Short selling

Introduction

We are all well aware of how people normally gain profit in the stock market right? They buy shares for a low price and sell them when the price rises. Simple, so they just keep hoping that the share price will increase. However, in short selling, the person actually keeps hoping that the price drops. So how does it work? The following will be discussed:-

* Definition of short selling

* Types of short selling

* Who short sells

* Islamic point of view

* Attempts to Islamizing short selling

* Short selling and the financial crisis.

Definition

The definition of short selling according to Wikipedia is, the practice of selling assets, usually securities, that have been borrowed from a third party (usually a broker) with the intention of buying identical assets back at a later date to return to the lender. The short seller hopes to profit from a decline in the price of the assets between the sale and the repurchase, as he will pay less to buy the assets than he received on selling them.[1]

From the diagram above, we can see that the short seller borrows shares and immediately sells them. He then waits, hoping for the stock price to decrease, when he can profit by purchasing the shares to return to the lender. On the contrary the borrower will incur a loss if the prices go up.

Short Selling Process

We now know the exact meaning of short selling, but what about its process? How does it really function? How do people borrow shares?

This will all be explained using an example below:-

After hours of research and analysis, Fahad decides that company X is not going to make any progress and the share prices are only going to fall down. The stock price is currently 35 BD but Fahad is predicting it will be much lower in the coming few months. The transaction will unfold as follows:

Step 1: Set up a margin account.

Step 2: Place your order by calling up the broker or entering the trade online. Most online brokerages will have a check box that says “ short sale” and “ buy to cover.” In this case, Fahad decided to put in your order to short 100 shares.

Step 3: The broker, depending on availability, borrows the shares. According to the SEC, the shares the firm borrows can come from:

* the brokerage firm’s own inventory

* the margin account of one of the firm’s clients

* another brokerage firm

Step 4: The broker sells the shares in the open market. The profits of the sale are then put into your margin account.

One of two things can happen in the coming months:

Borrowed 100 shares at 35 BD

3, 500 BD

Bought Back 100 shares at 50 BD

5, 000 BD

Loss

-1, 500 BD

* Share price rises to 50 BD * Share prices sink to 24 BD

Borrowed 100 shares at 35BD

3, 500 BD

Bought Back 100 shares at 24BD

2, 400BD

Profit

11, 000 BD

According to a study conducted by MIT, at least 30% of all trades in the past 2 years have been short sales despite of its uncertainty.

Types of Short Selling

There are over 20 different types of short selling; all with the same concept but differ in details and fields. The most common types will be discussed, in order to show how diverse short selling can be when applied to different fields of business.

The first is the Traditional Short Sale. Which has already been explained thoroughly in the definition and it is the most common type of short selling.

Then there is A Market Maker Short Sale. Where the U. S. Market Makers are not required to make physical delivery of stock certificates when they sell it. They are assumed to be a repository of the company’s shares. Therefore a whole sale is made based solely on false assumption.

A Brokerage House Short Sale is another common type. In this deal there is a decision not to execute a buy order from a client, but it shows the stock as owned by the client on their monthly brokerage firm account statement. It shows fake responsibility of stock in order to deal with them as if they were their own.

Naked Short Sale is when two brokerage firms agree to trade stock in a company with neither brokerage firm requesting physical delivery of the share certificates. It is similar to the traditional short sale but in here the shorter does not even borrow the stock.

Last but not least, The MIDI Short Sale. This is when the brokers sell stock at prices well above the actual trading price of the stock. This has been popular with German OTC stocks sold to the Middle East. The gap between the sale price and the trading price is an effective short sale.[2]

Who Short Sells?

Some insiders of the finance world indicate that it takes certain type of people to short stocks.

Many short sellers have been depicted as pessimists who are rooting for a company’s failure, because of the negative nature of the deals they make. Nevertheless, they’ve also been described as disciplined and confident in their judgment. Considering that what they do isn’t particularly easy and not anyone can successfully get it done.

Short Sellers fall typically and usually under these categories:

- Wealthy sophisticated investors
- Hedge funds
- Large institutions
- Day Traders

The research conducted proves that short selling isn’t for everyone. It involves a great amount of time devotion. Short sellers need to be informed, skilled, and experienced investors in order to succeed in the short selling trade.

A lot of detailed knowledge is required, especially sophisticated financial knowledge. These people must know how security markets work, trading techniques and strategies, market trends, and the firm's business operations.

Islamic Point of View

Short selling is prohibited (Haram) from the Shariah perspective. Shariah scholars found several reasons behind which, short selling is considered haram, and the reasons are as follows:-

1- Selling something you don't own:-In Islamic transactions, to sell something you must first have the ownership of what is being sold or the subject of the sale. Therefore in order to sell a security, the security must be owned by the seller and not borrowed – which is the case in short selling.

