

The Arboon Sale

A Shariah Compliant Alternative to Selling Short with Borrowed Securities

SHARIAH CAPITAL

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Introduction

Until the present stage of its development, modern Islamic Finance has been without the ability to profit from falling markets or even to protect stock market investments from downward trends. It is widely acknowledged in Shariah finance circles that the conventional methods for hedging, and the short sale in particular, are simply unacceptable owing to their use of elements that are contrary to Shariah principles and precepts. However, for the past several years scholars and experts have indicated a growing consensus that it may be possible, at least in theory, to use classical transactional models like salam and arboon to provide investment managers with effective tools for hedging and managing risk, including the ability to profit when the price of shares declines. This White Paper outlines the development of the Arboon Sale by Shariah Capital as a practical solution for the Al Safi Trust, providing investment managers with an effective way to benefit from stock market investments regardless of market trends. Most importantly, the Arboon Sale solution is completely Shariah compliant and has been certified as such by means of a fatwa signed by senior and experienced Shariah scholars, each of whom is a member of the Shariah Board of the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), the standard setting board for the modern Islamic financial industry.

Difficulties with Conventional Short Sales

Since conventional short sales require the sale of borrowed shares, such sales are clearly contrary to Shariah rules. There is complete unanimity of agreement among Shariah scholars on this point. In order to sell something, according to the Shariah, one must first have ownership of what is to be sold, or the subject of the sale. Under Shariah rules, then, if securities are to be sold into the market, the seller must first establish ownership of those securities. It is not possible, using conventional prime brokerage documentation, for a hedge fund manager to be Shariah compliant and to borrow shares of stock from a prime broker and then sell those shares into the market. It is for this reason that hedge funds are widely understood to be non-compliant with Shariah norms. It is for this reason too that it is widely believed that hedge funds will never become Shariah compliant.

It is perhaps this mistaken belief that has led some product providers to have recourse to artificial solutions which attempt to circumvent Shariah strictures by swapping returns from hedge funds, even though the hedge funds themselves are without Shariah supervision and may invest in anything from currency futures to interest-bearing instruments like T-bills and bonds; and may even include shares of companies in the business of gambling or alcohol. Such defeatist stratagems, however, have been rejected by the market. Other difficulties associated with short sales as practiced by prime brokers using the conventional borrow and sell methodology include a series of interest-based charges for services and, remarkably, interest payments on borrowed securities; any and all of which render the transaction unacceptable from a Shariah perspective. None of this, however, need concern the Muslim investor any longer. The Arboon Sale is the ideal solution to all of these problems.

Shariah-based Strategies for Shorting

The conventional short sale is a forward-looking transaction that involves different times for initiation and completion. In this respect, it is immediately suggestive of two types of sales sanctioned by classical Islamic law. These are the salam and the arboon sales. The salam sale, used historically in an agricultural context, was designed to provide farmers with seeds and, at the same time, to offer merchant/financiers protection from price fluctuations on the crops which they effectively financed by providing the farmers with seeds. The arboon sale also has its roots in classical Islamic law. In an arboon, the seller takes an earnest money deposit from the buyer with the understanding that the deposit will be credited toward the price if the sale is concluded, and forfeited if it is not.

From a theoretical perspective, both of these sales would appear to be suitable for replicating the conventional short sale in a manner that complies with Shariah.

Approval for the Arboon Sale

While both of these transactional models have been approved by Shariah supervisory boards around the world and are routinely used by Islamic banks and multinational banks with Islamic windows as base solutions for financing, only the arboon model has been found suitable for use in compliance with both AAOIFI and SEC (Securities and Exchange Commission, the US regulator of stock markets) standards and regulations. Original approval for the arboon sale came from the Jeddah-based OIC Fiqh Academy which reviewed the arboon transaction and found it acceptable for use by modern Islamic banks and investment houses. This decision is documented in the *Journal of the Islamic Fiqh Academy*, 1993, vol. 1, number 8, p. 641.

The use of the salam model in the sale of securities, however, is prohibited by AAOIFI Shariah Standards, as below:

The basis for the impermissibility of salam in shares is that the subject matter of salam is a debt and not a thing, while in shares of corporations nothing works except by mentioning the name of the corporation whose shares are desired through salam thereby rendering the shares an ascertained thing and not for a debt. Shares cannot, therefore, essentially be the subject matter for the salam transaction. Further, the salam in shares implies the sale of ascertained things that are not owned and this is not permitted.

