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ISLAMIC CAPITAL MARKET & ISLAMIC BANKING: AN APPRAISAL OF UNRESOLVED ISSUES

A SHARIA ANALYSIS OF CONTRA TRADING IN LIGHT OF THE LEGAL AND REGULATORY ENVIRONMENT IN THE UNITED STATES

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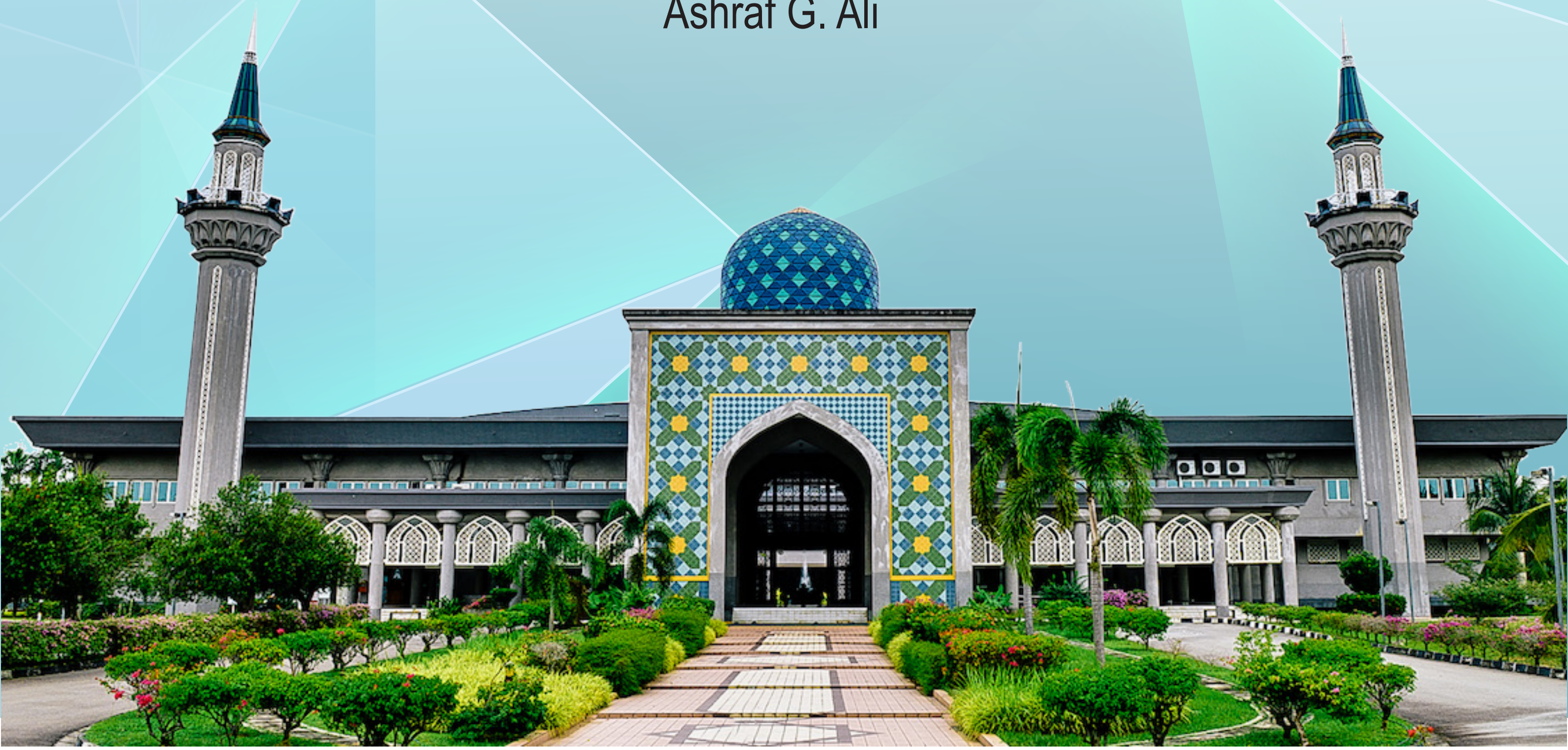

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A Sharia Analysis of Contra Trading in Light of the Legal and Regulatory Environment in the United States

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Abstract

In this paper, I seek to explore the issue of contra-trading to determine its permissibility in Shariah. My research will seek to answer the following critical questions:

What is contra trading and what is the need of researching it? Further, does contra-trading involve selling something that does not exist? At what point does ownership and liability transfer, and does contra-trading involve selling what one doesn't own? Does contra-trading involve selling something before taking possession of it? Or does it involve deferring both counter-values in the transaction? Further, what is the role of third parties to the transaction? What are the respective roles of margin-trading, short selling and speculation in contra trading? Lastly what is the basis for prudent regulation of contra-trading?

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The methodology that I will follow in this research is that I will focus on the modern system of electronic trading and the indirect system of holding securities. I will examine the relevant laws and regulations that govern this modern system in the US and explore the answers to the above questions in light of these laws and regulations. This paper does not seek to weigh the varying Sharia opinions on the relevant issues on the weight of the respective proofs in Sharia, but rather if there is a difference of opinion on any issue, I will comment on the underlying assumptions in light of the laws and regulations and raise issues that may need to be reconsidered by Sharia scholars.

I. What is contra-trading, and what is the need for researching it?

Contra-trading is defined as "the practice of buying and selling shares within the same settlement period so that no payment need be made. Contra-trading is typically found in day trading, where a speculator purchases shares during the day and closes out the position before the close of business. Since both transactions settle on the same day (e.g., T+3), the speculator has no gross cash outflow."[2] A contra trade involves a purchase or sale order for a counter transaction, which has not been settled yet. The gain (or loss) between the selling and buying orders is called contra gain (or contra loss). [3]

The reality of contra-trading is that the securities intermediary extends credit to the trader, enabling the trader to purchase securities without funding part or all of the purchase. The trader takes ownership of the securities and can sell them within the settlement period, resulting in both an amount due from the trader for the purchase and an amount due to the trader for the sale. As these amounts are owed to the securities intermediary, they are netted off and the trader either receives the difference (in case of a profit) or pays the difference (in case of a loss).

