

## PRINCIPLES OF SHARI'AH GOVERNING ISLAMIC INVESTMENT FUNDS

The term 'Islamic Investment Fund' here means a joint pool wherein the investors contribute their surplus money for the purpose of its investment to earn *halal* profits in strict conformity with the precepts of Islamic Shari'ah. The subscribers of the Fund may receive a document certifying their subscription and entitling them to the pro-rata profits actually earned by the Fund. These documents may be called 'certificates', 'units', 'shares' or may be given any other name, but their validity in terms of Shari'ah, will always be subject to two basic conditions:

Firstly, instead of a fixed return tied up with their face value, they must carry a pro-rata profit actually earned by the Fund. Therefore, neither the principle nor a rate of profit (tied up with the principle) can be guaranteed. The subscribers must enter into the fund with a clear understanding that the return on their subscription is tied up with the actual profit earned or loss suffered by the Fund. If the Fund earns huge profits, the return on their subscription will increase to that proportion. However, in case the Fund suffers loss, they will have to share it also, unless the loss is caused by the negligence or mismanagement, in which case the management, and not the Fund, will be liable to compensate.

Secondly, the amounts so pooled together must be invested in a business acceptable to Shari'ah. It means that not only the channels of investment, but also the terms agreed with them must conform to the Islamic principles.

Keeping these basic requisites in view, the Islamic Investment Funds may accommodate a variety of modes of investment which are discussed briefly in the following paragraphs.

### Equity Fund:

In an equity fund the amounts are invested in the shares of joint stock companies. The profits are mainly derived through the capital gains by purchasing the shares and selling them when their prices are increased. Profits are also earned through dividends distributed by the relevant companies.

It is obvious that if the main business of a company is not lawful in terms of Shari'ah, it is not allowed for an Islamic Fund to purchase, hold or sell its shares, because it will entail the direct involvement if the share holder in that prohibited business.

Similarly the contemporary Shari'ah experts are almost unanimous on the point that if all the transactions of a company are in full conformity with Shari'ah, which includes that the company neither borrows money on interest nor keeps its surplus in an interest bearing account, its shares can be

purchased, held and sold without any hindrance from the Shari'ah side. But evidently, such companies are very rare in the contemporary stock markets. Almost all the companies quoted in the present stock markets are in some way involved in an activity which violates the injunctions of Shari'ah. Even if the main business of a company is *halal*, its borrowings are based on interest. On the other hand, they keep their surplus money in an interest bearing account on purchase interest-bearing bonds or securities.

The case of such companies has been a matter of debate between the Shari'ah experts in the present century. A group of the Shari'ah experts is of the view that it is not allowed for a Muslim to deal in the shares of such a company, even if its main business is *halal*. Their basic argument is that every shareholder of a company is a *sharik* (partner) of the company, and every *sharik*, according to the Islamic jurisprudence, is an agent for the other partners in the matters of the joint business. Therefore, the mere purchase of a share of a company embodies an authorization from the shareholder to the company to carry on its business in whatever manner the management deems fit. If it is known to the shareholder that the company is involved in an un-Islamic transaction, and still he holds the shares of that company, it means that he has authorized the management to proceed with that un-Islamic transaction. In this case, he will not only be responsible for giving his consent to an un-Islamic transaction, but that transaction will also be rightfully attributed to himself, because the management of the company is working under his tacit authorization.

Moreover, when a company is financed on the basis of interest, its funds employed in the business are impure. Similarly, when the company receives interest on its deposits an impure element is necessarily included in its income which will be distributed to the share-holders through dividends.

However, a large number of the present day scholars do not endorse this view. They argue that a joint stock company is basically different from a simple partnership. In partnership, all the policy decisions are taken through the consensus of all the partners, and each one of them has a veto power with regard to the policy of the business. Therefore, all the actions of a partnership are rightfully attributed to each partner. Conversely, the policy decisions in a joint stock company are taken by the majority. Being composed of a large number of shareholders, a company cannot give a veto power to each shareholder. The opinions of individual shareholders can be overruled by a majority decision. Therefore, each and every action taken by the company cannot be attributed to every shareholder in his individual capacity. If a shareholder raises an objection against a particular transaction in an Annual General Meeting, but his objection is overruled by the majority, it will not be fair to conclude that he has given his consent to that transaction in his individual capacity, especially when he intends to refrain from the income resulting from that transaction.

Therefore, if a company is engaged in a *halal* business, but also keeps its surplus money in an interest bearing account, wherefrom a small incidental income of interest is received, it does not render all the business of the

company unlawful. Now, if a person acquires the shares of such a company with clear intention that he will oppose this incidental transaction also, and will not use that proportion of the dividend for his own benefit, how can it be said that he has approved the transaction of interest and how can that transaction be attributed to him?

