In The Name of Allah

Research, Development and Islamic Studies

Islamic view point of short selling

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Abstract
Compliance or noncompliance of contracts in conventional financial system with the Islamic jurisprudence has been always one of the major concerns of capital market principals in Islamic countries.
Short selling as one of these contracts is regarded as a useful contract in finance community. It is an essential element of portfolio management and is used as an instrument for maximizing the return while minimizing the risk. Market Makers and Proprietary Traders are generally by far the largest borrowers of stock and are responsible for the majority of securities lending transactions in capital markets.
In this essay we are going to discuss about the mechanics of short selling and then we will go through a survey about the compliance of short selling with Islamic principals and jurisprudences. In order to do that we followed two approach:
First, Survey of any prohibition that may exist in this contract due to Islamic jurisprudence point of view was performed. By seeking for any prohibitions in short selling mechanism we found that Riba evidences exist in this contract.
Second, comparative study of short selling with Islamic traditional contracts was done to distinguish the conformability of this contract with Islamic contracts. We came to this point that short selling is not conformable with traditional contracts.
Finally a shariah compliance solution for this contract is introduced.

Keywords: short selling, Islamic jurisprudence, contract, Islamic contract.

Introduction
Compliance or noncompliance of contracts in conventional financial system with the Islamic jurisprudence has been always one of the major concerns of capital market principals in Islamic countries.
Short selling as one of these contracts is regarded as a useful contract in finance community. It is an essential element of portfolio management and is used as an instrument for maximizing the return while minimizing the risk. Market Makers and Proprietary Traders are generally by far the largest borrowers of stock and are responsible for the majority of securities lending transactions in capital markets.

Definition of Short Selling
Short Selling is the selling of a security that the seller does not own, or any sale that is completed by the delivery of a security borrowed by the seller. Short sellers assume that they will be able to buy the stock at a lower amount than the price at which they sold short.[3]

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[1] Jurisprudential views of this article are on the basis of SEO Shariah Board Resolutions.
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[3] www.investopedia.com

The Mechanism of Short Selling

An investor who wants to sell a stock short must first find a party willing to lend the shares.

Once a lender has been located and the shares are sold short, exchange procedures generally require that the short-seller deliver shares to the buyer on the third day after the transaction (t + ٣) and post an initial margin requirement at its brokerage firm.

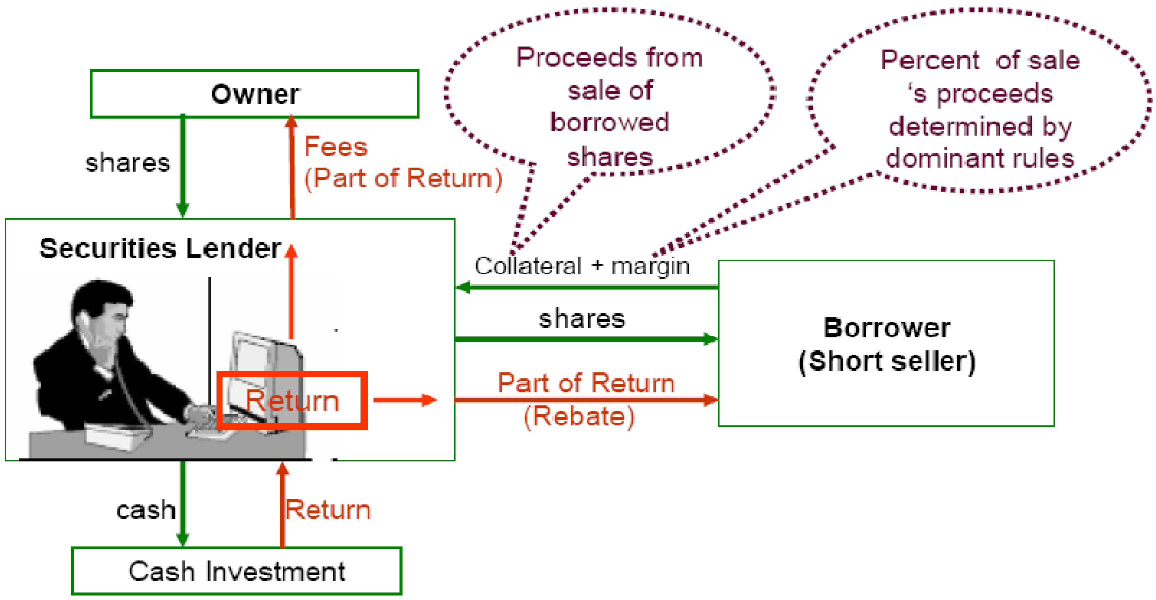
NYSE and NASD require the short seller to maintain a margin of at least ٣٠% of the market value of the short position as the market price fluctuates.