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[2] E. Banks, Dictionary of Finance, Investment and Banking (Pg 116)

[3] http://www.maybank2u.com.my/mbb_info/m2u/public/personalDetail04.do?channelId=INV-Investment&cntTypeId=0&cntKey=INV01.05.01&chCatId=/mbb/Personal/INV-Investment

In Singapore some estimates put the volume of trading activity that can be either directly or indirectly traced to contra-trading to 31% of the total market activity for 2013[4]. A number of high profile securities intermediary defaults cased the Singapore regulator to re-examine the practice of contra trading and to mandate a margin requirement, essentially ending the zero margin contra trading practice. This represented a trade off between increased trading activity and market stability, and the regulators took a stance that they believe struck a balance between the two.[5]

It is well known that markets are international and that instability in one market can affect others. It is for this reason that the Bank of International Settlements released their suggestions for securities settlement systems to facilitate stability across the international financial system. [6] Today, emerging markets are changing the existing settlement systems to make them more in line with the international standards both with the aim of moving towards best practices as well as to make their markets more hospitable for international investors. This is reflected in the recent announcement in Saudi Arabia to move towards a T+2 settlement system for securities from a T+0 system, as well adopting a number of additional securities regulations to make the Saudi market more in line with international standards.[7] Advanced markets are also adding new regulations to decrease systemic risks, such as the introduction of a margin requirement in Singapore to decrease the risks associated with contra trading[8] as well as a move towards the shortening of the settlement

[4]http://www.mas.gov.sg/~/media/MAS_Newsletter/SIFC05032014/Market%20greets%20proposed%20rule%20changes%20with%20thoughtful%20hmm%20The%20Business%20Times%2011%20February%202014

[5]http://www.mas.gov.sg/~/media/MAS/News%20and%20Publications/Consultation%20Papers/Response%20to%20Feedback%20received%20on%20MASSGX%20consultation%20on%20the%20Review%20of%20Securities%20Market%20Structure%20and%20Practices.pdf

[6] http://www.bis.org/cpmi/publ/d46.htm

[7] http://www.cma.org.sa/En/News/Pages/CMA_N_2036.aspx

[8]http://www.mas.gov.sg/~/media/MAS/News%20and%20Publications/Consultation%20Papers/Response%20to%20Feedback%20received%20on%20MASSGX%20consultation%20on%20the%20Review%20of%20Securities%20Market%20Structure%20and%20Practices.pdf

period from 3 days to 2 days in the US.[9] It is significant for both Sharia scholars as well as industry participants to be aware of the Sharia implications of securities trading in the T+n settlement window as well as to be aware of the considerations of securities regulations in their attempt to advise regulators and lawmakers in light of the principles of Sharia. This paper seeks to explain the concept of contra trading as well as the T+n settlement system for securities and explore the related Sharia aspects.

A. The nature of the securities ownership in light of modern regulations and systems:

In order to properly address the questions related to contra trading, it is essential to examine the nature of securities ownership in light of modern regulations and systems.

In a typical securities purchase transaction, on the trade date (T) the customer gives a buy order to the securities intermediary who then executes the order in the market on behalf of his customer. The customer becomes liable to pay the price of the securities to the securities intermediary who is liable to make payment to the seller, and the seller is liable to deliver the securities.

In the past, the securities intermediary would enter into this transaction on the trading floor of the exchange on behalf of the customer and a binding contract will take place on the trade date. Based on this contract, the share certificates would be manually transferred over to the new owner through the registrar of the corporation. This process could take 5 days or more. Today, the vast majority of securities are traded electronically through book entries through a system called the "indirect holding system, "the electronic transfer taking place within three days based on the type of security. I will discuss this further in this paper.

In order to determine the market practice that governs these transactions, it would be helpful to examine the current regulations that govern securities transactions. For the purposes of this paper, I will examine the laws and regulations of the US since many other jurisdictions have adopted similar laws and regulations governing securities.

[9] United States of America, Securities and Exchange Commission. (n.d.). Amendment to Securities Transaction Settlement Cycle (Release No. 34-78962 ed., Vol. 17 CFR 240, File No. S7-22-16.

One of the most important laws that govern securities transactions in the U.S. is the Uniform Commercial Code – Article 8[10]. Drafted in the 1940s, this law mainly addresses securities that are traded in certified form. At the time of its drafting, certified securities were evidenced by paper certificates which were endorsed and passed over to the new purchaser upon completion of a sale transaction and forwarded on to the company registrar to register the new owner in the company records and issue a new share certificate, if needed. The law was revised in 1978 to address uncertified securities, which functioned in the same way as certified securities but without the issuance of a paper certificate where changes of ownership were recorded in the register of the company. But rather than function on the basis of uncertified securities, the market evolved to create the "indirect holding system." In this system, paper certificates are issued by companies and deposited with a custodian, such as the DTC (the Depository Trust Company).

B. The Indirect Holding System

The DTC is a trust company registered in New York. Paper security certificates are deposited with them for safekeeping. DTC holds legal title of these paper securities on its books (representing over 90% of the securities traded in the US) and grants its Participants (generally banks, securities intermediary-deals and other custodians) beneficial ownership of these securities through a system called "security entitlements." Participants maintain "securities accounts" with DTC and ownership of securities is represented by debits and credits to their respective accounts. Customers, in turn, also hold securities accounts with their securities intermediaries (who are participants on the DTC) and their ownership of securities is also represented by credits and debits to their respective securities accounts.[11]

> "The depository holds securities in "fungible bulk" – no unit of the security is different than any other unit and no Participant has a right to a particular unit of the security, but, rather, a proportional interest in the aggregate amount of the securities held by DTC. This type of holding requires that, to

[10] USA, The Depository Trust Company. (2015). Disclosure under the Principles for Financial Market Infrastructures. pg 15

[11] Nutter, S. E., & Pratt, B. T. (1998, April). Practitioners' Guide to Revised Articles 5 and 8 of the Uniform Commercial Code, Missouri Law Review, 63(2), spring 1998, 325-369. pg, 6

> be eligible at DTC, securities must be able to be held in this manner, so that any holder of the security has the same rights and interests as any other and interests in the security must be freely transferable among Participants."[12]

Participants do not have a claim on any "specific, identifiable" security. Rather, they have a senior claim on the security holdings of the DTC that relate to their specific security entitlement. Similarly, customers of securities intermediaries have a claim on the general pool of the security for which they hold a security entitlement.

