

MASTER OF BUSINESS ADMINISTRATION

MANAGEMENT CENTER

INTERNATIONAL ISLAMIC UNIVERSITY MALAYSIA

PROGRAMME COORDINATOR
MANAGEMENT CENTER
INTERNATIONAL ISLAMIC UNIVERSITY MALAYSIA
JALAN SIKAP, KAMPUS 2
43600 SEREMBAN, NEGERI SEMBILAN
MALAYSIA
TEL: 603-8921 8888
FAX: 603-8921 8889
WWW: WWW.IIUM.MY



الجامعة الإسلامية العالمية ماليزيا
INTERNATIONAL ISLAMIC UNIVERSITY MALAYSIA
بِسْمِ اللَّهِ الرَّحْمَنِ الرَّحِيمِ

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EFFECT ON STOCK RETURNS AND VOLUME OF INCLUSION AND
EXCLUSION FROM THE SECURITIES COMMISSION SYARIAH
ADVISORY COUNCIL'S LIST OF APPROVED SECURITIES

BY:
MIMI HAFIZAH BT. ABDULLAH

**EFFECT ON STOCK RETURNS AND VOLUME OF INCLUSION AND
EXCLUSION FROM THE SECURITIES COMMISSION SYARIAH ADVISORY
COUNCIL's LIST OF APPROVED SECURITIES**

by

Mimi Hafizah bt. Abdullah

G9716068

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CANDIDATE NAME:

MIMI HAFIZAH BT ABDULLAH
G 9716068

TITLE OF PROJECT PAPER:

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The undersigned certifies that the above candidate has fulfilled the conditions of the project paper prepared in partial fulfillment of the requirements for the Master of Business Administration (MBA).

Supervisor



DR. OBIYATHULLA ISMATH BATCHA

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ABSTRACT

The objective of this study is to examine the effect on stock price and trading volume of inclusion in or exclusion from the Securities Commission Syariah Advisory Council's list of approved securities. In particular, this study examines whether there is any difference in abnormal return or excess return and average trading volume changes when a stock is included or excluded from the Securities Commission's list.

From this study it was found that when a stock is added to the SC's list, there is a significant permanent increase in price, investors earn a significant positive abnormal return after the announcement date. As for the trading volume, there is a temporary increase in volume after the announcement date, up to 10 days.

It was also found that when a stock is deleted from the SC's list, there is a significant permanent decrease in price, investors earn a significant negative abnormal return after the announcement date. However the decrease in price does not occur immediately but in a later stage. As for the trading volume, there is a permanent decrease in volume following the event. However, the decrease in the average trading volume does not occur immediately but at a later stage , approximately 2 months later.

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1. Introduction

1.1 Objective

The objective of this study is to examine the effect on stock price and trading volume of inclusion in or exclusion from the Securities Commission Syariah Advisory Council's list of approved securities. In particular, this study examines whether there is any difference in abnormal return or excess return and trading volume changes when a stock is included or excluded from the Securities Commission's list.

The efficient market hypothesis (EMH) predicts that security prices reflect all publicly available information. Therefore, one corollary of EMH is that "you can sell (or buy) large blocks of stock at close to the market price as long as you can convince other investors that you have no private information."¹ This statement assumes that securities are near perfect substitutes for each other. If so, the excess demand for a single security will be very elastic, and the sale or purchase of a large number of shares will have no impact on price.

In other words, stock prices fluctuate randomly. According to the theory, there should be no difference in abnormal return because markets are efficient. Therefore

¹ Brealey, R. and Myers, S, (1984), *Principles of Corporate Finance, second edition*, New York McGraw-Hill, p 279.

returns before and after the announcement should be random in nature since the Securities Commission's list of approved securities is public information. In an efficient market, on the announcement date, the information is not disseminated immediately, it might be one day later or one week, for example.

1.2 Significance of the study

Given the rapid development of the Islamic equity market in Malaysia and across the world, this study has great significance. There is a growing awareness among Muslim investors to invest their money in *halal* securities. Institutions such as Bank Islam Malaysia, Rashid Hussain Bhd, have already entered into the Unit Trust business based on *Syariah* principles. Each of them has a list of permissible securities. As the idea becomes increasingly popular, the Securities Commission has come up with a list of approved or in other words *halal* (permissible) securities. All this has made the Islamic investment more significant and thus worthy of more attention.