AAOIFI Standard 21 - Financial Paper (Shares and Bonds), at Appendix B: Basis of the Sharia Rulings, Art. 14, page 377 of the 2004-2005.

Thus, even though in theory both models may be adapted for use by a prime broker as short sale alternatives, in practice only the Arboon Sale is acceptable under present Shariah standards.

The Arboon Sale in Classical Islamic Jurisprudence

The Arboon sale, also known as 'urboon, arbaan and urbaan, is known to have been practiced in the time of the second Caliph, Umar ibn al Khattab which indicates that its origins were earlier and, most importantly, that it was considered a lawful transaction in the earliest days of Islam. A reliable report was related on the authority of trusted condition that if Umar approved the purchase the down payment would become a part of the purchase price, and if Umar did not approve then the down payment would be kept by the seller, Safwan.¹

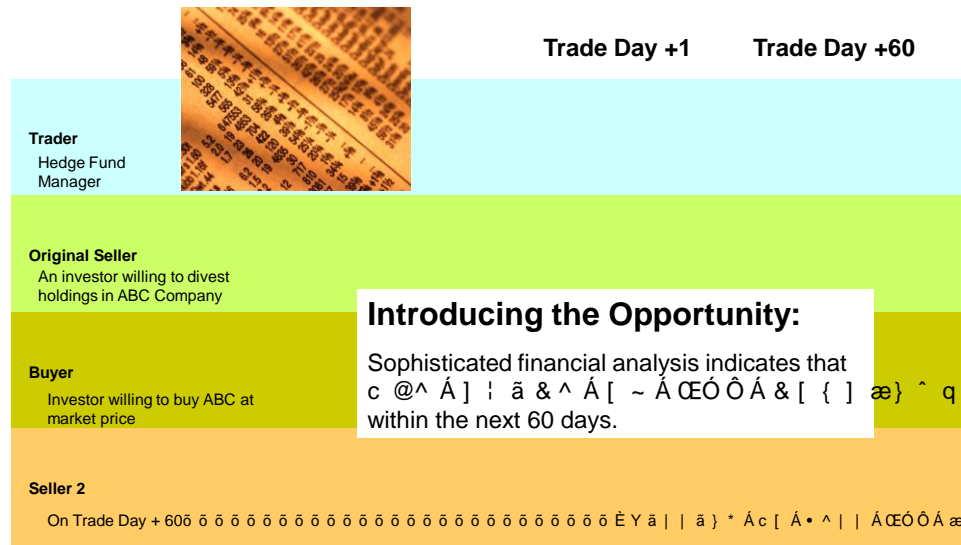
As explained in the preceding section, 'Approval for the Arboon Sale', modern scholars are agreed on the acceptability of the Arboon sale in general. In addition to support for Arboon in the writings and research of individual scholars and Shariah boards all over the globe, the decision of the OIC Fiqh Academy on the matter has

¹ Ibn al Najjar al-Futuhi, *Muntahal-Iradaṭ*, Kitāb al-Umūr al-ʿAlīyah, al-Mughnīyah, vol. 4, p. 161.

never been disputed.² As a result, the arboon sale is regularly used in a variety of financings offered by Islamic banks and finance houses all over the world today.

The Workings of the Arboon Short Sale

The Arboon Sale is an alternative transaction which replicates the economic results of a conventional short sale without using the "borrow and sell" method of shorting employed by conventional prime brokerages for their hedge fund clients. In essence, the Arboon Sale is a sale transaction which has the effect of generating a net economic benefit arising from a fall in the price of the shares. (Please refer to thentire Arboon Sale slide presentation.)



A complex transactional process is required to achieve the same economic benefit as a conventional short sale by means of the Arboon Sale. Several different Shariah, regulatory, legal and commercial elements are involved; and the legal documentation for the same is extensive.