According to the Article 8 of the UCC, there are certain ownership rights that a accompany a "security entitlement," as well as duties on the securities intermediary in the most important of which, for the purposes of this paper, are subsections 503-507.

The nature of an entitlement holder's property interest under Section 8-503 is described under the revisions as "a pro rata property interest in all interests in that financial asset held by the securities intermediary, without regard to the time the entitlement holder acquired the security entitlement or the time the securities intermediary acquired the interest in that financial asset." Because the pro rata common interest relates to a particular type of financial asset and not to identifiable units of that asset, particular financial assets are not traceable to specific entitlement holders.[13]

This shows that the entitlement holder is an owner of the security but that it is held in a state of general common ownership (مشاع) in relation to the securities intermediary's bulk holding of the particular security.

Subsections 504 through 507 deal with duties of securities intermediaries. A securities intermediary is required to maintain only a sufficient inventory of a particular security to cover all claims, and the securities may be held either directly or indirectly through other

[12] USA, The Depository Trust Company. (2015). Disclosure under the Principles for Financial Market Infrastructures, pg 35

securities intermediaries.[14]Furthermore, intermediaries have a duty to take appropriate actions which ensure that entitlement holders receive the economic benefits of ownership of a financial asset. [15]

This further supports the idea that the security entitlement represents real ownership in the security as it entitles the holder to the economic benefits of ownership.

Subsection 506 clearly dictates that the intermediary is acting for the entitlement holder in a representative capacity to exercise the various corporate rights vested in the holder of a security, such as voting.[16]Lastly, subsection 507 charges the intermediary to comply with the entitlement holder's order to sell his securities (or otherwise dispose of them) at any time, which is a major requisite of ownership[17]

C. Netting and Trade Settlement

A second key aspect of the indirect holding system is the netting of transactional book entries at each level of the system. The purpose of netting is to function as a risk mitigation to mitigate principle risk. Principle risk is defined as "the risk that counterparty will lose the full value involved in a transaction - for example, the risk that a seller of a financial asset will irrevocably deliver the asset, but not receive payment."[18] All settlement systems are designed to minimize this risk as it puts the entire transaction in jeopardy in case of failure. The sister organization to the DTC in the indirect holding system is the NSCC (National Securities Clearing Corporation) which is a CCP (Central Counterparty) which is responsible for clearing securities transactions in the US with the main goal of

[14] Nutter, S. E., & Pratt, B. T. (1998, April). Practitioners' Guide to Revised Articles 5 and 8 of the Uniform Commercial Code, Missouri Law Review, 63(2), spring 1998, 325-369. pg, 22-23
[15] ibid
[16] ibid
[17] U.C.C. § 8-507(a).
[18] http://www.bis.org/cpmi/publ/d00b.htm?&selection=54&scope=CPMI&c=a&base=term

minimizing principal risk. The following is an overview of the trade settlement process for a retail securities transaction. [19]

D. Retail Investor Trade Settlement Process

Trade comparison, which consists of reporting, comparing, matching, and validating the buy and sell sides of a trade is the first step in the clearance and settlement of retail investor transactions. At the trading venue, such as an exchange or non-exchange trading venue (e.g., alternative trading system or electronic communication network), a buy order is electronically matched against a sell order. If the details of the trade submitted by the counterparties agree (e.g., the security price and quantity), the trade is considered "locked in" and then sent from the trading venue to NSCC. This represents a binding contract between the buyer and seller.

The following is a high level description and illustration of what generally occurs each day following execution of a retail investor trade and submission of the trade to NSCC:

Trade Date - NSCC validates trade data received from the trading venue and confirms receipt of the transaction details by electronically sending communication to NSCC members that are counterparties to the trade.

This communication legally commits the members to complete the trade.

T+1 - At midnight on T+1, NSCC novates the trade, becoming the buyer to the selling securities intermediary-dealer, and the seller to the buying securities intermediary-dealer and attaches a trade guaranty. **(Step 1)**

[19] Nutter, S. E., & Pratt, B. T. (1998, April). Practitioners' Guide to Revised Articles 5 and 8 of the Uniform Commercial Code, Missouri Law Review, 63(2), spring 1998, 325-369, pg, 6

> This step effectively eliminates the risk of default as the NSCC guarantees to deliver the securities to the buyer and the cash to the seller.

