

# Participating in an IPO

*The Halal Perspective*

AZZAD ASSET MANAGEMENT WHITE PAPER SERIES

## ABSTRACT

Is it permissible to invest in an initial public offering, or IPO? The question requires an exploration of the basics of Halal investing, including the intention behind one's action and how IPOs are set up. The American Muslim investor should approach this issue and others like it in an informed and thoughtful way. Such are the questions that present themselves in an increasingly complex and financialized world. The answer, although technically possible provided that certain conditions are met, is typically negative. This brief paper explains the different sets of operating procedures and considerations in financial markets, depending on whether one is participating in the primary or second market.

## UNDERSTANDING THE BASICS OF CONTRACT LAW

There is a legal axiom from the scholars of *fiqh* (Islamic jurisprudence) that states:

“Matters that are prohibited may be allowed to continue, provided that they were done before the fact. However, the same rule is not allowed for its initiation.”

يجوز في الاستمرار أو في الإنتهاء ما لا يجوز في الإبتداء

The implications of this statement in contract law are many. An example of its application in early Islamic history relates to marriage contracts. Many of the Prophet Muhammad's companions were married prior to their acceptance of Islam. Even though Islam requires a contractual arrangement in order for a marriage to be valid, companions married prior to Islam were not required to “renew their vows” or to draft a contract. In other words, the matter was allowed to continue because it was done prior to the application of the relevant rule.

This axiom also applies to investing and financial contracts.

The issuance/purchase of shares of companies that have impermissible activities, no matter how little, are deemed by Standard No. 21 of the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) to be unacceptable in the primary market. This is because the matter is at its point of initiation, as stated in the aforementioned axiom. In order to discourage impermissible activities, participation in the IPO becomes a prohibited transaction.

*The purchase of shares that have impermissible activities, no matter how little, are deemed by AAOIFI Standard No. 21 to be impermissible in the primary market.*

### AAOIFI STANDARD NUMBER 21

Based on the legal axiom, AAOIFI makes a distinction between:

- a) The issuer; and
- b) Market participants who exchange shares that have already been issued.

In the secondary market—when market participants trade the stock of companies whose shares have already been issued—there are rules by which one is able to invest in and benefit from these assets. The primary market, however, involves the actual structuring of the asset. Usually, there is some element of impermissibility in an IPO arrangement that would make it unacceptable. Often times, for example, an IPO will leveraged, or some other interest-based provision will apply. In these cases, zero tolerance applies. The AAOIFI thresholds for investing in the secondary market (debt ratios below 30%, accounts receivable ratios below 45%, and interest income below 5%) are reduced to zero in the primary market.

To put it simply, the AAOIFI guidelines one should follow when trading shares of stock in the secondary market do not apply when transacting in the primary market. In the primary market, proceeds of the IPO go directly to the issuer, rather than to another investor, or market participant.

### FLEXIBILITY OF HALAL INVESTING

The AAOIFI distinction between investing in primary and secondary market illustrates the flexibility and pragmatism of Islamic financial and contract law. There is zero tolerance for violating Islamic prohibitions in the primary market because Muslims should not participate in the perpetuation of a practice that is by definition unjust (i.e., a transaction involving lending with interest). In the secondary market, however, the initial harm has already taken place. In this situation, investors are already in the market, so what should they do? They follow the guidelines that scholars have outlined based on the teachings of the Prophet Muhammad. In addition, investors are encouraged to attempt to rectify the situation with other means such as shareholder advocacy.

### KNOW BEFORE YOU INVEST

The rules governing investment in an IPO illustrate the depth and breadth of the guiding principles of Halal Investing. Familiarizing oneself with those principles can lead the values-conscious individual through the sometimes murky world of modern investing. Azzad is pleased to provide this information to those motivated to invest in a manner consistent with their values.

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