For example, it is not enough to work with a hedge fund manager, however willing the manager may be to comply with the investment guidelines specified by a Shariah Supervisory Board. This is because the hedge fund manager does not control the short sale process but depends instead on the services of a prime broker. Only a prime broker is in a position to provide the complicated series of services required for short sale transactions. More importantly, only a prime broker has the contracts that satisfy the various legal, regulatory, exchange and prime broker credit and balance sheet requirements and parameters, such that all such transactions may take place in accordance with stock exchange \ c i g Y ` f i ` Y g ` U b X ` f Y [i ` U h c f m ` f Y e i] f Y a Y b h g ` Theg, i W \ ` U g ` while the creation and certification, by means of a fatwa, of Shariah-compliant short sale methodology is key to the Shariah compliant short sale alternative, there are many other factors that comprise the process. In order to

² Perhaps among the most influential of these scholars are Dr. Yusuf al-Qaradawi and Shaykh Mustafa al-Zarqa, both of whom have pointed in their writings to the utility of Arboon and its harmony with the spirit of Shariah law which seeks to remove hardship and bring ease.

understand the workings of the Arboon Sale alternative it may be helpful to compare the Arboon Sale to the classical arboon sale model and also to a

Comparing Features of the Short and Arboon Sales

1. In a Shariah-compliant Arboon Sale, stocks are purchased using an arboon contract so that the investor actually takes ownership of the stocks. By means of the arboon contract, no stocks are borrowed. In a classical arboon sale, the buyer agrees to purchase goods by paying earnest money against an agreed sale price. In the Arboon Sale, the prime broker agrees to sell stock to the investment manager at the quoted (and therefore agreed) market price. The investment manager makes an arboon down payment and assumes ownership of the stocks.
2. The Arboon Sale complies with the condition stipulated by the OIC Fiqh Academy that a time period for payment of the remaining purchase price must be specified.
3. In the classical arboon sale, if the buyer does not complete the purchase within the time period specified, he must return the goods and forfeit the down payment of earnest money. In the Arboon Sale, if the investment manager decides not to complete the sale, he returns the shares and forfeits the arboon earnest money.
4. In a classical arboon sale, once the purchaser has paid the arboon earnest money to the seller, he is free to dispose of whatever he purchased. In an Arboon Sale, once the investment manager has made a down payment equal to a margin account deposit, he may arrange through the prime broker to sell the stocks purchased by means of the Arboon Sale to a third party at the market price when the sale is concluded.
5. In order to close out the transaction in the Arboon Sale, the investment manager instructs the prime broker to purchase the required number of stocks from the market at the market price. Using these securities, the investment manager terminates the Arboon and the Prime Broker retains the earnest money. The same process is used in a conventional short sale.

Legal Documentation

No transaction can be certified Shariah compliant by a Shariah Supervisory Board unless the underlying contracts conform to the principles and precepts of the Shariah. As the prime broker transacts on behalf of the investment manager, it is essential that all prime broker contracts and related documentation for conventional short sales be replaced by contracts and documentation for the Arboon Sale. Unless this is done, none of the transactions described above may be considered Shariah-compliant. The Al Safi Trust platform utilizes an alternative set of prime brokerage documentation by means of which all trades, whether long or short, may be conducted in accordance with Shariah rules, with no interest, no prohibited terms and conditions, and no prohibited sales (like the sale of what one does not rightly own, or like the purchase or sale of prohibited businesses like pork or alcohol production, banks and insurance companies, and so on). In order to ensure Shariah compliance, all managers on the Al Safi Trust platform are

contractually obligated to settle short sales through one prime broker. Shariah compliant contracts allow the prime broker to process trades initiated by the platform's hedge fund managers, while avoiding all the prohibited elements (interest, prohibited terms, prohibited businesses) that are present in prime brokerage contracts commonly used by hedge funds for conventional short sales.

To Conclude

The Arboon Sale solution for hedge funds goes beyond the usual development of a financial product because Shariah compliance requires more than structuring and monitoring a fund to ensure compliance of the hedging strategy and the securities held in the investment portfolio by means of screening, investment guidelines, and oversight by a qualified Shariah supervisory board. Most importantly, the Arboon Sale for hedge funds requires fundamental changes to the way that trades are processed. In particular, the contracts that underlie the exchange of securities must be made to comply with Shariah rules. Without these modified legal documents, no short sale solution, however sound its Shariah methodology may be, can be considered Shariah compliant.