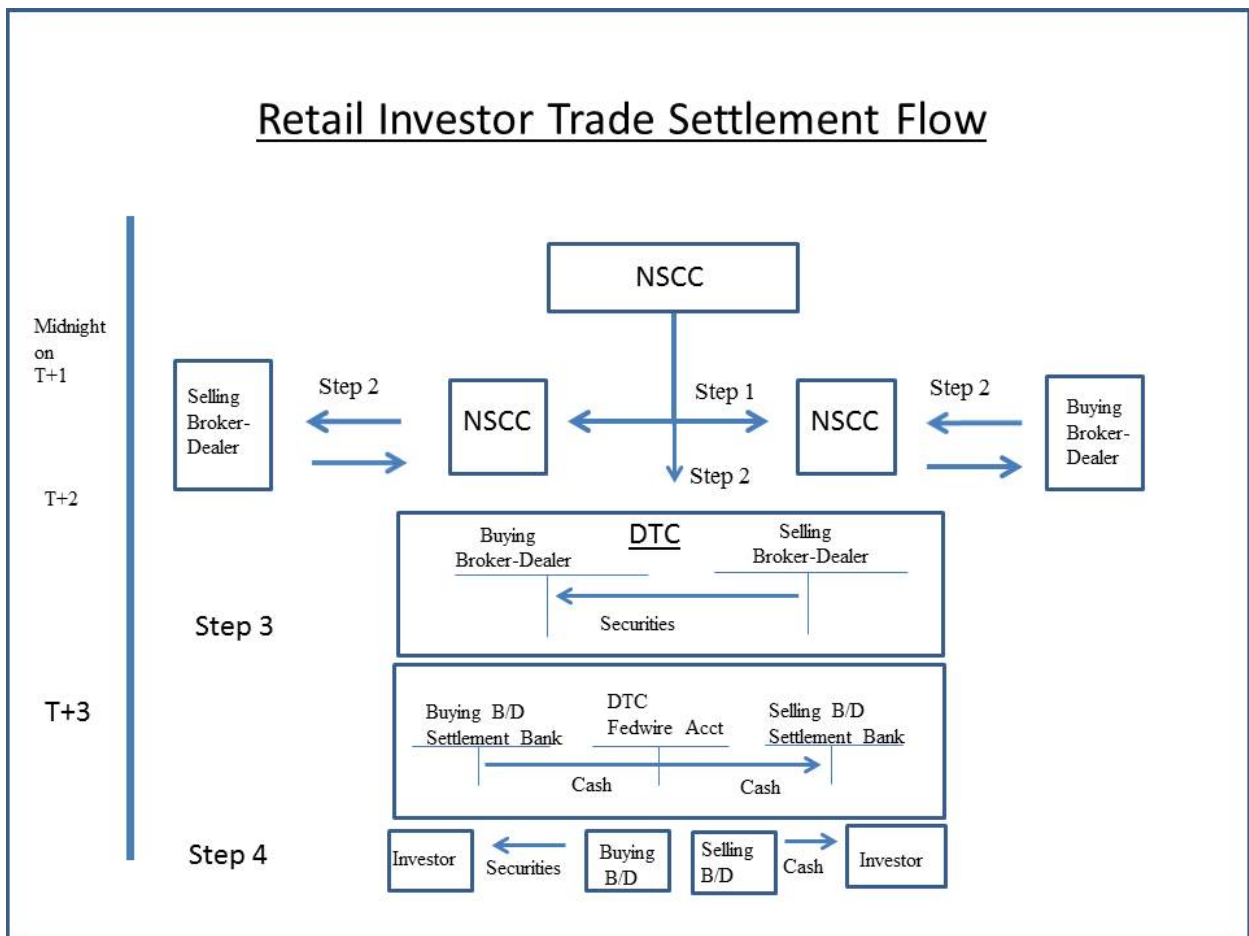
By virtue of the net debit cap and collateral monitor controls, the deliverer may rely on payment through the net settlement process, even if the receiver defaults, because DTC will have liquidity resources to cover the amount of the failed net settlement payment. A Participant that fails to settle will not receive securities delivered or pledged to it, as it will not have paid for them. Under Rule 9(B), those securities are collateral that DTC may liquidate or pledge to secure a borrowing, to fund settlement among the nondefaulting Participants. Through the net settlement process, the deliverer will, nevertheless, have been paid on the value date of the delivery[20]

T+2 - NSCC issues a trade summary report to its members with a summary of all securities transactions and cash to be settled the following day, specifically indicating the net positions of securities and the net cash amount owed by the member or to be received by the member. NSCC also sends an electronic instruction to DTC detailing the net positions and cash that need to be settled for each member/participant. **(Step 2)**

> The netting process functions to minimize the transfers that happen between participants. It is possible that there is no need to transfer securities between participants or cash despite the existence of transactions between them, for example, if a client of participant A bought a security from a client of participant B at a particular price following which an opposite transaction occurred. In such a case, there will be no net change in the respective positions of the participants, although the trades will be recorded in the records of the NSCC.

[20] USA, The Depository Trust Company. (2015). Disclosure under the Principles for Financial Market Infrastructures., pg 57-63

T+3 - DTC transfers the securities electronically between the buying and selling securities intermediary-dealer accounts at DTC thus transferring ownership of the net securities. The participant securities intermediary-dealers instruct their settlement banks to send money to, or receive money from, DTC to complete the transaction. **(Step 3)** Investors receive title to securities and cash from their respective securities intermediary-dealers. **(Step 4)**



II. Does contra trading involve selling something that does not exist?

The rules of and processes of the DTC explicitly do not allow for transacting on securities that do not exist. The DTC states in its public disclosure documents that:

A. The Existence of Securities

> Physical deposits are necessary for the immobilization of securities at DTC. DTC accepts for deposit physical certificates or instruments representing securities and other financial assets in order to effect book-entry transfers of interests in the underlying securities or other financial assets. As DTC neither "creates" nor "deletes" securities, but can only effect book entry transfers of securities in its custody, all securities traded on the DTC, according to the rules, must exist. [21]
>
> DTC's accounting system does not allow for short positions in securities through Participant transfers; securities may generally only be transferred from one Participant to another if the first Participant has position available to transfer. [22]
>
> Under the UCC, securities intermediaries, such as DTC, are required to maintain a sufficient quantity of a financial asset or issue of a security to satisfy all of their Participant's claims, that is, the aggregate amount of all of the issue credited to any of DTC's Participants. DTC has procedures and controls in place to support this obligation.[23]

Therefore, there is no Sharia issue from the angle of whether the securities exist or not at the time of the transaction.

When the customer purchases certain shares on the trade date, he is actually purchasing a security entitlement which will be credited into his securities account. When the securities intermediary credits the securities account of the customer, the purchase is complete and the security entitlement has transferred to him. The security entitlement represents all of

[21] USA, The Depository Trust Company. (2015). Disclosure under the Principles for Financial Market Infrastructures.pg 63
[22] Ibid, pg 68
[23] Ibid, pg 68

the rights associated with the physical certified securities held on deposit with the DTC. [24] From this moment, the purchaser is granted all of the rights of ownership of the stock including voting rights and rights to dividend distributions (as per the dates set by the company for dividend distribution) as well as the right to pledge the securities or to sell them.