The proceeds from the short sale are deposited in an investment account with the lender of the stock. For U.S. stocks, the lender requires ١٠٢% of the value of the shorted stock value in collateral. The interest on this deposit is often split between several parties participating in the lending process.

The value of the shorted stock is marked to market daily; an increase in the stock price will result in the lender requiring additional collateral for the loan, and a decrease in the stock price will result in the lender returning some of the collateral to the borrower. When the borrower returns the shares to the lender, the collateral will be returned.

While a stock is on loan, the lender (often brokerage firm) invests the collateral and receives interest on this investment. Generally, the lender returns part of the interest to the borrower in the form of a negotiated rebate rate.

Equity loan (lending) structure



Lender's Rights

The owner of a stock retains beneficial ownership of the shares it lends. This status gives the owner the right to receive the value of any dividends or distributions paid by the issuing company while the stock is on loan. However, rather than being paid by the company, the dividend and distributions are paid by the borrower. This is referred to as a substitute payment. The only right the lender gives up when lending their assets is the right to vote on a security.

Recall; end of procedure

In the event of a recall, the borrower is responsible for returning the shares to the lender within the normal settlement cycle (i.e. T + ٣)

If the shares are returned within this period, the custodian can settle the pending sell trade. If the borrower fails to return the shares by (T + ٣), the agent may use the collateral to buy shares to cover the position, therefore closing out the short position of short seller.

Lenders Incentives

١. Long term holder (pension fund, tracker fund) receives dividend plus borrowing cost so increases yield on portfolio.

٢. Another incentive for investors to act as a lender in short sale mechanism is the benefit of covering the risk of long positions. In the other words, whereas long position itself brings about the risk of decrease in value of securities, short sale can act as a mechanism to neutralize this kind of risk because of its short position function.

٣. The third motive which is often beneficial for market principal is using short sale as an instrument to make securities liquid by improving the side of supply for a specific security or the whole market. As sometimes securities owners don't offer their securities with the hope to benefit of price increase and make the market illiquid, market principal can short sell that illiquid security to make it liquid.

Borrowers Incentive

١. The first and also the main incentive for investors to play the role of short seller is the incentive to exploiting the leveraged investment property of short sale. Because of using a margin mechanism in short sale, the short seller doesn't have to pay the whole price of shorted security but gaining the benefit of whole price decrease.

In the table below you can see the function of margin in short sale mechanism.

Initial margin= ٥٠%

Maintenance margin=٣٠%

At Time of Short Sale	Shares	Share Price	Short Sale Value	Initial Margin Requirement	Total Margin Requirement
	1000	$50	$50,000	$25,000	$75,000

As Stock Price Increase	Shares	Share Price	Short Sale Value	Maintenance Margin Requirement	Total Margin Requirement	Margin Call
	1000	$55	$55,000	$16,500	$71,500	$0
	1000	$60	$60,000	$18,000	$78,000	$3,000
	1000	$75	$75,000	$22,500	$97,500	$22,500

As Stock Price Decreases	Shares	Share Price	Short Sale Value	Additional Margin Requirement	Total Margin Requirement	Margin Released
	1000	$45	$45,000	$22,500	$67,500	$7,500
	1000	$40	$40,000	$20,000	$60,000	$15,000
	1000	$35	$35,000	$17,500	$52,500	$22,500

٢. "Making profit of down-ward security or down-ward market" can be mentioned as a willing for short seller to make profit in a security or market which is expected to experience a down-side tend in price.

٣. Market principals who concern about the market price Efficiency may use the mechanics of short sale to make the market efficient by playing the role of short seller to neutralize the speculators' price up-ward activities and consequently making the market trends more regular.

٤. Borrow for failed trades -A failed trade may be defined as where delivery cannot be completed because of insufficient securities available.

٥. Borrowing for market making and proprietary trading. Market Makers and Proprietary Traders are generally by far the largest borrowers of stock and are responsible for the majority of securities lending transactions in the country.

