

## **A MODEL OF AN ISLAMIC STOCKBROKERAGE FIRM**

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### I. Introduction

One of the greatest challenges facing practitioners of Islamic finance is the task of bridging the deceptively narrow gap between the general principles that serve as the foundation of their particular fields and the specific applications that make up the ever-changing universe of practical experience. In terms of both quantity and quality, Islamic banking is experiencing an increase of material covering the broadest spectrum of issues that help practitioners meet this daily challenge. On the other hand, the Islamic stockbrokerage industry has not seen any similar attention. This lack of material need not be interpreted as a disadvantage, however. On the contrary, it serves as an opportunity to establish the Islamic brokerage industry as an institution that is born and raised in its own right and on its own merits, rather than as something owing its existence to the adaptation or mimicry of less acceptable systems and institutions.

Of course, we must attempt to answer the obvious questions concerning the need for an Islamic brokerage industry and why its creation is important. The Islamic brokerage house (IBH) serves as pseudo gatekeepers at the entrances of the stock markets themselves. The types of trading they will allow their clients to perform will have its effect on the activity performed on the floors of the exchanges. Also, this same regulation will assist the individual investors in investing in an Islamically acceptable manner. The IBH should be a repository of expert knowledge on the acceptable methods and instruments available to the investor. Lastly, the IBH should serve as an important advocate on the behalf of the individual investor before the corporate leadership of publicly traded firms in which their clients hold shares.

Yet, we must develop these general principles and specify further. While proscribing these general duties, we will also discuss concrete examples of how the IBH can fulfill them. The regulatory environment in which any brokerage house operates defines to a great extent the form the organization takes in order to meet external regulatory requirements. For this reason, the IBH can appear exactly like any other brokerage house. It is a matter of a prevailing ethos and not the concrete organization in which we wish to differ. In light of this, while it may be said that adaptation and mimicry of existing brokerage institutions may not be the best means to achieving our goals, we must not deny the value of

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learning from their experience. However, we must keep in mind that we are working with a paradigm in which the ethical drives the practical and not vice versa. Indeed, this may be the essence of the difference between the IBH and its non-Islamic counterparts.

## II. General Principles

An Islamic firm has functions and responsibilities. If we allow the wedge that positivism has driven between the two in modern economics to be driven between them in Islamic economics and finance, then by definition — or, by re-definition — we must cease calling these fields Islamic. The functions of a firm are those activities that need to be performed to make the firm what it is and to keep it alive. Functions can be considered as both general and specific. General functions are those requirements shared by all business entities, such as paying employees. Specific functions are more definitional. These are those functions that make a firm exactly what it is, such as a brokerage firm, a restaurant, and etceteras. These functions exist necessarily and are independent of ethical and moral considerations.

Islam does not put itself in the absurd position of denying necessary activities, though it does set the acceptable boundaries of their use. In addition, Islam adds responsibilities to these functions. Where necessity ends, Islam begins. The precepts held in this realm become what we will call the responsibilities of the firm. These activities start as abstract principles such as fair dealing, honesty and a host of others. As we apply these fairly abstract ideas into reality, we create the more concrete responsibilities. These do not always exist separately from the necessary functions. We must market our firm's services as a necessity, but we have the responsibility to perform these marketing activities in an honest manner. As such, it is these responsibilities that define a certain universe of necessary functions — in this case, a brokerage firm — as Islamic. The present discussion focuses for the most part on these unique responsibilities of such an Islamic brokerage firm.

No brokerage firm operates in a vacuum. As an institution, its existence and operation has an impact on four different levels. Firstly, it has a role in the overall economy, which benefits from highly developed capital markets. Secondly, brokerage firms affect this influence on the economy through the securities markets. Thirdly, brokerage firms obviously impact themselves and the broader securities industry. Lastly, individual investors, whether defined as a specific person or group of person such as a corporation, are stakeholders in the efficient and equitable operation of the brokerage firms as well.