Upon purchasing the securities, the customer becomes liable to pay the purchase price. It is possible that the securities intermediary grants credit to the customer until the settlement date or beyond, according to the agreement between the customer and the securities intermediary, although the securities intermediary is liable to the counterparty (as principle) to make payment for the securities by the settlement date.

Ownership (*Milk*) is defined in Sharia as: " A legal (Shari) connection between a person and a thing which gives the person freedom to act with regards to the thing and prevents others from acting in regards to it. It is an initial ability that the Sharia establishes to act in regards to something. It is alternatively defined as: "A legal (Sharia) ruling assumed in a specific thing or usufruct that grants the one to whom it is attributed the right to use and compensation. Full Ownership is defined as: "That which grants its possessor the right to unrestricted action in regards to the thing that he owns. As a result, it is allowed for him to act in regards to through sale, gift, or endowment. It also allows acting in regards to a usufruct by possessing it himself or transferring ownership to another person who can then rent it. It is also permitted for such a person to lend the specific property and to make its usufruct the subject of a will. [25]

There is a legal debate as to when ownership transfer: when the contract is completed or when possession is transferred. The general opinion amongst legal professionals is that ownership is transferred once the contract is completed.[26]

It is clear that the buyer of the securities has a legally binding contract to receive the securities. It is also clear that as per the indirect holding system and the securities clearing

[24] USA, The Depository Trust Company. (2015). Disclosure under the Principles for Financial Market Infrastructures

[25] Hammad, N, Dictionary of Economic terms in Fiqh Literature, Pg 441

[26] Benson, P. (2007). Contract as Transfer of Ownership. William and Mary Law Review, 48(5), 1673-1731.

process, the securities exist and the chance that the securities will not be delivered is close to zero. Also, by the securities intermediary executing the trade, the buyer now has a claim against the securities intermediary in case of non-delivery and the clearing agency (NSCC) once it is novated. The buyer is also liable for the transactions as he will be exposed to the increase or decrease in the value of the shares during the settlement period based on the contracted price on the trade date. Nonetheless, he does not have a right to dividends or voting until the settlement is complete and the shares are recorded in his securities account. He may also not have the right to take delivery of the physical certificates until settlement.

The issue of contention is whether this contractual right established on the trade date that the buyer has to the security can be considered as ownership or not. I would tend to lean towards the opinion that ownership transfers with the contract as this is the general position in Islamic law as well as the majority position in common law which represents the custom (*urf)* in the jurisdictions in which these transactions occur.

AAOIFI Standard No. (21) Financial Paper (Stocks and Bonds) states:

> 3/2 It is permissible to buy and sell shares of corporations, on a spot or deferred basis in which delay is permissible, if the activity of the corporation is permissible irrespective of its being an investment (that is, the share is acquired with the aim of profiting from it) or dealing in it (that is, with the intention of benefiting from the difference in prices)
>
> 3/7 It is permissible to the buyer of a share to undertake transactions in it by way of sale to another and the like after the completion of the sale formalities and the transfer of liability to him even though the final settlement in his favour has not been made.

Based on these two standards, if it is accepted that the transaction on the trade date transfers both ownership and liability for the securities, then.it would be permissible for the contra trader to sell the shares before the settlement date and benefit from the resulting gain (or bear the resulting loss).

On the other hand, if the alternate opinion is adopted which states that ownership is only transferred on the settlement date and that on the trade date the buyer only has a promise to deliver the shares, but not the shares themselves, then this can be based on the issue of whether it is possible to sell something that the seller does not have. Although this is a contentious issue and prohibited by a number of scholars due to the presence of Gharar, the SAC of BNM allowed it in their opinion on short selling which is mentioned later in the paper. Furthermore, one may make the argument that the prohibition is based on the uncertainty of being able to deliver the object of sale while in the modern context of securities trading this uncertainty is almost eliminated.

IV. Does contra trading involve selling something before taking possession of it, and does contra trading involve deferring both counter-values in the transaction?

The answer to both of these questions is directly related to the question of ownership since there is no physical possession possible before the settlement. Based on the theory that ownership is transferred on the trade date, then the customer is considered to be in possession of the security from the moment it is credited in his account.[27] Similarly, if ownership is transferred at the trade date then the transaction does not involve deferring both counter-values.

On the other hand, if the alternate opinion on ownership is adopted, then the question would be whether the contract represents possession of the securities. Since the securities cannot be physically possessed in the indirect holding system, possession happens when securities are credited to a securities account. This can happen anytime from the trade date until the settlement date. Therefore, a sale would only be permitted once the securities are credited to the securities account of the buyer. If this opinion is adopted then the issue of deferring both counter values can be mitigated by considering the spot transfer of cash over the settlement period as a cash transaction and not a deferred transaction by analogy to the modern implementation of currency exchange transaction where scholars have allowed the practice of T+2.

[27] U.C.C. § 5

V. What is the role of third parties to the transaction such as securities intermediaries and other settlement entities and how does this affect the Islamic rulings that pertain to trading during the settlement period

When a customer buys or sells an exchange traded security, this is performed through a securities intermediary who serves as the agent of the customer. The general Sharia ruling of an agent is that he is "*ameen*" and therefore is not liable except in cases of transgression or negligence. Nevertheless, when the securities intermediary who is a participant of the DTC transacts, he could either be transacting as principle or as agent. The exchange always treats the securities intermediary as a principle and therefore he is liable for any failure to deliver (of the securities or the price)[28]. For this reason the exchanges require certain collateral to be posted by exchange members to cover such risks. There is also a mark to market process to ensure that the exchange member should always be able to fulfill the contract to the counterparty to the transaction.[29] Therefore, one can argue that there is a guarantee given from the securities intermediary to the exchange on behalf of its customer. The central counter party (NSCC), in turn, will guarantee to both counterparties to deliver the counter values of the transaction. This guarantee from the NSCC happens at T+1 and typically takes the form of "novation" where the NSCC will take over the liability to deliver the price to the seller and to deliver the securities to the buyer. As a result, the original contract between the buyer and seller will be automatically cancelled and replaced with a contract between the buyer and the NSCC and a contract between the seller and the NSCC[30]. This process protects all of the parties to the transaction against non-delivery and non-payment, reducing settlement failures to almost zero.[31] The guarantee of the exchange typically happens at T+1 although now there are some efforts to move this to the end of the day on the trade date.[32]