The other aspect of the dealings of such a company is that it sometimes borrows money from financial institutions. These borrowings are mostly based on interest. Here again the same principle is relevant. If a shareholder is not personally agreeable to such borrowings, but has been overruled by the majority, these borrowing transactions cannot be attributed to him.

Moreover, even though according to the principles of Islamic jurisprudence, borrowing on interest is a grave and sinful act, for which the borrower is responsible in the Hereafter; but this sinful act does not render the whole business of the borrower as *haram* or impermissible. The borrowed amount being recognized as owned by the borrower, anything purchased in exchange for that money is not unlawful. Therefore, the responsibility of committing a sinful act of borrowing on interest rates with the person who wilfully indulged in a transaction of interest, but this fact does render the whole business of a company as unlawful.

#### Conditions for investment in Shares:

In the light of the foregoing discussion, dealing in equity shares can be acceptable in Shari'ah subject to the following conditions:

1. The main business of the company is not violative of Shari'ah. Therefore, it is not permissible to acquire the shares of the companies providing financial services on interest, like conventional banks, insurance companies, or the companies involved in some other business not approved by the Shari'ah, such as companies manufacturing, selling or offering liquors, pork, haram meat, or involved in gambling, night club activities, pornography, etc.
2. If the main business of the companies is *halal*, like automobiles, textile, etc. but they deposit their surplus amounts in an interest-bearing account or borrow money on interest, the shareholder must express his disapproval against such dealings, preferably by raising his voice against such activities in the annual general meeting of the company.
3. If some income from interest-bearing accounts is included in the income of the company, the proportion of such income in the dividend paid to the shareholder must be given in charity, and must not be retained by him. For example, if 5% of the whole income of a company has come out of interest-bearing deposits, 5% of the dividend must be given in charity.
4. The sharers of a company are negotiable only if the company owns some illiquid assets. If all the assets of a company are in liquid form, i.e. in the form of money they cannot be purchased or sold except at par value,

because in this case the share represents money only and the money cannot be traded in expect at par.

What should be the exact proportion of illiquid assets of a company for warranting the negotiability of its shares? The contemporary scholars have different views about this question. Some scholars are of the view that the ratio of illiquid assets must be 51% in the least. They argue that if such assets are less than 50% then most of the assets are in liquid form, and therefore, all its assets should be treated as liquid on the basis of the juristic principle:

*The majority deserves to be treated as the whole of a thing.*

Some other scholars have opined that even if the illiquid asset of a company are 33%, its shares can be treated as negotiable.

The third view is based on the *Hanafi* jurisprudence. The principle of the *hanafi* school is that whenever an asset is a combination of liquid and illiquid assets, it can be negotiable irrespective of the proportion of its liquid part. However, this principle is subject to two conditions:

Firstly, the illiquid part of the combination must not be in ignorable quantity. It means that it should be in a considerable proportion.

Secondly, the price of the combination should be more than the value of the liquid amount contained therein. For example, if a share of 100 dollars represents 75 dollars, plus some fixed assets, the price of the share must be more than 75 dollars. In this case, if the price of the share is fixed as 105, it will mean that 75 dollars are in exchange of 75 dollars owned by the share and the balance of 30 dollars is in exchange of the fixed assets. Conversely, if the price of that share is fixed as 70 dollars, it will not be allowed because the 75 dollars owned by the share in this case against an amount which is less than 75. This kind of exchange falls within the definition of 'riba' and is not allowed. Similarly, if the price of the share, in the above example, is fixed as 75 dollars, it will not be permissible, because if we presume that 75 dollars of the price are against 75 dollars owned by the share, no part of the price can be attributed to the fixed assets owned by the share. Therefore, some part of the price (75 dollars) must be presumed to be in exchange of the fixed assets of the share. In this case, the remaining amount will not be adequate for being the price of 75 dollars. For this reason the transaction will not be valid. However, in practical terms, this is merely a theoretical possibility, because it is difficult to imagine a situation where the price of a share goes lower than its liquid assets.

Subject to these conditions, the purchase and sale of shares is permissible in Shari'ah. An Islamic Equity Fund can be established on this basis. The subscribers to the fund will be treated in Shari'ah as partners *interse*. All the subscription amounts will form a joint pool and will be invested in purchasing the shares of different companies. The profits can accrue either through dividends distributed by the relevant companies or through the appreciation in

the prices of the shares. In the first case i.e. where the profits are earned through dividends, a certain proportion of the dividend, which corresponds to the proportion of interest earned by the company, must be given in charity. The contemporary Islamic Funds have termed this process as 'purification'.