A direct link lies between the markets and the individual investor: the securities firm. Brokerage firms are the intermediaries that bring the investor into the markets, and hence, into the health of the economy as well. In the reverse, the brokerage firm serves as a conduit of information and opportunities that the capital markets have an interest in seeing taken to the individual

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investor. The key to this whole discussion lies within this seemingly innocent description: the securities firm, while having duties that it owes to itself, owes additional duties to the individual investors who are its accountholders and to the markets within which it carries out its business functions. It is the duty that the securities firm owes to the markets in general that is most often ignored or forgotten, drastically changing the course of developments in the overall economy, securities markets, brokerage industry, and personal finance as represented by the four spheres, mentioned above.

The importance of the distinction that has just been made is evident if we delve into the issue further. We can generalize the intertwined relationship between the markets, the brokerage industry and the investors into three prominent functions. In the first instance, there exists a distributive function. Here, the brokerage house facilitates in moving investment funds from areas of surplus to areas of deficiency. This occurs mainly through the underwriting of new securities issues as the firm acts as an investment bank. This is probably the source of the markets greatest impact upon the overall economy. An incredible amount of money finds its way from the savings of the investors onto the balance sheets of growing companies, which in turn cumulatively builds the wealth of the economy.

In addition, the brokerage firm, after this initial distributive function takes place, maintains the vitality of the markets by providing liquidity. No investment is held forever, and funds must be relatively accessible to those participants who, once invited in, want to get out — or at least re-distribute these savings once again. As opposed to the initial distribution from surplus to deficiency, this function includes more mundane, everyday buying and selling.

Lastly, brokerage firms serve as conduits of information and, more importantly, as pricing mechanisms for the securities they broker. In point of fact, the pricing is set on the floors of the markets, but the market makers and specialists located there are by no means immune to the valuations created by the brokerage houses and the individual investors themselves. The firm, as a conduit, shuttles pricing and other information from the markets to the investors. Along the way, the firm may add its own analysis and valuations. In return, the firm executes the wishes of the investors by transforming their savings into investments. The markets respond, and the cycle is begun again.

Ideally, then, the brokerage firm operates within an environment in which everyone stands to gain. However, the efficiency and equity of the system begins to break down when the perception arises that benefits accrue in only one direction, or when undue emphasis is placed on the rewarding of one group of stakeholders regardless of what might be owed to all others. When the lifeblood of your brokerage firm is the commissions generated by the activity of your clients, it is easy to become focused on your firm's duties to them at the expense of its duties to the industry, the market, and the economy. When this philosophy arises, distortions begin to blur the picture.

Equity investment, from the viewpoint of the individual investor, is best used as a tool for wealth building instead of speculation. As a brokerage firm abdicates its responsibilities to all stakeholders except itself and investors in an effort to generate revenues, it helps create an environment in which speculation is the norm rather than the exception. Generating activity and profits for both the investor and the firm would then be the focus. When the creation of new investment instruments should be driven by the needs of the capital deficient stakeholders, it is instead driven by the perceived profit deficiencies of the individual investor. In addition, this philosophy results in the increased tolerance of more questionable investment activities. The firm's functions as part of an efficient distribution and pricing mechanism cease.

The distortions that are thereby caused often reach levels that can become a source of great concern. Wild over- and under-valuations occur as the prices of stocks become disconnected from reality. Pronounced boom-and-bust cycles appear, creating greater uncertainty for the speculator as well as the average investor. Theoretically, enough investors could be driven out of the markets such that the liquidity that they once helped provide to the savings deficient sectors all but dries up and overall economic growth suffers as well.

To be sure, this paints a rather bleak picture; the reader is justified in making this criticism. However, it is meant only as valid evidence that the relationships do in fact exist. For this reason, we do not need to make mention of the exact extent to which the activities within one sphere effect the others spheres. The attention is directed toward the brokerage firm as it operates within the environment depicted.