1.3 Islamic investment

The idea of an Islamic investment is to invest in the company's stocks whose operations are in accordance with Islamic principles. Under Islamic laws, more accurately called Syariah law, Muslims are prohibited from practising or profiting from activities deemed 'non halal' or 'unclean'. The charging of interest, gambling, drinking alcohol and pornography are among activities that fall under this category.

Thus for Muslims seeking an investment or saving tools, options are very limited when 'non-halal' interest or 'riba' is the lifeblood and the only returns available from the conventional banking system. And for Muslims wanting some stock market action, besides having to contend with the inherent risks and uncertainties of shares trading, they have also to ensure that the stocks they buy are not of companies engaged in or profiting from activities prohibited by the Syariah. As earlier stated, following Bank Islam Malaysia Bhd which has engaged in unit trust management since 1983, the Securities Commission has decided to issue a list of approved securities from time to time. The first of these lists was published in the New Straits Times on 19 June 1997.

1.4 *Terms and definitions*

1.4.1 *The Meaning and Concept of Syariah*

The original meaning of the word *Syariah* or *shar* is 'the path or the road leading to the water' and the verb *shara'a* literally means 'to chalk out or mark out a clear road to water.' In a religious sense, it means 'the highway of good life.' In other words, *Syariah* is the way which directs a man's life to the right path.² *Syariah* is, therefore, expected to provide not only the right path but also to govern all activities of the Muslims toward the betterment of the whole community. In reality, however, instead of being governed by the *Syariah*, Muslims are constantly bound by customary and positive laws.

There are three basic elements in Islam namely, *Aqidah*, *Syariah* and *Akhlaq*. *Aqidah* concerns all aspects of faith and belief of a Muslim. *Akhlaq* covers all aspects of Muslim behaviour, attitude and work ethics with which he performs his practical actions. *Syariah* as mentioned earlier is concerned with all forms of practical actions by a Muslim. Aspects of *Syariah* can be further divided in to two,

² Sudin Haron, Bala Shanmugam, 1997, *Islamic Banking System: Concepts and Applications*, Pelandok Publications, p 68

namely *Ibadat* and *Muamalat*. *Ibadat* is concerned with the practicalities of a Muslim's worship of Allah, whereas *Muamalat* is concerned with the man-to-man relationship. Consequently, political, economic and social activities will be under the ambit of *Muamalat*. The Islamic banking and financial activities, therefore, being part of economic activities is linked to *Syariah* principles through *Muamalat*.³

1.4.2 Meaning of Riba

Riba is an Arabic word which literally means 'increase' (*al-ziyada*), 'growth' (*al-numuw*), 'to rise' and 'to become lofty' (*al-irtifa* and *al-uluw*). From the *Syariah* (Islamic law) point of view, however, *riba* technically refers to the 'premium' that must be paid by the borrower to the lender along with the principle amount as a condition for the loan or for an extension on its maturity. Taking this definition into consideration, therefore, we conclude that *riba* and interest are the same thing and can be used interchangeably.⁴

³ Sudin Haron, Bala Shanmugam, 1997, *Islamic Banking System: Concepts and Applications*, Pelandok Publications, p 69

⁴ Sudin Haron, Bala Shanmugam, 1997, *Islamic Banking System: Concepts and Applications*, Pelandok Publications, p 45

1.4.3 Prohibition of Riba

Muslims are totally prohibited from dealing with *riba*. The prohibition of *riba* is not only revealed in various Verses of the Qur'an but is also reinforced by the Prophet. The prohibition of *riba* in the Qur'an first appeared in Verse 39 of Chapter al-Rum.:

"That which ye lay out For increase through the property of (other) people, will have No increase with Allah. But that which ye lay out For charity, seeking The Countenance of Allah, (Will increase): it is These who will get A recompense multiplied."

1.5 Introduction of SC's approved list of securities

1.5.1 Securities Commission

The Securities Commission (SC) was set up on 1 March 1993. SC is a statutory body reporting to the Minister of Finance, it was established under the Securities Commission Act 1993. It is the sole regulatory agency for the regulation and development of capital markets. Its mission statement is to promote and maintain

fair, efficient, secure and transparent securities and futures markets and to facilitate the orderly development of an innovative and competitive capital market.