The Shari'ah scholars have different views about whether the 'purification' is necessary where the profits are made through capital gains (i.e. by purchasing the shares at a lower price and selling them at a higher price). Some scholars are of the view that even in the case of capital gains, the process of 'purification' is necessary, because the market price of the share may reflect an element of interest included in the assets of the company. The other view is that no purification is required if the share is sold, even if it results in a capital gain. The reason is that no specific amount of the price can be allocated for the interest received by the company. It is obvious that if all the above requirements of the shares are observed, then most of the assets of the company are *halal*, and a very small proportion of its assets may have been created by the income of interest. This small proportion is not only unknown, but also ignorable as compared to bulk of the assets of the company. Therefore, the price of the share, in fact, is against bulk of the assets, and not against such a small proportion. The whole price of the share therefore, may be taken as the price of the *halal* asset only.

Although this second view is not without force, yet the first view is more precautionous and far from doubts. Particularly, it is more equitable in an open-ended equity fund, because if the purification is not carried out on the appreciation and a person redeems his unit of the Fund at a time when no dividend is received by it, no amount of purification will be deducted from its price, even though the price of the unit may have increased due to the appreciation in the prices of the shares held by the fund. Conversely, when a person redeems his units after some dividends have been received in the fund and the amount of purification has been deducted therefrom, reducing the net asset value per unit, he will get a lesser price as compared to the first person.

On the contrary, if purification is carried out both on dividends and on capital gains, all the unit-holders will be treated at par with regard to the deduction of the amounts of purification. Therefore, it is only free from doubts but also more equitable for all the unit-holders to carry out purification in the capital gains also. This purification may be carried out on the basis of an average percentage of the interest earned by the companies included in the portfolio.

The management of the fund may be carried out in two alternative ways. The managers of the Fund may act as *mudaribs* for the subscribers. In this case a certain percentage of the annual profit accrued to the fund may be determined as the reward of the management, meaning thereby that the management will get its share only if the fund has earned some profit. If there is no profit in the fund, the management will deserve nothing. The share of the management will increase with the increase of profits.

The second option for the management is to act as an agent for the subscribers. In this case, the management may be given a pre-agreed fee for its services. This fee may be fixed in a lump sum or as a monthly or annual remuneration. According to the contemporary Shari'ah scholars, the fee can also be based on a percentage of the net asset value of the fund. For example, it may be agreed that the management will get 2% or 3% of the net asset value of the fund at the end of every financial year.

However it is necessary in Shari'ah to determine any one of the aforesaid methods before the launch of the fund. The practical way for this would be to disclose in the prospectus of the fund the basis on which the fees of the management will be paid. It is generally presumed that whoever subscribes to the fund agrees with the terms mentioned in the prospectus. Therefore, the manner of paying the management will be taken as agreed upon by all the subscribers.

### Ijarah Fund:

Another type of Islamic Fund may be an *ijarah* fund. *Ijarah* means leasing the detailed rules of which have already been discussed in the third chapter of this book. In this fund the subscription amounts are used to purchase assets like real estate, motor vehicles or other equipments for the purpose of leasing them out to their ultimate users. The ownership of these assets remains with the Fund and the rentals are charged from the users. These rentals are the source of income for the fund which is distributed pro rata to the subscribers. Each subscriber is given a certificate to evidence his proportionate ownership in the leased assets and to ensure his entitlement to the pro rata share in income. These certificates may preferably be called '*sukuk*' –a term recognized in the traditional Islamic jurisprudence. Since these *sukuk* represent the pro rata ownership of their holders in the tangible assets of the fund, and not the liquid amounts or debts, they are fully negotiable and can be sold and purchased in the secondary market. Anyone who purchases these *sukuk* replaces the sellers in the pro rata ownership of the relevant assets and all the rights and obligations of the original subscriber are passed on to him. The price of these *sukuk* will be determined on the basis of market forces, and are normally based on their profitability.

However, it should be kept in mind that the contracts of leasing must conform to the principles of Shari'ah which substantially differ from the terms and conditions used in the agreements of conventional financial leases. The points of difference are explained in detail in the third chapter of this book. However, some basic principles are summarized here:

1. The leased assets must have some usufruct, and the rental must be charged only from that point of time when the usufruct is handed over to the lessee.
2. The leased assets must be of a nature that their *halal* (permissible) use is possible.

3. The lessor must undertake all the responsibilities consequent to the ownership of the assets.
4. The rental must be fixed and known to the parties right at the beginning of the contract.

In this type of the fund the management should act as an agent of the subscribers and should be paid a fee for its services. The management fee may be a fixed amount or a proportion of the rentals received. Most of the Muslim jurists are of the view that such a fund cannot be created on the basis of *mudarabah*, because *mudarabah*, according to them, is restricted to the sale of commodities and does not extend to the business of services and leases. However, in the Hanbali school, *mudarabah* can be effected in services and leases also. This view has been preferred by a number of contemporary scholars.