Shariah Scholars Approving the Arboon Short Sale

Formal approval by means of a fatwa has been issued for the Al Safi platform and its various solutions, including the Arboon Sale, by a Shariah Supervisory Board composed of internationally renowned scholars.

SHAYKH NIZAM YAQUBY, BAHRAIN

Shaykh Nizam is well known as a leading expert in modern Islamic finance with significant contributions of original research. His Shariah Advisory Board memberships include: the Dow Jones Islamic Market Index, ABC Islamic Bank, Citi Islamic Investment Bank, Investcorp, National Bank of Abu Dhabi, UBS, HSBC Amanah Finance, Abu Dhabi Islamic Bank, Bahrain Islamic Bank, Gulf Finance House, Sharjah Islamic Bank, Royal Bank of Canada, Guidance Financial Group, Unicorn Investment Bank, WAFRA (Kuwait Investment Advisory), Shamil Bank, Al-Ahli United Bank, Islamic Bank of Britain, European Islamic Investment Bank and others. He is also a member of the AAOIFI Shariah Supervisory Board.

DR. MOHAMED DAUD BAKAR, MALAYSIA

Dr. Mohamed Daud Bakar is the Chairman of the Central Shari'ah Advisory Council of the Central Bank of Malaysia and a member of the Shariah Advisory Council of the Malaysian Securities and Exchange Commission. He is considered the leading authority on Islamic legal theory and Islamic finance in Malaysia. A former Associate Professor in Islamic law and Deputy Rector, Student Affairs and Disciplines, at the International Islamic University Malaysia, Dr. Daud's areas of specialization include Islamic legal theory, Islamic banking and finance, and Islamic law of zakat. Dr. Daud is a member of numerous international Shariah Supervisory Boards, including the Dow Jones Islamic Market Indexes, HSBC (Malaysia), Unicorn Investment Bank (Bahrain), BNP Paribas, Oasis Asset Management, the Japan Bank for International Cooperation, the Shariah board of Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) and others.

DR MOHAMMAD ABDUL RAHIM SULTAN AL OLAMA, UAE

Dr. Mohammad Abdul Rahim Sultan Al Olama is a member of the faculty of Shariah at UAE University. Dr. Mohammad is a member of the Fatwa Committee at the Department of Religious and Charitable Affairs in Dubai. He is a member of the Shariah Board of the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) and serves as a member of the Shariah Boards of Mawarid Finance in Dubai, Manazel Real Estate in Abu Dhabi, and Al Mada'in Finance in Dubai. Dr. Mohammad has written extensively on modern Islamic finance and has presented numerous research papers at industry conferences. He holds a PhD in Islamic law from Umm Al Qurra University in Mecca, Saudi Arabia.

SHAYKH YUSUF TALAL DELORENZO

Shaykh Yusuf Talal DeLorenzo, Chief Shariah Officer at Shariah Capital, is a scholar of Islamic Transactional Law whose 30 year career was featured in an August 2007 front page story in The Wall Street Journal. Based in the United States, he has worked for major financial institutions, including investment banks, insurance providers, institutional investors, home finance providers, international investment banks and a variety of asset managers. Shaykh Yusuf is the author of the three volume *Compendium of Legal Opinions on the Operations of Islamic Banks* and has written numerous chapters in books on the subject of modern Islamic Finance. He also serves as a member of the Shariah board of AAOIFI, and is a member of the ISRA Council of Scholars attached to the Central Bank of Malaysia.

Frequently Asked Questions related to the Arboon Sale Solution

Q: There is a general impression that hedge funds are highly speculative. Is this true?

A: It is unfortunate that many people have the impression that all hedge funds are about speculation and wild rides on Wall Street. For the majority of hedge funds, nothing could be further from the truth. In the hedge fund industry, the preservation of capital is rule number one. Typically, however, it is not the disciplined funds that catch the eye of the public.

A fundamental principle of hedging is that every trade, every move is calculated to preserve capital by balancing risk against reward. The name itself, hedge, is indicative of this fundamental principle. In a garden, a hedge is used to protect flowers from the feet of people walking by. The Arabic word for the same, *tahawwut* is equally indicative of this fact. In challenging market circumstances, there is more downside risk in an ordinary mutual fund with fewer tools than those available to hedge funds. Hedge funds, with their variety of sophisticated strategies, are designed to better protect capital in challenging markets while offering superior returns when markets are favorable. This is certainly true of the hedge funds on the Al Safi Trust platform whose strategies and track records establish them as truly risk averse and profitable.