As the securities intermediary who is a participant of NSCC is responsible for ensuring payment is made, either as principle or as agent, he is liable for negligence in the event of

[28] United States of America, Securities and Exchange Commission. (n.d.). Amendment to Securities Transaction Settlement Cycle (Release No. 34-78962 ed., Vol. 17 CFR 240, File No. S7-22-16.
[29] ibid
[30] ibid
[31] ibid
[32] ibid

a default. Therefore, there is no Sharia objection for the NSCC holding him liable as principle for all transactions performed.

VI. Margin trading

Another issue that may come up in a discussion of contra-trading is margin trading. Margin trading is defined as "A form of leveraged trading arising when an investor secures a margin loan through a margin account"[33] A Margin account is similarly defined as "An account at a bank, securities intermediary, or financial institution in which an investor can borrow against a specified percentage of securities or commodities held within the account."[34] Depending on the jurisdiction, an investor may or may not need a margin account to perform contra-trading activities. For example, in the USA, investors with cash accounts are not permitted to sell a security purchased before paying the price for it. A violation of this rule is called "free-riding" and it may lead to freezing the customer account for 90 days.[35] Therefore, in the US, contra-trading could be performed in a margin account where the securities intermediary grants credit to the investor to trade. The securities intermediary will take collateral from the investor, typically the balance of his securities account, and the customer is required to maintain a certain portfolio value in his securities account. If the value drops below a certain level, the securities intermediary will require the customer to add additional collateral to the account, ie. a margin call. If this is not fulfilled, the securities intermediary has the right to sell securities from the customer's securities account to cover the loan extended to the customer.

From a Sharia perspective it may be useful to examine margin trading in stages: (1) At the time of granting the facility and before the utilization, (2) at the time of utilization of the facility until the time that the securities intermediary pays the price either cash or through netting, and (3) after the securities intermediary pays the price of the shares.

[33] E. Banks, Dictionary of Finance, Investment and Banking, Pg. 320
[34] ibid
[35] https://www.gpo.gov/fdsys/pkg/CFR-1999-title12-vol3/xml/CFR-1999-title12-vol3-sec220-8.xml

At the time of granting the facility, typically the securities intermediary does not take any fees, although it is possible that a commitment fee may be taken. Contemporary scholars have taken differing positions of commitment fees, some allowing them based on a general position allowing taking fees in exchange for commitments, others allowing them in light of the credit study that the financial institution performs on the customer, and other not allowing them at all.

The securities intermediary also takes the securities account as collateral securing the margin facility. This is permissible according to the AAOIFI Standard which states that: "It is permissible to mortgage shares that are lawful according to the Shariah."[36]

At the time of utilization, the customer with a margin account with a value of collateral of $10,000 may be able to purchase shares for a value of $20,000, with the additional $10,000 representing a credit facility from the securities intermediary. This is not a cash facility where the customer has the right to withdraw the money or to use it for any purpose other than securities trading, therefore one may concern whether it really takes the ruling of a Qard which is defined as "paying property (maal) to someone who will benefit from it in exchange for the person returning its equivalent".[37] As the securities intermediary has not extended a loan from an Islamic sense of "Qard" since no property was extended to the customer, rather, the securities intermediary will be liable to pay for the shares at the end of the day as settlement of funds in the DTC happens on a net basis at the end of the day. Therefore, it may be proper to categorize the relationship during this period as that of "*Daman*" or guarantee. The securities intermediary is guaranteeing the performance of his customer to the counterparty of his customer. Any fee at this stage (if any) may be considered is in exchange for this guarantee and not in exchange for a loan.

Sharia scholars have differed regarding the legitimacy of taking a fee for guarantee, some permitting it and others prohibiting it. AAOIFI takes the position that it is not permissible for an Islamic Financial Institution to take a fee for a financial guarantee except within the bounds of the actual cost of the guarantee. Other scholars allow taking a fee for guarantee

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[36] A. (2015). AAOIFI Shariah Standards for Islamic Financial Institutions. Manama, Kingdom of Bahrain: Dar Almaiman., Pg 567
[37] Hammad, Nazih, Definitions of Economic terms in Fiqh literature, pg 361

and their main grounds for this is that there is no clear text from the Quran or Sunnah prohibiting this. The SAC of BNM ruled in its 158th meeting: "that *kafalah* fee may be imposed on any party who benefits from the *kafalah* service, either on the guaranteed party, beneficiary or both or any other party as per agreed by the contracting parties."[38]

In contra-trading, the transaction begins at this stage and ends at this stage (if intra-day), it can be considered that the securities intermediary essentially grants the investor a credit facility and allows him to buy and sell with the securities intermediary guaranteeing the investor in the event of non-payment for the day. If the investor closes out the position before the end of the day, the transactions are netted off and the difference is settled between the investor and the securities intermediary according to their agreement. The net amount becomes a debt either on the customer or the securities intermediary and the rules of debt in Sharia apply to this such that no interest should be charged on the amount. The ruling on this may follows from the ruling on daman. Although it is permissible for the securities intermediary to guarantee the investor, the scholars have differed regarding the legitimacy of taking fees against this guarantee as previously mentioned.

The third stage starts when the securities intermediary pays for the shares at the end of the day up to the settlement date. At this point, a loan is generated in favor of the customer. If this loan is a conventional interest bearing loan, then this fall under the definition of Qard as the securities intermediary paid the price on behalf of the customer and the customer is now liable to repay it, generating a cash debt against the customer. If the debt is non-interest bearing, then there may be no Sharia objection on such an arrangement or if a Sharia compliant mechanism is employed to grant credit to the customer. On the other hand, if interest is charged, then this may be considered as a violation of the rules of riba.