Lender's Risks

There are three types of risk the beneficial owner faces when lending stock: investment risk, counterparty risk, and operational risk. Investment risk involves the choices that the beneficial owner or their agent makes in investing collateral. Some lenders are reluctant to take risk in their reinvestment of collateral, and they invest primarily in overnight repurchase agreements or other very low risk investments. Other lenders look to achieve extra income by investing in higher risk assets. For example, lenders can earn more return by investing in longer term investments and short-term corporate debt with lower credit ratings. It is the beneficial owner's responsibility to monitor the investment of the collateral to manage these risks. Even if there is a loss from investing the borrower's collateral, the beneficial owner is still responsible for returning the borrower's full collateral when the security is returned. Counterparty risk is the risk that the borrower fails to provide additional collateral or fails to return the security. The beneficial owner can manage this risk by approving only the most creditworthy borrowers and by imposing credit limits on these borrowers. Furthermore, the fact that collateral is marked to market daily allows lenders to buy shares to cover the loan if the borrower will not return the shares.

The last major risk to the beneficial owner is operational risk. This is the risk that various responsibilities of the agent lender or borrower are not met. This could be the failure to collect dividend payments, the failure to instruct clients on corporate actions resulting in missed profit opportunities, the failure to mark a loan to market, and the failure to return a security in the event of a recall. These risks can be minimized by maintaining a good lending system which tracks dividends, corporate actions, and the collateralization of loans.

Borrower's Risks

two risks that a borrower faces are the risk of a loan recall and the risk of a decrease in rebate rates. A borrower's challenge is to find a lender that best balances these risks. Recall risk is the risk of the stock being recalled by the lender before the borrower is prepared to close out his position, which happens in approximately ٢% of the loans in the sample of one study. Borrowers would prefer to have loans lasting the duration of the short position, but guaranteed term loans are rare. So, borrowers need to manage recall risk by working with a lender that is likely to be willing to loan the stock for an extended period of time. Often the most stable sources of stock loans are portfolios with little turnover, such as index funds.

Buy-in

If the borrower fails to return the shares, the lender can use the borrower's collateral to buy shares to cover the loan, which is known as a buy-in. In the other words, recalls can force borrowers to unwind their trading strategies Sub-optimally or expose the borrowers to potentially poor execution in the case of a buy-in.

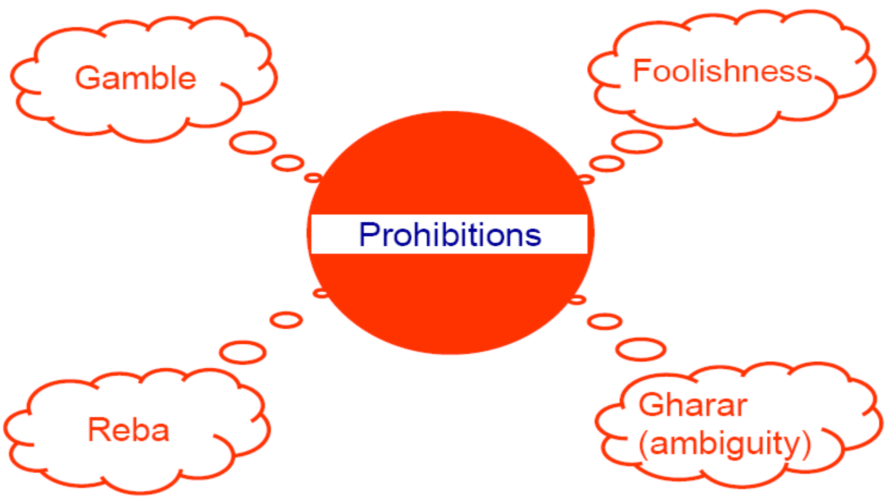
Survey of short selling legitimacy on the basis of Islamic jurisprudence

In currant survey two views were considered:

First, Survey of any prohibition that may exist in this Contract due to Islamic jurisprudence point of view. So if any kind of prohibition exists in the contract we consider it as an illegal contract and vise versa.

Second, comparative study with Islamic jurisprudence conformable contracts (Traditional contracts).

As shown below, according to Islamic jurisprudence principles, there are four prohibited factors which Muslim have to avoid any contract contains one or more of them: Gamble, Foolishness, Riba and Gharar.



The criteria to distinguish the existence or lack of prohibitions are the common expectation and interpretation of Islamic jurists.

Verifying any kind of foolishness in short selling

Short seller and lender know everything about risks and pitfalls in this contract and decide by analyzing the market situation, technically and fundamentally. Furthermore, rational incentives exist for both sides in this transaction and both sides expect to benefit according to their own analysis of securities price, so foolishness evidence doesn't exist in this contract.