Q: Is hedging the same as gharar?

To equate hedging with *gharar* is clearly a mistake. Hedging should be understood to mean "protecting". The true nature of a hedge fund is to protect against gambling and speculation, even when others in the marketplace are carried away by speculation. For example, at times buyers speculate wildly, perhaps on the basis of no more than a rumor, and bid prices up, leading to artificially inflated markets. Then, when investors realize that stocks have become over-valued, and the market adjusts or corrects (usually downward) to compensate, hedge funds that employ strategies to reduce volatility (like long/short or market neutral) will not be affected. This is how hedge funds protect against volatility caused by speculation in the markets; and this is why hedging is not the same as *gharar*.

Q: But, even so, hedge funds do speculate and may therefore run contrary to the Shariah prohibition of gharar. Is this correct?

All business is based on a degree of speculation because no one, other than the Almighty, knows the future. Without some level of speculation and risk, there can be no business or progress. Shariah compliant finance is based on risk and reward; and the key to success in business is managing risk intelligently. The prohibition against *gharar* is a prohibition against undisciplined and uncontrolled speculation or the sort of speculation that resembles a toss of a coin. Hedge funds employ the most modern and technologically advanced tools, including fundamental and technical analysis, often using complex mathematical models, to identify, quantify and deal with risk. Thus, when they accept

investment risks, they do so in a disciplined and informed manner. It is this aspect of hedging that makes hedge funds the investment of choice for sophisticated investors. None of this runs contrary to the Shariah prohibition of *gharar*

Finally, it should also be noted that speculation is often fueled by excessive leverage. Shariah principles discourage the use of leverage, and the Al Safi Shariah Supervisory Board monitors all sub trust managers very closely to ensure that this sort of speculation does not occur.

Q: It has been suggested that short selling drives falling prices even further downwards, and is therefore somehow immoral and contrary to general Shariah teachings about just dealings. Is this true?

A: Ethical values and justice are an integral part of Islamic Finance. To the extent that it is possible, Shariah boards will attempt to codify ethical considerations into specific rules or investment guidelines, especially as new investment products are introduced to the market. The general Shariah rule with regard to transactions is that a transaction will be considered lawful unless it can be established otherwise. Certainly, the classical *arboon* model upon which the *Arboon Sale* is based has been upheld by jurists as a lawful transaction. The problem is that hedging suffers from a bad reputation. However, like so many other things in the world today, it is not the instrument that is at fault but the uses to which it may be put.

The purpose of buying and selling stocks is to earn profits. At times it is profitable to sell, and at other times it is profitable to buy. Most investors buy stocks when they expect them to increase in value so that they may sell them at a higher price than they paid for them when buying. The difference is their profit. Investors may also profit by selling stock when its value is falling. In either case, the investor makes a business decision based on value or, more accurately, on how the market perceives value. If the market continues to hold a stock in high esteem, its value will remain high. If the market sees factors that will negatively affect value, then the price will very likely fall. This is what orderly and efficient markets do. *Arboon Sale* whose research focuses on looking beyond the obvious to determine the true value of stocks.

If an investor sees that the value of a stock is falling, or perceives that it is likely to fall, he will naturally want to sell that stock. The investor may continue to hold a falling stock in hopes that its price will rise again; or he may decide to sell the stock while it is still profitable to do so, i.e., before the price drops below the price at which he purchased the stock. In either case, it is difficult to attach a moral value to such a decision. It may be that if many investors begin selling that stock, **whether their positions are long or short**, then other people will follow their example and do the same. Then, it is possible that high volumes of selling will cause investors to panic and set off a precipitous drop in the price of the stock, as if without reason, leading to losses by many investors. At this point it may be possible to assign blame for such losses to those who first began selling the stock. But it is not an easy matter to characterize their selling as unethical because those who first starting selling the stock did so because they perceived, through analysis or by means of whatever method, that the value of the stock was falling or about to fall. So the investors who began the selling were merely attempting to protect themselves. If others are panicked as a result, their panic cannot rightfully be attributed to any one seller or group of sellers. Nor, for that matter, can their losses be attributed to others.