### Commodity Fund:

Another possible type of Islamic Funds may be a commodity fund. In the fund of this type the subscription amounts are used in purchasing different commodities for the purpose of their resale. The profits generated by the sales are the income of the fund which is distributed pro rata among the subscribers.

In order to make this fund acceptable to Shari'ah, it is necessary that all the rules governing the transactions of sale are fully complied with. For example:

1. The commodity must be owned by the seller at the time of the sale, because short sales in which a person sells a commodity before he owns it are not allowed in Shari'ah.
2. Forward sales are not allowed except in the case of *salam* and *istisna'* (For their full details the previous chapter of this book may be consulted)
3. The commodities must be *halal*. Therefore, it is not allowed to deal in wines, pork or other prohibited materials.
4. The seller must have physical or constructive possession over the commodity he wants to sell. (Constructive possession includes any act by which the risk of the commodity is passed on to the purchaser)
5. The price of the commodity must be fixed and known to the parties. Any price which is uncertain or is tied up with an uncertain event renders the sale invalid.

In view of the above and similar other conditions, more fully described in the second chapter of this book, it may easily be understood that the transactions prevalent in the contemporary commodity markets, specially in the features

commodity markets do not comply with these conditions. Therefore, an Islamic Commodity Fund cannot enter into such transactions. However, if there are genuine commodity transactions observing all the requirements of Shari'ah, including the above conditions, a commodity fund may well be established. The units of such a fund can also be traded in with the condition that the portfolio owns some commodities at all times.

### Murabahah Fund:

'Murabahah' is a specific kind of sale where the commodities are sold on a cost-plus basis. This kind of sale has been adopted by the contemporary Islamic banks and financial institutions as a mode of financing. They purchase the commodity for the benefit of their clients, then sell it to them on the basis of deferred payment at an agreed margin of profit added to the cost. If a fund is created to undertake this kind of sale, it should be a closed-end fund and its units cannot be negotiable in a secondary market. The reason is that in the case of *murabahah*, as undertaken by the present financial institutions, the commodities are sold to the clients immediately after their purchase from the original supplier, while the price being on deferred payment basis becomes a debt payment payable by the client. Therefore, the portfolio of *murabahah* does not own any tangible assets. It comprises either cash or the receivable debts, therefore, the units of the fund represent either the money or the received debts, and both these things are not negotiable, as explained earlier. If they are exchanged for money, it must be at par value.

### Bai'-al-Dain:

Here comes the question whether or not *bai'-al-dain* is allowed in Shari'ah. *Dain* means debt and *Bai* means sale. *Bai'-al-dain*, therefore, connotes the sale of debt. If a person has a debt receivable from a person and he wants to sell it at a discount, as normally happens in the bills of exchange, it is termed in Shari'ah as *Bai'-al-dain*. The traditional Muslim jurists (*fuqaha*) are unanimous on the point that *bai'-al-dain* with discount is not allowed in Shari'ah. The overwhelming majority of the contemporary Muslim scholars are of the same view. However, some scholars of Malaysia have allowed this kind of sale. They normally refer to the ruling of *Shafi'ite* school wherein it is held that the sale of the debt is allowed, but they did not pay attention to the fact that the *Shafi'ite* jurists have allowed it only in a case where a debt is sold at its par value.

In fact, the prohibition of *bai'-al-dain* is a logical consequence of the prohibition of 'riba' or interest. A 'debt' receivable in monetary terms corresponds to money, and every transaction where money is exchanged for the same denomination of money, the price must be at par value. Any increase or decrease from one side is tantamount to 'riba' and can never be allowed in Shari'ah.

Some scholars argue that the permissibility of *bai' al-dain* is restricted to a case where the debt is created through the sale of a commodity. In this case, they say, the debt represents the sold commodity and its sale may be taken as the sale of a commodity. The argument, however, is devoid of force. For, once the commodity is sold, its ownership is passed on to the purchaser and it is no longer owned by the seller. What the seller owns is nothing more than money. Therefore, if he sells the debt, it is no other than the sale of money and it cannot be termed by any stretch of imagination as the sale of the commodity.

That is why this view has not been accepted by the overwhelming majority of the contemporary scholars. The Islamic *Fiqh* Academy of Jeddah, which is the largest representative body of the Shari'ah scholars and has the representation of all the Muslim countries, including Malaysia, has approved the prohibition of *bai' al-dain* unanimously without a single dissent.

### **Mixed Fund:**

Another type of Islamic Fund may be of a nature where the subscription amounts are employed in different types of investments, like equities, leasing, commodities, etc. This may be called a Mixed Islamic Fund. In this case if the tangible assets of the Fund are more than 51% while the liquidity and debts are less than 50%, the units of the fund may be negotiable. However, if the proportion of liquidity and debts exceeds 50%, its units cannot be traded according to the majority of the contemporary scholars. In this case the Fund must be a closed-end fund.