Verifying the existence of gharar in short selling

Gharar occurs when one of the two parties is not aware of any aspects of the contract and my make loss because that unawareness. Verifying potential losses related to both parties in this contract and the sources of loss will lead us through this verification.

Potential losses for borrower

If the price of borrowed securities goes up the borrower will make loss. As the borrower is aware of this risk, it cannot be taken as gharar, because rational associated risks cannot be supposed as gharar of unawareness.

Potential losses for lender

As mentioned previously, investment risk, counterparty risk, and operational risk are referred to as lenders risk that again we can say as the lender is aware of these and use hedging actions to avoid these risks, they cannot be mentioned as sources of gharar.

So no sign of gharar can be considered in short sale contract.

Verifying any evidence of gambling in short selling

Gamble is any action that relies on chance or luck which results in obtaining without paying or bearing any suffering. In short selling two parties do transitions based on their technical or fundamental analysis about the future of prices. Market principles and market makers also may pay the way for that to make the market more liquid.

Riba and short selling

As short selling is defined by words; borrowing and lending it assumes to be a kind of debt (qard). The lender receives an amount more than borrowed securities in the form of investment proceeds. This amount is supposed as riba in debt, so if we consider it as a kind of qard as the conventional financial system suppose it (securities borrowing and lending (SBL)) it can not be conformed with Islamic conformable qard.

Conclusion

By seeking for prohibitions in short sale you come to this conclusion that

Riba evidence is founded in short selling contract.

Comparative study with Islamic jurisprudence conformable contracts (traditional contracts approach)

At the first look short sale contract seems to be able to conform with Rent or lease (Ijarah), *bay*' *al*- khiar, debt (qard)

Comparing with ijarah

Although short shale is similar to ijarah in many aspects but some main distinction can be considered:

١- The “right to benefit” of underlying asset is sold in ijarah but “the right to sell the asset itself” is not transferred.

٢-The benefits such as DPS and participating in tender offers is not transferred to short seller in this contract which is the opposite of ijarah because in ijarah all of the benefits are transferred to the counterparty(tenant).

Comparing with *bay*' *al*- khiar

Although short sale has some similarities with ***bay' al***- khiar in seller's right to return the price of the sold goods to buyer and the buyers obligation to return the good to the seller in a predetermined period, its mechanism has some differences as follows:

١-As Islamic jurisprudence point of view in ***bay'*** transition, asset and all of its beneficiaries are transferred to buyer, but in short sale some part of beneficiaries of underlying securities is not transferred to buyer (short seller).

٢-In *bay' al*- khiar the price is fully paid to seller but the option of taking the asset back is given to seller for a period, too. But in short sale the margin is paid not the whole price.

Comparing with debt (qard)

١-Debt (qard) is a kind of ownership contract and the borrower in debt will acquire the asset itself and its beneficiaries. In sale, this is not achieved.

٢-In jurisprudence point of view an acceptable debt is not compensated by anything more than something like the underlying asset. But in short sale the lender receives an amount more than borrowed securities in the form of investment proceeds. So short sale is not a legal qard contract.

Malaysian Shariah Advisory Council point of view

Our brothers in Malaysia adopted short selling as rent (Ijarah) on the basis of ISTIHSAN principle. They describe it as follows:

"SBL (securities borrowing and lending) contract is similar to the terms in the ijarah contract in many situations, such as the authority of the owner recalling the assets, evaluating the assets according to current market value and so forth. The SAC members resolved that the ijarah concept, with the consent of the owner to sell the leased shares can be applied to the Islamic capital market."

Yet you have considered unlawfulness of short sale according to jurisprudence point of view, here my some questions may spring to your mind.

Questions:

Is there any solution to make use of advantages of short selling regarding principles of jurisprudence? Or in the other words is there any substitute mechanism to benefit of short selling contract without preparing any prohibition as an independent contract shariah conformable contract?

It seems yes.

Solution

The substitute mechanism can be considered as:

Simultaneous cash sale and salam purchase (*bay' al*- salam)[٤] of the stock by the owner to short seller.

Example

The owner sells his shares to the other counterparty in cash at ١٠٠$.

The owner purchases the same amount of shares from that counterparty at an agreed price on salam at ٨٥$ for a specific period.