AAOIFI does not make this distinction between the various stages of the transaction in its standard which states: "It is not permissible to purchase shares by raising interest-bearing loans through a securities intermediary or another (margin sales), just as it is not permitted

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[38] Malaysia, Bank Negara Malaysia. (2010). Shariah Resolutions in Islamic Finance (Second ed.). Bank Negara Malaysia.

to mortgage the shares for such a loan.[39] I believe that it may be prudent to consider the stages of the transaction to determine when exactly the daman ends and the loan begins to determine the permissibility of credit facilities granted to traders, particularly contra-trading where the securities intermediary does not actually pay any money on behalf of the customer.

Another issue related to margin trading is that sometimes a term is added to the agreement that allows the securities intermediary to lend out the shares pledged in the margin account to other customers. The customer will not receive any benefits from this practice, as all interest from securities lending of the shares of the customer will accrue to the securities intermediary. Although the customer will continue to benefit from any dividends or distributions on his securities, he may lose the voting benefits for the time that the securities are lent out.[40] The Sharia implications of this relate to the rulings of securities borrowing and lending.

VII. Short Selling and Securities Borrowing and Lending

So far, I have discussed only transactions where the customer buys first and then sells. On the other hand, it is also possible for the customer to take a short position. A short sale is the sale of a stock that an investor does not own or a sale which is consummated by the delivery of a stock borrowed by, or for the account of, the investor. Short sales are normally settled by the delivery of a security borrowed by or on behalf of the investor. The investor later closes out the position by returning the borrowed security to the stock lender, typically by purchasing securities on the open market.[41] Short selling can be either covered short selling with borrowed securities, obtained through securities borrowing and lending facilities on the short selling trade date, or naked short selling without borrowed securities

[39] A. (2015). AAOIFI Shariah Standards for Islamic Financial Institutions. Manama, Kingdom of Bahrain: Dar Almaiman., Pg 565
[40] Scotttrade account opening agreement (www.scotttrade.com)
[41] https://www.sec.gov/answers/shortsale.htm

where eligible market participants close-out the naked short-selling position by conducting an offsetting deal at a later date.[42]

Sharia scholars have heavily debated the validity of short selling as well as the associated practice of securities borrowing and lending. AAOIFI takes a number of positions that, when combined, make the practice of short selling untenable. These positions are:

> 3/6 It is not permissible to sell shares that the seller does not own (short sale), and the promise of a securities intermediary to lend these shares at the time of delivery is of no consequence.

This is on the stated basis that the seller does not own the shares and that this leads to selling something that is not within the liability of the seller nor in his ownership, and this is prohibited in the Shariah.[43]

> 3/9 It is not permissible to lend shares of corporations .

This is on the stated basis that the share at the time of repayment, in consideration of what it represents, does not represent the same thing that it did at the time of lending due to the constant change in the assets of the corporation. [44]

> 3/11 The contract of Salam is not permissible in shares.

This is on the stated basis that the object of a salam sale should be a debt and not an ascertained thing and shares of a company is an ascertained thing as the name of the corporation is specified, as well as the fact that it is not guaranteed that the shares will be available at the time of delivery. [45]

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[42] Malaysia, Bank Negara Malaysia. (2014). Regulated Short-Selling of Securities in the Wholesale Money Market (p. 5).
[43] A. (2015). AAOIFI Shariah Standards for Islamic Financial Institutions. Manama, Kingdom of Bahrain: Dar Almaiman. Pg 572-579
[44] Ibid, Pg 572-579
[45] Ibid, Pg 572-579

> 3/15 It is not permissible to rent shares, whether this is for pledging them or for the purpose of selling the rented shares, and returning shares similar to them.[46]

No specific basis is given for this ruling.

> 3/16 It is permitted to lend shares by way of I'arah for the purpose of pledging them or for the purpose of granting their profit to the borrower as is done in the stock market. The borrower does not have the right to sell the shares except for the execution of the terms of the mortgage.

On the other hand, the issue of regulated short selling and securities borrowing and lending was researched by the Shariah Advisory Committee of Bank Negara Malaysia and it was approved based on the following arguments:

A. Arguments permitting regulated short selling:

> "In general, short selling involves the selling of shares not owned by the seller. As a result, such transactions fall under the category of *bai` ma`dum*. Islam prohibits such transactions involving *bai` ma`dum* since the delivery of the subject matter cannot be effected and this brings about the prohibited element of *gharar*. However, the issue of *gharar* can be overcome in RSS – the inclusion of SBL principles in RSS eliminates the element of *gharar*. In other words, the introduction of SBL can increase the probability that the shares sold will be delivered. When the probability of delivery is high, then the element of *gharar* will no longer be significant.
>
> Consequently, when an obstacle that hinders the recognition of a certain activity as Shariah compliant is overcome, then that activity can be classified as Shariah compliant. This fulfils a *fiqh* methodology: which means: "When an issue that impedes (the permissibility) is removed, then the activity which was initially forbidden becomes permissible".

[46] Ibid, Pg 566

B. Arguments permitting securities borrowing and lending:

1. *Istihsan* Principle

The SAC in several of its meetings attempted to identify a Shariah principle that can be used as a basis for the implementation of SBL. As a result of the studies and discussions, the SAC decided that the *istihsan* principle should be instilled in the *ijarah* methodology to form the basis for SBL after evaluating that other methods such as *i`arah* (asset borrowing), *hawalah* (debt assignment contract) and *bai` wafa'* (selling and buying back) were found to be unsuitable for the concept and implementation of SBL.

Istihsan is an exemption of a ruling that is *juz'ie* (branch) in nature compared with a general principle decision.181 Al-Syatibi defined *istihsan* based on the Maliki *Mazhab* as accepting *maslahah* (public interests) that has *juz'ie* as compared with accepting *dalil kulliy* (general).182 In summary, it means the use of a specific method as an exemption from the general one.

