Short Selling in Islamic Finance

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Islamic Finance Theoreticians and Islamic Economists often get caught up in the doctrinaire. Rather than exploring the feasibility of an arrangement, they will find arguments against it based on legitimate (but to some extent overused) sources. In the case of short-selling, many would quote the truly famous hadith, where the Prophet (pbuh) was quoted to have said ‘Do not sell what is not with you.’ This hadith is the basis for much speculation about the inner meaning of Islamic Finance and has even been cited and misused by Western Economists as a rationale for why Islamic Economic systems must be more stable than conventional. (see Kamali, Islamic Commercial Law: An Analysis of Futures and Options chapter 10 for a deep discussion of this hadith).

We can only point to the recent announcements of Dubai World as an example of the lack of stability of any system based on huge amounts of leverage, as well as an opportune time for discussing the mechanisms for a short-sale. Certainly, shorting DP World or Nakheel a few months back might have made perfect sense, given the questionable support of the Abu Dhabi government for the speculative excesses of its super-trendy neighbour.

But, given the explicit authorization of bai as-salaam contract (forward sale, where payment is made upfront and the sales item is delivered at a later date), which certainly calls the applicability of the above-mentioned hadith into question, we leave the open debate (see for instance our LinkedIn discussion here for a lively debate on the topic) of whether something should or should not be allowed behind in order to tackle the specifics of just how would short-selling be accomplished.

If this justification for our discussion were not sufficient, the possibility of Islamic Hedge Funds had been much in the news within the past two years. Perhaps this was just the dreams of structurers who always want to solve the next puzzle, rather than a case of genuine demand. And, recently the role of hedge funds in the Global Financial Crisis may call to question the wish to Islamize many of their activities. Nonetheless, the primary obstacle to the development of Islamic Hedge Funds was seen to be the lack of a short-selling mechanism, although some would cite at least three requisites in order to launch a hedge fund: leverage, short-sales, and compensation schemes (see, for example this article on the death of hedge funds from 1969). We hope to tackle issues of leverage (through Shari’ah-compliant repos for instance) in later articles. As we shall see here, the structuring teams have been very active when it comes to developing the means for short-sales.

Although we shall discuss four methods for short-sale below (with links to three already detailed in Islamic Finance Resources), further methods and nuances of each of these are likely to emerge over the coming years, given the level of activity and interest among market participants in finding solutions to the issue of Islamic Hedge Funds.

1. Short-sale by Salaam:

This uncovered short-sale method was originally used by Newedge in their hedge fund platform, which has some following in KSA due primarily to the Shar’ah Advisor. It came under more scrutiny after AAOFI issued a standard on bai as-salaam, which explicitly limited salam sale to commodities. Effectively rejecting this limitation, Malaysia’s SC recently elaborated on the mechanism for salam sale, extending its applicability to short-sale of financial securities (see reference link here for a more detailed discussion in Islamic Finance Resources).
2. Short-sale by exchange of (conditional) promises (wa’dan)
This method for covered short-sales has been used by Amiri Capital in their hedge fund platform. It allows for the exchange of two promises or wa’d (unilateral promises, dual wa’dan, plural wu’d), one by short-seller, one by lending party where the conditions for entry are different for each promise, effectively skirting the prohibition on bilateral promises (muwa’dah). This method is discussed in further detail in Islamic Finance Resources (see reference link here).

3. Short-sale by Sale and Promise:
The Malaysian SC developed a method for a covered short-sale involving the purchase and sale of a security to a central exchange with the promise to buy back at some later date. The exchange would similarly enter into a sale and promise with a subsequent purchaser. In effect the exchange will circumvent the need for bilateral promises (and may not act like a ‘rational economic agent’). This method is also detailed in Islamic Finance Resources (see reference link here).

4. Short-sale by Arboon (down-payment sale):
This method for a covered short-sale was developed extensively by Shariah Capital as the basis for its own hedge-fund platform (upon which its own commodities hedge fund has been successfully operating for several years now). Arboon sale or down-payment sale (buyer pays a downpayment in order to have the option to purchase a security in the future) is a call option with far less flexibility than the unilateral promise, which has been approved only for the Hanbali maddhab (school of jurisprudence, followed primarily in KSA) and mostly disapproved in the other maddhabs. Nonetheless, modern faqaha (scholars) have been approving its use in a wider and wider range of applications, irrespective of the school of thought. We aim to write more on this method in Islamic Finance Resources, but the following white paper by Sh Yusuf Talal DeLorenzo (see reference link here) provides further details.

We may very well see new developments and methods for short-sales in the future as well as a quest for dominance of one prime brokerage platform (and method) over the others. As different as those methods might be, it seems the lack of a cohesive approach to alternative investments represents yet another hurdle for this sector. Nonetheless, looking at the mechanisms for the individual methods (with their respective pros and cons) can give further insight into the plausibility of both hedging and benefiting from the speculative excesses of others.

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