[٤] Pay in advance

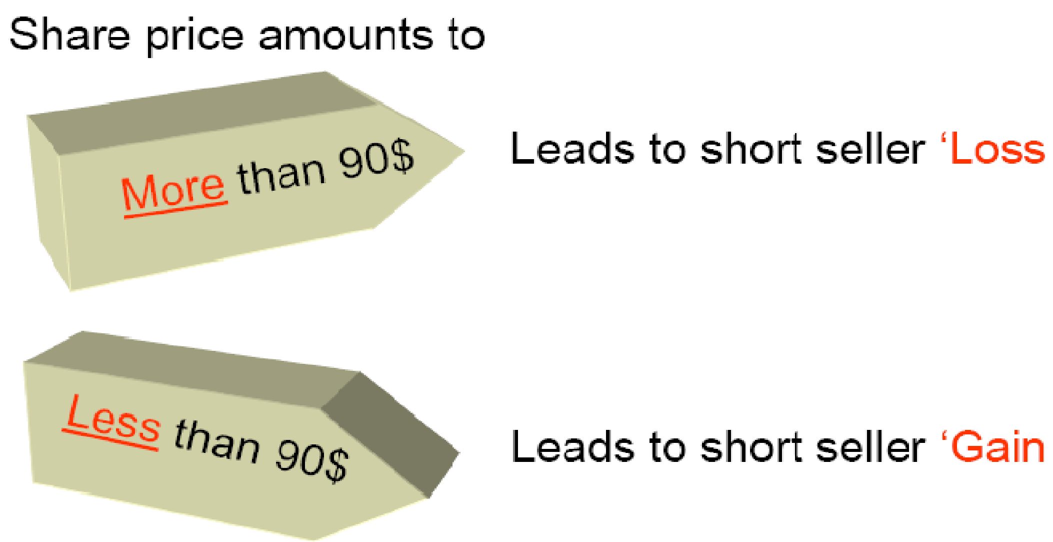
Dividend and amounts equal to proposed interest on proceeds of shorted stock sale are included in credit purchase price. (So maybe the salam price amounts to ٩٠$)[٥]

Balance of payments

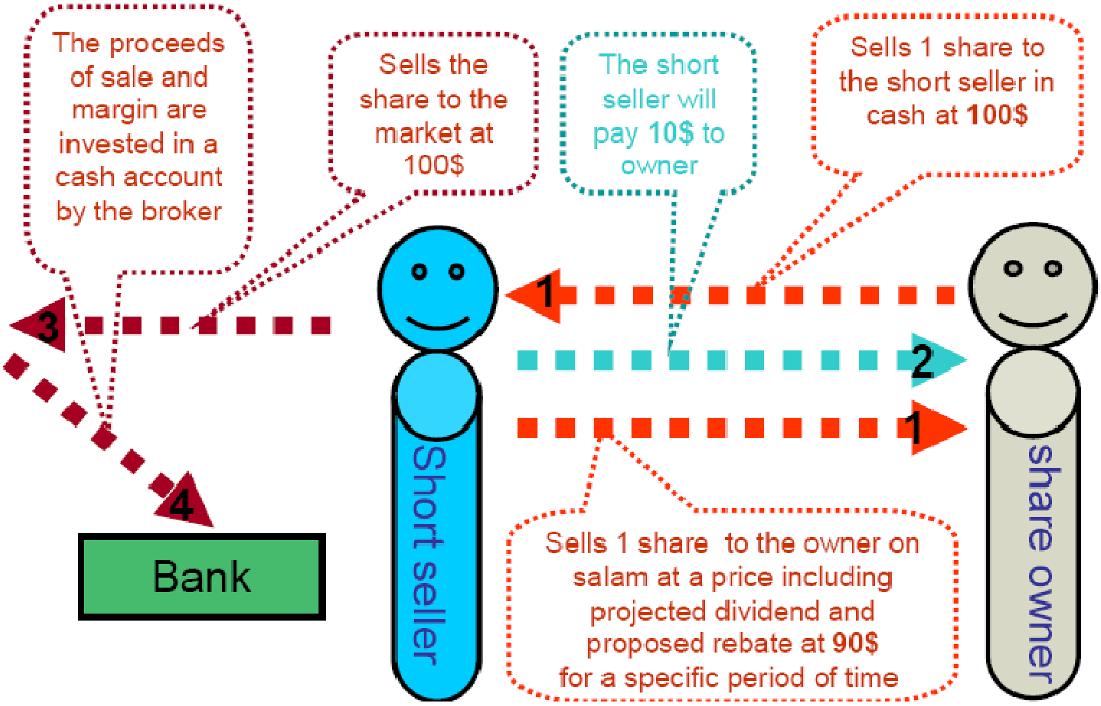
share Owner	Short seller
10$ in cash 90$ on salam	100$ in cash

The shares are transferred by the owner to the short seller instead of ١٠$ in cash. So the Leverage property of short sale is considered.