2- Riba:-Short selling is associated with the conventional borrowing and lending system of securities which includes a series of interest-based charges for services, and interested payments on borrowed securities. And as we all know, charging interest on services and borrowed securities is considered as Riba.

3- Speculation: – Since short sellers are watching out for fluctuations in the markets, to sell the share at a higher price and buy it back at a lower price and pocket the difference. Speculation has been perceived negatively due to its resemblance with gambling.

4- Gharar/ Ghobun :- there is uncertainty in the contract and the buyer is also deceived.

5- Unjust deeds

In short selling the investor may gain while the company loses value, which is a clear violation of the prohibition against unjust deeds stated by the Quran.

Moreover, by selling a short stock more people might be triggered towards to invest in short selling. This leads the firm to expensive stock buy-back initiatives or in the worse bankruptcy.

In addition, the concept of insider trader is practiced by those who short sells which is also considered as haram as it is cheating the other party.

6- Against the aspect of Tauhid:-Tauhid is core aspect in Islamic finance. It is not only about investing in ‘ pure’ stocks or avoiding interest, it is also about protecting society from trickery, fraud and social tensions.

Attempts towards Islamizing short selling

Almost every financial contact can be Islamized in this age of financial engineering. Concepts were laid out to make short selling Islamic in Malaysia.

According to Yusli Mohammed Yousoff – Bursa Malaysia chief executive, Islam allows short-selling provided it is done within the sharia’s confines. One way of doing that is for investors to buy the stock instead of borrowing it, by paying a fraction of the stock price and executing a simultaneous agreement to sell it back to the seller at a later date – hence the use of Arboun contract.

8-spo-sc1. jpgOn the other hand, the Shairah Advisory council (SAC) in Malaysia came to a resolution that RSS (regulated short selling in the

Malaysian capital market) and stock borrowing and lending (SBL) can be replicated under a shariah complaint mechanism as follows:

* Supplier sells the stocks to CFA as an outright sale with a purchase undertaking (wad 1) to buy from CFA whenever CFA sells the stocks.

* CFA sells the stocks to the user as an outright sale with a purchase undertaking (wad 2) from the user that whenever CFA asks for them, the user will sell the stocks to CFA.

Under the shariah compliant replicated SBL the short selling party purchases the stock therefore, the trade takes with a stock that is owned rather than borrowed. Since shairah perspective considers that the ownership is transferred from the seller to the buyer as soon as the sale occurred.

Therefore, that the negative prohibited elements of bai madum and gharar are eliminated and in that way short selling is Islamized or so they think.

But, what about the other negative aspects of short selling? Short selling is short selling and Islamizing it is an attempt to twist the text and rules of shariah in order to serve the certain needs of some.

Short Selling and the Financial Crisis

Short Selling is not a new phenomenon, it has been there since the origin of Stock Markets, but it hasn't always been encouraged. It has caused the worst failures in the world's Financial Markets. This has occurred throughout history in various countries.

Amsterdam:

Short selling has been around since the stock markets emerged in the Dutch Republic during the 1600s. In 1610, the Dutch market crashed, and Isaac Le Maire, a prominent merchant, was blamed because he was actively short selling stocks. He was a major shareholder in the Dutch East India Company (also known as Vereenigde Oost-Indische Compagnie or VOC). Le Maire, a former member of the company's board, and his associates were accused of manipulating VOC's stocks. They attempted to drive share prices down by selling large of quantities of shares on the market. The Dutch government took action and instituted a temporary ban on short selling.

Great Britain:

In 1733, naked short selling was banned after thefallout fromthe South Sea bubble of 1720. The difference between naked short selling and the traditional short sale is that the shares being shorted are never actually borrowed by the short seller.

In the case of the South Sea bubble, speculation arose about the South Sea Company's monopoly on trade. The company took over most of the England's national debt, in exchange for exclusive trading rights in the South Sea. This led to a rise in its share prices. Shares rose from nearly £130 to more than one £1000 at its peak. Then the market collapsed. The company was accused of falsely inflating its prices by spreading false rumors about its success.

France:

The stock market was shaky leading up to the beginning of the French Revolution. Napoleon Bonaparte not only outlawed short selling, but considered it unpatriotic and treason and had sellers imprisoned. Bonaparte didn't like the activity because it got in the way of financing his wars and building his empire.

Unites States:

Short selling was banned in the U. S. due to the young country's unstable market and speculation regarding the War of 1812. It remained in place until the 1850s when it was repealed.

The U. S. later restricted short selling as a result of the events leading up to the Great Depression. In October 1929, the market crashed, and many people blamed stock trader Jesse Livermore. Livermore collected $100 million when shorting the stock market in 1929.