The Islamic Brokerage House (IBH), given these related environments, must do its part to ensure both the efficiency and equity of the capital markets in the broad sense. The broader capital markets reach from the individual investor to the overall economy. The individual investor must have his or her savings translated into a wealth building asset base efficiently and then have that asset base managed efficiently as well. At the same time, each investor must have equal access to the markets and the opportunities they provide. In the reverse sense, the savings deficient sectors must have equal access to this pool of surplus savings as it finds its way to the markets. These firms must be able to take advantage of this capital source efficiently. The market mechanism serves a purpose of much lesser importance to the economy at all levels if its activity reduces the value of the investments it offers and the functions it performs.

It remains, then, to study in more detail the various operational units of the standard brokerage house, delineate their specific functions, and identify the unique responsibilities of the Islamic brokerage house.

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### III. Operational Principles

With the general principles of the Islamic Brokerage House (IBH) now put forth, we must discuss the more specific details derived as the theory is put into practice. As has already been noted, the majority of the functions of an IBH do not need to be formulated from scratch; we can find them in existing brokerage firms. Michael T. Reddy, in his book, *Securities Operations*, outlines the basic structure of a modern brokerage house. Reddy's outline is perfectly acceptable foundation upon which to build the following discussion. Taking this as the starting point, we will then examine the responsibilities a firm has in upholding the general principles formerly discussed.

Reddy divides the brokerage firm into two broad divisions: business units and support units. The former generates revenues while the latter supports the revenue-producing activities. Within these two broad divisions are subdivisions. We will treat each broader division, with its subdivisions, separately. The first of the two is subdivided as:

#### Business Units

- ☞ Sales/Marketing
- ☞ Investment Banking
- ☞ Research
- ☞ Trading
- ☞ Finance/Administration

While this division performs its functions, it generates needs of the firm's clients as well as needs of its own. These needs are fulfilled by the second division which contains the following:

#### Support Units

- ☞ Order Processing
- ☞ Comparison (Purchase & Sales)
- ☞ Cashiering
- ☞ Margin
- ☞ Dividends
- ☞ Stock Record
- ☞ Transfer
- ☞ Reorganization

Together, these units, with all of their subsidiary units make up Reddy's brokerage firm<sup>2</sup>. For discussion purposes, we will use this outline as Reddy has developed it.

One of the most influential factors determining the nature of each department's role in the overall firm is the actual business mix the IBH chooses for itself. Specifically, the IBH may choose to pursue discount brokerage clients, or opt for the opposite end of the spectrum by choosing a full-service line of business. Regardless, each of these departments have universal characteristics that we can discuss without differentiating to a fault between the forms of brokerage houses. Within the scope of the Business Units, we must limit the discussion due to reasons of simple expediency; the issues involved are often too complex. Below is a more detailed discussion of both Business and Support Units.

#### Business Units

Sales/Marketing - The name of this department speaks for itself. In the U.S. brokerage firm, the bulk of the sales force is comprised of representatives who are properly licensed to market securities. The material that could be produced revolving around the ethics of this activity, especially within the IBH, could fill volumes but still not yield any definite measures of significance. Suffice it to say that this activity must be performed honestly and with the best interest of all the capital markets stakeholders. For the investor, the instruments and strategies must be suitable both financially and Islamically. At the same time, the seekers of investment capital must be served by having an adequate array of instruments offered within an efficient and equitable market. Finding new ways for the investor to make money does not necessarily equate to finding new ways for firms to cultivate capital.

Investment Banking - This division markets itself to the seekers of investment capital. As has already been mentioned, the brokerage house is servant to all stakeholders involved in the capital markets. Their needs must be considered with equal weight. The extent to which an IBH will act as an investment bank depends upon the type of business it pursues. A discount brokerage house may not underwrite issues at all, whereas a full-service firm may do so to varying degrees. In the United States, at the time of this writing, the most influential factor is the repeal of the Glass-Steagall Act, removing the Depression-era barricade between banking and brokerage. Because of this, investment banking, while deserving more attention, would be better treated at a later date.