Two likelihood scenarios after the expiration of salam sale period



[٥] As you know the salam price is always lower than cash price.

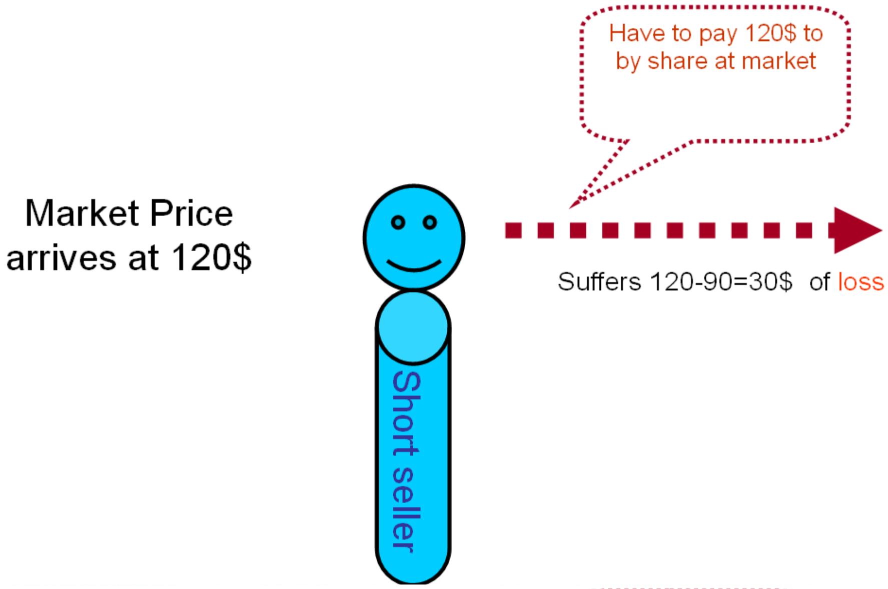


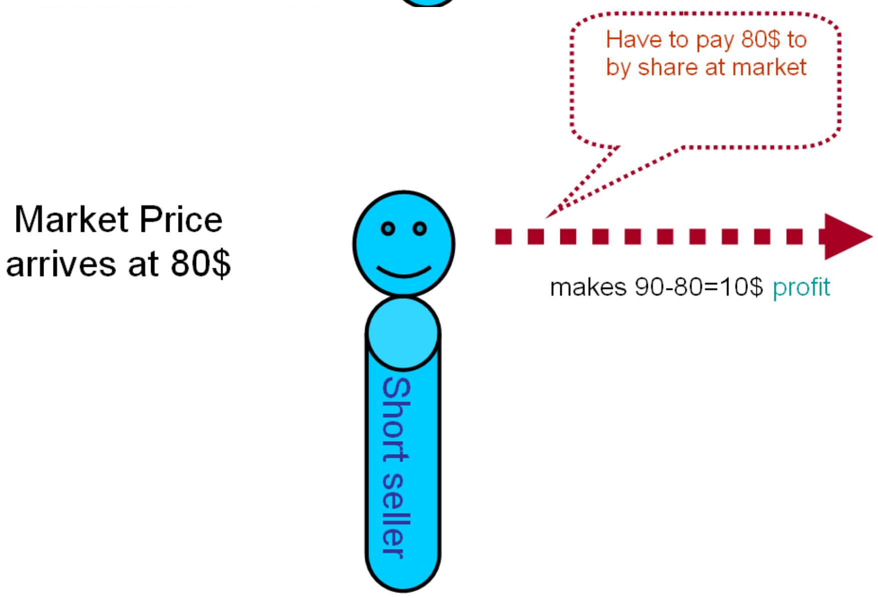
But there may be seen some differences between short sale and the above mechanism:

١-Although the proposed solution covers the aim of short selling (benefit from decrease in prices) but it is somehow different from short sale

٢-In Short sale there isn't maturity date. Returning shorted stocks depends on both parties desire. (Liquidity for owner is considered)

٣-New terms have to be used instead of LENDER and BOROWER in proposed solution.





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Conclusion from SEO Shariah Board Point of view

The Board approved this solution considering ٢ reservations:

Although this transition can not be considered as *bay' al-'inah* but in order to avoid *bay' al-'inah* evidences in the proposed solution, the second salam purchase should not be considered as an obligation in the first cash sale contract and the broker should be authorized to do the cash sale contract when the case for salam purchase occurred.

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