Recent financial crisis:

According to former Lehman Brothers CEO Richard Fuld, said a host of factors including a crisis of confidence and naked short selling attacks followed by false rumors contributed to the collapse of Lehman Brothers, also many other companies such as:

* GP Morgan Chase

* Merrill Lynch

All these crises show that shorting selling has somehow been the cause of it. As for the major effects of short selling, they are:

Market abuse:

Short selling can be used abusively to create misleading signals about the real supply, or the correct valuation of a stock. Firms whose existence depends on the confidence of their customers and counterparties in the stability of the institution (e. g. financial sector companies) may be particularly susceptible to market manipulation of this kind, especially in a climate of severe market turbulence and uncertainty.

Disorderly markets:

As mentioned above, short selling can convey a signal to the market that a firm is overvalued. If investors act appropriately on this signal, this improves the accuracy of the valuation of the stock in question. However, if investors over-react (e. g. in the context of a general lack of confidence in some financial services stocks), the price decline may be excessive. Such volatility reduces the ability of a firm to raise equity capital or to borrow money and makes it harder for banks to attract deposits.

Transparency deficiencies:

Information asymmetries between informed short sellers and uninformed market participants could result in price inefficiency. Information about the aggregate short position in a single stock could help the market judge the extent to which short selling is driving the price of that stock and the amount of the overhang that would need to be covered at some point by short sellers purchasing shares.

However, from an economic point of view the optimum level of transparency is not necessarily full transparency. Studies demonstrate that excessive transparency can reduce liquidity because traders are unwilling to reveal their trading strategies. More generally, lack of full information on intentions or reasons for purchase and sales is a fundamental element of markets as information is costly to obtain. With full transparency, investors actually have less incentive to gather new information as they would not get compensation for the resources they expend.

Settlement issues:

Naked short selling gives rise to the risk that the seller is unable to deliver stocks to the buyer i. e. there is the risk of settlement failure. This may impair the proper functioning of the market resulting in enhanced transaction costs and sub-optimal levels of trading.

Because of such major negative effects, many countries have come to a decision where a temporary ban on shorting selling will be established. For example:

United States: On 19th September 2008 practices were halted in 799 financial institutions by Securities Exchange Commission in companies such as:

* Atlantic American Corp

* BankShares Inc

* First United Corp

United Kingdom: Practices were halted in 32 financial institutions by FSA. However, this ban will be lifted on 16th January 2010.

Australia: On 22nd September 2008 the country ordered a complete ban of short selling to all its companies.

However, did the ban really help the market? According to some, should short selling really be banned? As said by Surjit Bhalla, MD, Oxus Research and Investments " The stocks in which short sales were banned in the US fell the most! Investors, who want to get out, will do so through the cash market if need be"

Other sources say that the United States is the only " ban country" that's banned stock price increased. The ban on short-selling increased the daily volatility of the S&P 500 by 0. 09% while the crisis increased it by only 0. 02%. The impact of the ban on market volatility was greater than the impact of the financial crisis!!

It is true that short selling has some kind of positive outcomes, but Islam has prohibited it because it's negative elements over shadow its positive outcomes. That is why most Islamic Banks in the GCC have so far achieved double-digit gains in 2008 while conventional banks currently recount their biggest losses in history.

Conclusion

Now that we have completely explained short selling starting with the definition up until relating it to the financial crisis. We have concluded that despite its negative elements, the west sees it as an evil they can't let go of. They think its positives are more important. While from an Islamic point of view, the negatives over-shadow the positives and it's most certainly forbidden. Despite some efforts in Malaysia to Islamize short selling, it's still what it is and it doesn't make it Halal. In conclusion, short selling is forbidden in Islam.

Reference Page (Bibiliography)

Short selling transaction

http://www. investopedia. com/university/shortselling/shortselling2. asp

http://www. investopedia. com/university/shortselling/shortselling1a. asp

Types of short selling

http://www. tradingresource. com/content/articles/Short-Selling-Strategies. html

Are short sellers to blame?

http://www. time. com/time/business/article/0, 8599, 1842499, 00. html

http://www. twnside. org. sg/title2/finance/twninfofinance20080806. htm

http://news. bbc. co. uk/2/hi/business/7624012. stm

https://www. cheuvreux. com/pdf/short%20selling%20rules. pdf

Islamic Short selling

http://saudiherald. com/news/newsfull. php? newid= 281336

http://gifc. blogspot. com/

http://elgamal. blogspot. com/2006/09/short-selling-and-travesty-of-islamic. html

http://www. ameinfo. com/170733. html

http://righttruth. typepad. com/right_truth/2008/10/selling-short-in-islams-sharia-finance-is-haram. htm

http://www. islamicfinanceasia. com/8_spo-sc. php

[1] http://en. wikipedia. org/wiki/Short_(finance)

[2] http://www. tradingresource. com/content/articles/Short-Selling-Strategies. html