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<sup>2</sup> Reddy, Michael T. (1995). Securities Operations. New York: New York Institute of Finance, pp. 12-15.

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Research - Here, as well, the role that this department takes is heavily dependent upon the business mix the IBN chooses for itself. Research could be totally non-existent if the IBH pursues discount brokerage business. If the IBH pursues full-service business lines, research would be a key participant as a business unit. The Research Department's functions can vary anywhere along the spectrum between these two.

The IBH Research Department departs from its traditional focus in that it should also be responsible for evaluating companies and instruments according to Islamic guidelines, whether it actively recommends investments to its clients or not. At a bare minimum, the IBH should either have a mechanism to screen firms suggested by clients or a database against which firms can be compared or from which advisors can draw. The IBH may also employ Islamic legal experts in order to respond to clients' questions and concerns about certain instruments, strategies, and miscellaneous issues regarding compliance with Islamic requirements, such as zakat obligations. Fortunately, recent developments in the financial services arena have made it easier to build a viable research department without extraordinary effort. Potential IBH Research Departments have toiled such as the Dow Jones Islamic Market Index (DJIMI) at their disposal. Rather than build from the ground up, the IBH can simply license sources such as the DJIMI to serve as the foundation of their research departments.

Trading - In the traditional brokerage house, the trading activity involves using the firm's funds to invest and generate profits. Obviously, if this activity is pursued, this must be done according to Islamic guidelines in the same manner that the firm would require its clients to do so. The investment strategies and instruments must conform to Islamic guidelines that would prohibit, for example, activities such as day-trading and currency trading.

Finance - This department involves what we might call direct support. These functions include HR and Payroll, to name two. Of course, this department may be charged with the responsibility of managing revenues from operations used to finance both short- and long-term needs. This being the case, again, Islamic guidelines are paramount. In addition, firms have financial reporting requirements. The various regulatory bodies monitor the financial soundness of brokerage firms, just as different regulatory bodies do with the banking system. Accounting and its attendant record-keeping is managed within this area.

### Support Units

Order Processing — This department can be covered quickly, since its functions do not create any Islamic ramifications. Nevertheless, from both an Islamic and regulatory viewpoint, orders that are received must be executed, the returned executions matched with the previously received orders, and reports made back

to the customer. In addition, Order Processing also involves the tracking of orders still valid though unexecuted for the clients. This department, along with the Comparison Department, completes the entire circuit an order will conceivably make if executed. This is a key factor in supporting the efficiency and equity of market activity.

Comparison — This may sometimes be referred to as Purchase & Sales or just P&S . After the Order Processing Department receives an order and routes it to the appropriate location for submittal, this department will take the executed purchase or sale and begin the process of updating the accounts involved. This involves matching orders with reports received by Order Processing. Again, there is little in the way of Islamic ramifications involved here.

Cashiering — The Cashiering Department manages the inflows of funds in and out of customer accounts. This involves more than just paying out funds and receiving deposits. It involves accepting securities bought in exchange for payment on behalf of the client as well as the reverse when a client needs to make receive funds into the account and have securities he or she sold delivered out of the account. Once again, we have little in the way of Islamic ramifications.

Note, however, that clients may buy securities and not pay, or they may sell and not get paid. The firm is likely to fund these shortfalls when extensions are needed for obligations due but not yet met. In a large firm, the number of these extensions, even though only over the period of one day, might involve a large portion of the firm's own assets or credit. In some cases, the obligation incurred can be extended without assets being involved. However, there will always be the instances where stock is bought or sold and the one of the two parties involved does not pay. The firm will either close the obligation or meet it on behalf of the client. This can open the firm to funding requirements that will then need to be managed along Islamic guidelines. To avoid this, the firm can encourage that each client keep purchased securities in street name , meaning that the securities are registered in the firm's name, allowing it to have access and make delivery of securities that are credited to each client's account. Otherwise, the firm must have an effective plan to manage these receivables just like any other firm in any other industry.

