Lynn, Betting the Bank: How the Derivatives Trading under Condition of Uncertainty Can Increase Risk and Erode Returns in Financial Markets (1995-1996) Volume 21, *Journal of Corporation Law* at p 53.

Stout, Lynn, How Deregulating Derivatives Led to Disaster, and why Re-Regulating Them Can Prevent Another, Lombard Street at p 5.

Stout Lynn, The Legal Origin of Credit Crisis (2011) at p 11. Downloaded from http://ssrn.com/abstract=1432654.

Strudler, Alan & Eric Orts, Moral Principle in the Law of Insider Trading (1999) Volume 78, *Texas Law Review* at p 402.

Sylla, Richard, The Rise of Securities Market: What Can Government do? (1995) Presented at the World Bank Conference on Financial History: Lessons From History for Reformers of the Present.

Thani, Nik, The Effectiveness of the Legal and Regulatory Framework for Islamic Financial Services, Published in *Current Issues in Islamic Banking and Finance: Resilience and Stability in Islamic Banking* (2010) World Scientific publishing Ltd at p 81

Thel, Steve, Regulation of Manipulation under Section 10(b): Security Prices and the text of Security Exchange Act of 1934 (1988) *Columbia Business law Review* at p 367-368.

Tobias, Adrian & Shin, Hyun Song, Liquidity, Monetary Policy and Financial Cycles, Current Issues in Economics and Finance (2008) *Current Issues in Economics and Finance.* Downloaded from www.nyfed.org/research/current_issues at p 1.

Tobias Adrian, Bubbles Caused by Cheap Cash Menace (24rth July 2006) World Economy - Reuters.

Tracinski, Robert, The Moral Basis of Capitalism, Downloaded from http://www.capitalismcenter.org/Philosophy/Essays/The_Moral_Basis_of_Capitalism.htm.

Walsh, Christine, Ethics: Inherent in Islamic Finance through Shariah Law: Resisted in American Business despite Sarbanes Oxley (2007) Volume XII, *Fordham Journal of Corporate and Financial Law* at 757.

Warner, Jeremy, Why Government Bond Market have become the latest Mad and Bad Asset Bubble, *The Daily Telegraph*, 22nd October 2010.

Wilson, Rodney, Islamic Capital markets: The Role of Sukuk (2010) at p 3. Downloaded from www.qfinance.com.

Wilson, Rodney, Global Islamic Capital Markets (2007) www.islamicfinancenews.com.

Wilson, Rodney, Innovation in the Structuring of Islamic Sukuk Securities (2006) Paper presented at 2nd Banking and Finance International Conference in Beirut at p 1.

Wilson, Rodney, Islamic Bonds: Your guide to issuing, structuring and Investing in Sukuk – Overview of the Sukuk Market at p 1. Downloaded from http://www.euromoneybooks.com.

Wilson, Rodney, Regulatory Challenges Posed by Islamic Capital Market Products and Services (2011) Centre for Middle Eastern and Islamic Studies, University of Durham, UK Downloaded from http://kantakji.com/fiqh/Files/Markets/y136.pdf.

Wu, Hsui-Kwong, Corporate Insider Trading in the Stock Market 1957-1961 (1965) Volume 2, *National Banking Review* at p 373.

Yusof, Eddy & Ezry Fahmy & Kashoogie, Jhordy & Anwar Kamal, Islamic Finance: Debt versus Equity Financing in the Light of Maqasid-al-Shariah (2009) at p 10 http;//mpra.ub.uni-muenchen.de/20722.

Zarqa, Mohammad Anas, Rules of Exchange in Islamic Jurisprudence: An Introduction for Economist, Islamic Research and raining and Institute.

Zarrokh, Ehsan, Iranian Islamic Banking (2010) Volume 29, *European Journal of Law and Economic* at p 178.

Wilson, Rodney, Islam and Business (2006) *Thunderbird International Business Review* at p 109.

Official Reports, Releases and Consultation Documents:

Ainley, Michael & Mashyekhi, Ali and Hicks, Robert and Rehman, Arshdur, Islamic Finance in UK: Regulations and Challenges (2007) The Financial Services Authority. Downloaded from http://www.fsa.gov.uk/pubs/other/islamic_finance.pdf.

A Policy Dialogue Paper No 1, Islamic Financial Services Industry Development: Ten Years Framework and Strategies (2007) Islamic Development Bank, Islamic Research and Training Institute, Islamic financial services Board.

Accounting and Auditing Organisation of Islamic Financial Services, Shariah Standards 1425-26 H No 17 at 296. (AAOIFI 2004).

Bahrain Financial Exchange, The Exchange Business: An Insight. Downloaded from http://www.bfx.bh.

Bank for International Settlements, Semi-Annual OTC Derivatives Statistics at End-June 2010, Table 19. Available at http://www.bis.org/statistics/derstats.htm

Bursa Malaysia, The Islamic Capital Market and Labuan International Financial Exchange (LFX), http://lfxsys.lfx.com.my/others/bm2ICM.pdf.

Committee of European Securities Regulators, Call for Evidence–Regulation of Short Selling by CESR Members, December (2008) CESR/08 -1010.

Dar, Humayun Derivatives and Shariah, Business Asia, 6th December 2010.

Department of Trade and Industry, *Financial Services in the United Kingdom: A New Framework for Investor Protection* (1985) London Cmd No 9432.