1.5.2 Syariah Advisory Council

The Syariah Advisory Council (SAC) was formally established upon approval by the Minister of Finance, on 16 May 1996. The SAC was formed to advise the SC on matters relating to the Islamic capital market and among its noteworthy initiatives were efforts to analyse and scrutinise products and issues such as call warrants, transferable subscription rights (TSR), asset securitisation, and bai'al-dayn.

Specifically, the principal functions of the SAC would include the following:

- 1) to advise the SC on the aims and operations of the Islamic capital market in order to ensure that they are consistent with Islamic principles;
- 2) to provide an opportunity, and to expose jurists, scholars, intermediaries and investors, to Islamic financial products and Islamic jurisprudence;
- 3) to ensure that activities in the securities and derivatives markets which are represented as Islamic would conform with syariah principles; and
- 4) to study matters related to Islamic capital market operations in response to requests for advice from industry, investors and the Government.

1.5.3 The list of Approved securities by Securities Commission Syariah Advisory Council and its classification

In classifying these securities as approved securities, the SAC has applied a standard criteria, that is, focusing on the core activities of the companies listed on the Kuala Lumpur Stock Exchange (KLSE) and Malaysia Exchange of Securities Dealing & Automated Quotation (MESDAQ). Hence, companies whose activities are not contrary to the Syariah principles will be classified as approved securities.

Securities will be excluded from the list of approved securities based on the following criteria:

- (i) operations based on *riba* (interest) such as activities of financial institutions like commercial and merchant banks, finance companies etc;
- (ii) operations involving gambling;
- (iii) activities involving the manufacture and/or sale of *haram* (forbidden) products such as liquor, pork and meat not slaughtered according to Islam;
and
- (iv) operations containing element of *gharar* (uncertainty) such as conventional insurance business.

As for companies whose activities comprise both permissible and non-permissible elements, the Syariah Advisory Council (SAC) applied several additional criteria, that is:

- (v) the core activities of the company must be of activities which are not against the *syariah* as outlined in the four criteria above. Furthermore the *haram* element must be very small compared to the core activities;
- (vi) the public perception or the image of the company must be good; and
- (vii) the core activities of the company have importance and *maslahah* (benefit in general) to the Muslim *Ummah* (nation) and the country, and the *haram* element is very small and involves matters such as *'ulum balwa* (common plight), *'uruf* (custom) and the rights of the non-Muslim community which are accepted by Islam.

Approved securities include ordinary shares, warrants and transferable subscription rights (TSR). This means that warrants and TSRs are classified as approved securities from the Syariah perspective provided the underlying shares are also approved. On the other hand, loan stocks and bonds are non-approved securities unless their issuance is based on Islamic principles.

In classifying these securities The Syariah Advisory Council (SAC) follows these procedures:

Analysis Process

- 1) Identify companies' securities for classification based on the last financial reports;
- 2) Analyse and prepare company's reports;
- 3) Submit reports for SAC's decisions; and
- 4) Release list of approved securities.

Cases will be presented, extracted from the case studies of securities that are approved by the Syariah Advisory Council done by the Islamic Capital Market unit, Securities Commission.

Terms used:

- (i) Principal company : companies that hold or own shares in the subsidiaries and associate companies.
- (ii) Subsidiary company: companies that hold more than 50% (51% - 100%) of companies' shares.
- (iii) Associate company: companies that hold more than 20% but less than 51% of companies' shares (21% - 50%).
- (iv) Other investment: principal companies that hold less than 21% of companies' shares (1% - 20%).

In classifying whether the securities are permissible or non-permissible, the SAC goes through two phases of analysis that is Phase One: Quantitative Method and Phase Two: Qualitative Method. To analyse the securities SAC receives input and support from the SC. The SC gathers information about companies from various sources such as company annual financial reports, responses to a survey form which was issued to obtain detailed information and through inquiries made to the respective company's management.

Phase One: Quantitative Method

Phase One, is the calculation of percentage contribution of non-permissible activities to company's income and profit before tax. There are three classifications of companies, that is, 100% permissible, 100% non-permissible and mixed companies. Example of mixed companies, 97% permissible and 3% non-permissible.

There are four steps involved in the analysis of mixed companies:

- Step 1:* Get the earnings and the profit before tax of the whole company;
- Step 2:* Get the earnings of non-permissible activities and profit before tax of non-permissible activities;