Margin — This is certainly a department with Islamic ramifications. Simply put, Margin and margin investing have no place in the IBH. In the first place, margin involves interest. An investor can borrow up to 50% of the value of a purchase. Interest is then charged on the amount borrowed. Unless a mechanism can be created where interest is not involved, then this type of activity would be prohibited. Furthermore, even if such a mechanism were developed, there is still the issue of the need for margin purchases or the need to

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leverage what one has in order to have more. Margin buying is based on the assets held by the client. The greater the assets, the greater the margin account's buying power. This lends itself to a concentration of wealth that is in opposition to the principles of equality stressed by Islam.

Dividends — The Dividends Department processes incoming dividends due to the owners of specific equities. On the face of it, this would seem free of Islamic ramifications. However, it must be remembered that dividends are paid from earnings, and earnings are often proportionately attributable to interest. The Dividends Department must create a method or mechanism to track this portion of earnings so that the Islamic investor can then purify those dividends of its prohibited elements. Theoretically, there are two ways of accomplishing this. One method is to receive the dividends in a lump sum and, before crediting the specific accounts, remove the interest portion. However, due to practical considerations, this is not the preferred method. In some legal environments this may be outright prohibited. Each investor will wish to handle the purification in their own way. The preferred method is to simply credit the dividends to the appropriate accounts, inform the investor of the portion attributable to interest, and allow them to handle it in their own manner.

Stock Record — Stock Record keeps track of the location and disposition of the shares owned by the firm's clients. In a firm where a vast majority of its clients hold the securities with the firm in street name, this department is vital in keeping record of the number of shares belonging to the appropriate accounts. Without this, other departments, such as Cashiering, Dividends, Transfer, and Reorganization could not function. No Islamic ramifications are anticipated.

Transfer — When stock is received from a purchase, the firm must register them in the appropriate name if so directed by the client. Or, if securities currently held in street name are requested by the client, the number owned by the client is verified and registered directly in the name of the owner and sent to the requestor. Again, no Islamic ramifications are anticipated.

Reorganization — The Reorg Department informs the investors of changes affecting their holdings. This involves mergers and acquisitions, name changes, and splits to use some common examples. Often, Reorg activity requires the investor to take action or make an election. The IBH Reorg Department will fulfill this function, but also stand ready to advise in regard to how the changes affect the Islamic screening of the firm. For example, a firm that is Islamically acceptable at the time of the investment may either change their business to Islamically unacceptable business lines, or may simply be absorbed by a firm that is unacceptable Islamically. The investor may then act accordingly. This responsibility might be fulfilled within the Reorganization Department, or it

might be managed by those functioning in a similar capacity in the Research Department.

#### IV. Conclusion

This has been a brief attempt to outline the functions of a modern brokerage house, while adding what we have termed Islamic responsibilities in an effort to differentiate between the traditional brokerage firm and the Islamic Brokerage House (IBH). This is by no means the only form the IBH can take. It is not a definitive delineation of the IBH's functions and responsibilities. The final form the IBH takes is dependent upon the business it pursues and the environment within which it operates. The business the IBH might pursue ranges from discount to full-service brokerage. The environment within which the IBH operates is also a factor based on the extent of development the economy and financial industry have reached. If the IBH has a wide range of financial service firm with which to work, it may limit its direct participation to the Business Units listed above, while outsourcing the Support Unit functions to external vendors who provide established trading solutions, clearance, custody, and even compliance activities on behalf of the IBH.

The market for Islamic investments continues to grow, but the Islamic investment industry has not kept pace. Without such development, the potential Islamic investor has not outlet for their savings, and their wealth stagnates accordingly. Further stagnation occurs on the other side of the equation as Islamic enterprises suffer from the lack of capital needed to fund their growth or the ability to move assets off of their balance sheets. This discussion has been an attempt to offer a model Islamic brokerage firm that could be established to address this vital need.