In the reverse situation, when a herd mentality sets in and prompts buyers to buy and buy, thus artificially inflating the value of stocks, the same question may be asked. Is it moral to contribute to the artificial overvaluation of a stock if that overvaluation leads others to buy that stock at prices far above what is reasonable?

Clearly, the true cause of the problem with shorting is the selling off, the panic felt by investors who are in a hurry to divest their holdings of a falling stock. In an atmosphere of widespread selling, it is perhaps because short selling

results in profits for some sellers rather than others that people suspect short selling to be the cause of unruly markets. In fact, as illustrated above, it is selling of any kind, long or short, that can lead to panic in the market and losses for companies and investors.

Q: Then why, during the recent stock market crisis, did regulators around the world issue warnings against shorting or, in some cases, even ban short sales?

A: As explained in the previous answer, short selling is a form of selling and in difficult financial times selling can lead to panic which, in turn, can lead to downward spirals in prices. Thus, short selling is often blamed when stock markets decline. For example, following the US stock market crash of 1929, and again in 1987, Congress held hearings on the subject; and after 9/11, both the FSA in the UK and the SEC investigated allegations of abuse. The results of these hearings, and of official studies, show that short selling is actually beneficial in that it contributes to more efficient markets through aiding price discovery and preventing shares from becoming overvalued. Academic research, for example, has shown that in the period immediately preceding the stock market crash of 1929 short selling clearly targeted overvalued stocks. In other words, it was the decline in value of those stocks that led to short selling; and not short selling that led to the decline in value of the stocks. In a Yale University study of US stocks over the past thirty years, similar findings were reported.

It should also be noted that the recent ban on short sales was limited in most markets to the financial services industry, banks, asset managers and insurance companies (the so-called "short ban"). This was a protective measure designed to permit those companies to continue to raise capital, and was not aimed at the practice of short selling in particular.

Q: Does the Al Safi Trust employ legal strategies or short cuts to make it compliant with Shariah?

There is nothing controversial in the way that the Al Safi Trust operates or invests. The Shariah Supervisory Board insists that every aspect of the Trust's and the sub trusts' operations must be unambiguous and transparent. The Shariah Supervisory Board also insists on employing contractual norms established by the classical jurists of Islam. Thus, while it may be said that the Al Safi Trust is innovative, this is meant only in the sense that it brings about new solutions... but it employs old tools to do so. There is nothing controversial about the transactions themselves, as these are based on models approved by the classical jurists of Islam.

Q: Why is a short position on the Al Safi Trust platform Shariah Compliant?

The Al Safi Trust platform utilizes an alternative set of prime brokerage documentation by means of which all trades, whether long or short, may be conducted in accordance with Shariah rules, with no interest, no prohibited terms and conditions, and no prohibited sales (like the sale of what one does not rightly own or like the purchase or sale of prohibited businesses like pork or alcohol production, banks and insurance companies, and so on). In order to take a short position in a stock, a manager must request the prime broker to initiate an Arboon Sale. All managers on the Al Safi Trust platform are contractually obligated to execute Arboon Sales through one prime broker. (Otherwise, managers can initiate long only trades with other brokers, provided those trades are settled at the approved prime brokerage.) Shariah compliant contracts allow the prime broker to process trades initiated by the platform's hedge fund managers, while avoiding all the prohibited elements (interest, prohibited terms, prohibited transactions) that are present in prime brokerage contracts commonly used for conventional hedge funds.

Q: It is well known that Shariah scholars have many demands on their time. How does the Al Safi Trust answer questions without delay?

All of the situations mentioned in the answer above demand the attention and consideration of Shariah scholars. By defining a process to deal with these questions, and by providing access to Shariah scholars, the Al Safi Trust brings investors a platform that is as efficient as it is responsive to the needs of its Shariah compliant managers and investors. Moreover, the Al Safi Trust is unique in that the Shariah Supervisory Board includes an Executive Representative, a Shariah scholar who is dedicated to working full time for the Al Safi Trust. The Executive Representative works with fund managers, the prime broker, and with the trustees of the Al Safi Trust to ensure that every aspect of the Trust's and sub-trusts' operations comply with the guidelines laid down by the Shariah Supervisory Board.