Istihsan that was popularized by the Hanafi jurists and accepted by the Maliki jurists had become a serious topic of discussion among Islamic jurists from other schools of thought especially the Syafi`i jurists. The Syafi` jurists rejected *istihsan* if it had no basis. Despite that, *istihsan* is still widely referred to by those who have accepted it. In truth, many contemporary problems can be overcome by accepting *istihsan*. This need is strongly felt, especially in handling issues that have arisen in a *muamalat* system which is always developing and changing from time to time.

2. *Istihsan* with *Maslahah*

The decision taken by the SAC that the selling of borrowed/leased shares to a third party does not nullify the *ijarah `aqd*, because the decision is based on *istihsan* with *maslahah*. This gives a clear advantage to the original shareholder and can provide liquidity to the share market.

3. *Istihsan* with *`Urf Khas*

`Urf iqtisadi khas* (a customary practice accepted in economic activities) which occurs in SBL activities is *`urf sahih (customary practices accepted by *Syara'*). Therefore, the argument employing *istihsan* with *`urf* also strengthens the evidence.

4. Accepting the *Ijarah* Concept with Consent to Sell

Istihsan allows the *ijarah* concept, with the consent of the owner to sell the leased shares, to be acceptable as a basis for SBL. According to the original *ijarah* concept, the relationship between the owner and lessee will be severed when a transaction involving the sale and purchase of an asset occurs. This is because the *ijarah* contract as defined by the *ulama`* is the contract for using the asset and paying for its use.

With the sale of the assets, the *ijarah* contract will automatically be terminated. Nevertheless, as the SBL 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.[47]
>
> Although the positions of AAOIFI and SAC of BNM are opposed to one another, the Malaysian position is more in line with the general direction of the market and of regulators both in Muslim and Non-Muslim majority countries. Therefore, it would be proper for scholars to examine the arguments of the SAC and consider this novel ijtihad in their decision making.

VIII. Speculation

Another issue that comes up in the Sharia analysis of contra-trading is the issue of speculation. Speculation is typically defined as purchasing an asset with a short term aim of benefiting from a change in price. It is clear that the contra-trader is a speculator as he is not a long term investor interested in benefiting from the dividends of a company or from long term capital appreciation. Therefore, it is important to examine the Sharia rulings pertaining to speculation.

AAOIFI clearly permits speculative trades in its Shariah Standard which states:

> 3/2 It is permissible to buy and sell shares of corporations, on a spot or deferred basis in which delay is permissible, if the activity of the corporation is permissible irrespective of its being an investment (that is, the share is acquired with the aim of profiting from it) or dealing in it (that is, with the intention of benefiting from the difference in price).

This is based on the general texts of the Sharia that permit trade such as “And Allah has made trade permissible” as well as the general legal maxim that states: “The default ruling in worldly matters is permissibility.” Although some scholars have argued that speculation bears similarity to gambling, particularly when it is short term speculation, such a position

[47] Malaysia, Securities Commission. (2006). Resolutions of the Securities Commission Shariah Advisory Council (2nd ed.). Kuala Lumpur: Securities Commission., pg 72-74

has generally not been adopted by the standard setting bodies in the Islamic finance industry, such as AAOIFI, nor has it been adopted by central Sharia boards, such as the SAC of Bank Negara Malaysia and the Securities Commission.

IX. Prudent Regulation

One of the holistic aims of the Sharia is "the preservation of wealth." And stemming from this is the duty of the government to take measures to maximize the welfare of its citizen and to maintain and protect their wealth. Although based on the above, it may not be clear from a strictly legal/Sharia perspective that contra-trading is not permissible, it is nonetheless the duty of the regulator to put in place prudent regulations to ensure that all of the parties involved are aware of the risks that they are taking and capable of handling them. The recent move by the Singapore Monetary Authority to impose margin requirements on contra-trading is in line with this aim of Sharia as it decreases the systemic risk in the economy while allowing the free market mechanism to continue to work without significant government restraints. This is a proper balance between regulatory protections and free market policies and it is in line with the Sharia.

X. Conclusion

In this paper I have presented an overview of the modern system of holding and trading securities which is based on the indirect holding system. This system depends on a number of players including custody entities (such as the DTC), clearing entities (such as the NSCC), participants (such as securities intermediaries), exchanges, settling banks, customers, and others. The goal of the system is to facilitate economic exchange while minimizing principle risk. The settlement delay is necessary to manage this risk as the costs of a T+0 settlement system for international equity markets may be extremely high. [48] This is a goal that is noble and in line with the higher aims of sharia (*Maqasid al Sharia).* In examining the specific issue of contra trading, I focused on whether the securities exist and when both ownership and liability transfer to the buyer in order to determine the legitimacy of selling during the settlement window. The indirect holding system does not allow for

[48] United States of America, Securities and Exchange Commission. (n.d.). Amendment to Securities Transaction Settlement Cycle (Release No. 34-78962 ed., Vol. 17 CFR 240, File No. S7-22-16.

the indirect holding of non-existent securities since every security traded must generally exist in physical form or otherwise in the vaults and records of the DTC. Although the issue of ownership is contentious, with the buyer gaining some traditional rights of ownership on the trade date and others on the settlement date, I lean towards the description of the buyer as an owner as of the trade date from the moment the trade is executed and a binding contract is established between the buyer and seller as he is exposed to the market risk of the security from the trade date. Nonetheless, I acknowledge that this issue is debatable and may require further study to determine which opinion is most in line with both the aims of sharia as well as the proper custom in the market.

I also examined associated issues with contra trading which included margin trading, short selling, securities borrowing and lending, and speculation since all of these may be linked to contra-trading. I concluded with a discussion of the need for prudent regulation in the securities markets in line with the higher aim of Sharia of wealth preservation. Notwithstanding the legal and Sharia positions on contra trading, it must be understood that all of the Sharia rules revolve around the ultimate aim of maximizing utility and minimizing harm. Scholars, regulators, lawmakers, and practitioners should work together to put in place policies and systems that seek to achieve this noble aim.

I hope that this humble effort may be seen as an attempt to assist in achieving this goal.

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