Duncan McKenzie, Islamic Finance, http://www.exchange-handbook.co.uk/index.cfm?section=articles&action=detail&id=78445

EU Votes to ban Short Selling (8th March 2011) Downloaded from http://www.securitieslendingtimes.com/securitieslendingnews/article.php?article_id=21707, Accessed on 11th July 2011.

Financial Services Authority Consultation Paper 59, Market Abuse: A Draft Code of Market Conduct (2007).

Financial Crisis Inquiry Commission (January 2011) The Financial Crisis Inquiry Report XV.

Financial Services Authority Confirms the Extension of Short Selling disclosure Regime (14th Downloaded from http://www.fsa.gov.uk/pages/Library/Communication/PR/2009/009.shtml.

Gulf One Investment Bank, *The Global Financial Crisis and Its Impact on the GCC*, October 2008) Research Bulletin.

Gulf One Investment Bank, Islamic Finance: Opportunities and Challenges (December 2008) Volume 1, *Research Bulletin*.

Bashar, Habibullah Khan Omar, Islamic Finance: Growth and Prospects in Singapore (2008) U-21 Global Working Paper Series. Downloaded from http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1589796.

HM Treasury, Government Sterling Sukuk Issuance: A Consultation (November 2007)

HM Treasury, The Development of Islamic Finance in the UK: The Government Perspective (Dec 2008)

Husam el-Khatib, Harvard – LSE Workshop: Islamic Economic and Islamic Ethico-Legal Perspectives on the Current Financial Crisis (26th February 2009) Short Report.

Husam el-Khatib, Harvard – LSE Workshop: Islamic Economic and Islamic Ethico-Legal Perspectives on the Current Financial Crisis (26th February 2009) Short Report.

International Organisation of Securities Commission (IOSCO), Islamic Capital Market Fact Finding Report: Report of the Islamic Capital Market Task Forces (July 2004).

International Organisation of Securities Commission (IOSCO), Report of the Islamic Capital Market Task Forces, July 2004.

International Organisation of Securities Commission (IOSCO), Islamic Capital Market Fact Finding Report: Report of the Islamic Capital Market Task Forces (2004).

International Organisation of Securities Commission (IOSCO), Analysis of the Application of IOSCO Objective and Principles of Securities Regulation for Islamic Securities Products, (September 2008). Downloaded from http://www.iosco.org/library/pubdocs/pdf/IOSCOPD154.pdf, Accessed on 20th March 2010.

International Organisation of Securities Commission (IOSCO) Technical Committee, Regulation of Short Selling – Consultation Report, Appendix III (24rth March 2009) at p 22.

Islamic Development Bank and Islamic Financial Services Board, Islamic Financial Services Industry Development: Ten Years Frame- Work and Strategies (2007) at p 1.

Islamic Research & Training Institute, *Islamic Capital Markets: Products, Regulation & Development* (2008) Islamic development Bank.

Jickling, Mark, *CRS Report for Congress: The Enron Collapse*: *An overview of Financial Issues*, CRS-4 (2002) Downloaded from http://fpc.state.gov/documents.

Kiran, Afshan & Naz, Huma, Islamic Economic System, Capitalism and Socialism, Un-published MBA Thesis submitted on 13th August 2009. http://www.scribd.com/doc/19653430/Islamic-Economic-System-Capitalism-and-Socialism.

Latest Islamic Fiqh Academy Rulings on Finance, New Horizons, March 1993 (UK) at p 13.

Malaysian Securities Exchange Commission's Annual Report 2004, Islamic Capital Market Review (2004) at p 1.

Manan, Mohammed Understanding Islamic Finance - A Study of Securities Market in an Islamic Framework (1993) Research Paper No 18, Islamic Research and Training Institute of Islamic development Bank at p 21- 22.

OIC Islamic Fiqh Academy, Resolution and Recommendation of the Council of the Islamic Fiqh Academy (1985-2000) Downloaded from http://www.islamibankbd.com/page/oicres.htm,

Operational Manual of Islamic Development Bank (1981) Jeddah-Saudi-Arabia.

Press Release, Dow Jones Islamic Market Indexes Index Review Results for Q1 2010, http://www.muslims.net/news/newsfull.php?newid=343371 Accessed on 28th August 2010.

Standard & Poor, Sukuk Comes of Age in Infrastructure and Project Finance (May 2009) Volume 6, Islamic Finance News at p 1.

Monroe, Fischer, Unpublished Doctoral Thesis (1965) American University Department of Economics.

Sukuk trades executed by LMC in the Secondary Market: LMC Bahrain. 27 March 2007. Downloded from http://lmcbahrain.com/trade.asp.

Sukuk Report, A Comprehensive Study of the International Sukuk Market (Feb 2010) Downloaded from www.iifm.net.

UK Ban on Short Selling, downloaded from http://news.bbc.co.uk/1/hi/business/7812816.stm, Accessed on 11th July 2011, Short Selling Ban to be lifted. Downloaded from http://news.bbc.co.uk/1/hi/business/7812816.stm.

Films & Documentaries.

DeShuttier, Olivier UN Special Rapporteur on GT World News. Downloaded from http://www.youtube.com/watch?v=NbARnnTXI-s.

Michael Moor, Capitalism: A Love Story (2010) Holly Wood Documentary Film.

Oliver Stone, Wall Street: Money Never Sleeps (2010) Hollywood, Sequel to “Wall Street” (1987).