

Shari'ah Issues in Short Selling and its Potential Implementation in Qatar Stock Exchange

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Abstract

Through surveying the literature to examine the impact of short selling on the stock market, we found that most journal articles and research papers are strongly in favor of short selling. The finance literature claims that short selling is important for a well-functioning financial market because it offers number of advantages which include efficient price discovery, better market liquidity, and enhance risk management. We showed that these claims are not accurate, and that these studies are attempting to promote the practice of short selling despite its negative impact. The practice of short selling is still a subject of debate especially among Shari'ah scholars where they are still divided on its legitimacy. The paper provided an insight into this debate by investigating various Shari'ah aspects of short selling, and we found that this financial tool does not comply with Shari'ah principles. Since Shari'ah scholars do not permit short selling, some institutions and hedge funds claim offering Shari'ah compliant short selling alternatives. In this paper, we outlined four approaches based on Ijarah, Salam, Arbun, and Wa'd structures as alternatives to conventional short selling. Based on our analysis of the mechanism of each structure, we found that all the structures involve unresolved Shari'ah issues.

Malaysia claims offering short selling that complies with Shari'ah principles, we therefore discussed the short selling as applied in Malaysia to examine its compliance

with Shari'ah principles. The Shari'ah Advisory Council (SAC) of Malaysian Securities Commission resolved that Securities Borrowing and Lending (SBL) should be aligned to Ijarah principles in order for SBL to comply with Shari'ah principles. The SAC used the principle of *Istihsan* based on *Maslahah* as an exception to the general principles of Ijarah to justify the use of short selling in its Islamic Capital Market. The principle of *Istihsan* based on *'UrfKhas*, that is, a customary practice accepted in economic activities, was also used by the SAC as a basis for the permissibility of SBL. We showed that there is no *maslahah* to the market or the society from applying short selling as claimed by the SAC. Moreover, such use to the concept of *Istihsan* based on *Maslahah* to legalize what serves the benefit of some groups could dampen the credibility of Islamic finance.

Key words: Stock; Speculation; Gambling; Shari'ah; Financial crisis; Short selling; Securities borrowing and lending

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INTRODUCTION

Any entity requires money to start a new project has to raise the funds by issuing either stocks or bonds. The company receives money when they sell stocks to the public in the primary market. These stocks will be then traded between current and potential owners in the secondary market (which is referred to as "Stock Market" or "Stock Exchange"). Proceeds from sales in secondary market do not go to the company that issued the stocks, but rather to the owners of stocks. It is the investors who are buying and selling stocks that benefit or lose from

any increase or decrease in stock price. A stock is defined as a share in the ownership of a company; it represents a claim on the assets and earnings of the company. The terms stock, share, and equity, all mean the same thing. Generally, investors buy stocks for two purposes: either to retain them to receive dividends, or to sell them when prices rise. The former is called investment, whereas the latter is called speculation. There are other purposes such as hedging and arbitrage.

The stock market has always caused debates among economists. This is because in certain periods of history it has caused the loss of huge amount of wealth in a short time for some investors, while at the same time it has brought fortunes to others without effort. Trading in stocks was not known in the Islamic jurisprudence because it was developed in the modern era. The allowance of investment in stock markets by Shari'ah scholars (provided it meets certain criteria) has provided investors with opportunities to buy and sell stocks. An investor in need of liquidity can now sell his stocks in the secondary market and receive the sale's proceeds.

Given the importance of the stock market to the economy, including the economy of Muslim countries, the tools and activities carried out in this market need to be evaluated from a Shari'ah perspective. This research focuses on short selling as a financial tool in the stock market and explores its impact on the economy. The research will also explore both the validity of short selling from a Shari'ah point of view as well as reviewing the structures that have been offered as Shari'ah compliant alternatives to short selling. The discussion of the potential permissibility of short selling in this paper is based on the assumption that the short seller is borrowing the stock before conducting a short sale transaction and that the activities of the company whose stocks are being shorted are Shari'ah compliant.

In general, short selling is the sale of a security not originally owned by the investor at the point of a transaction. The concept of short selling involves borrowing a stock that the investor does not own, selling the borrowed stock, and then buying and returning the stock when the price drops (Dusuki & Abozaid, 2008). Economists perceive short selling as an important part of a well-functioning financial system. Some studies show that short sellers contribute in reducing the risk of artificially high stock prices, thus adding stability to the market price. It is argued that short sellers add efficiency to market price because their transactions inform the market of their evaluation of the performance of future stock price. According to Karpoff et al, short sellers contribute to market discipline by identifying companies that misrepresent their financial information (CFA Society UK, 2013).

We believe that the Qatar Exchange (QE) will launch the short selling in the near future, especially after the approval of the Securities Lending and Borrowing facility

by the Qatar Financial Market Authority in June 2012. At the end of 1995, the Malaysian Securities Market launched the Stock Borrowing and Lending (SBL) facility, which was then followed by introducing a guide on regulated¹ short selling (RSS) in the following year². We believe that the same scenario will occur in Qatar. It is therefore important to understand this financial tool and explore its impact on the market.

(1) Research Motivation

Starting from August 2013, Qatar was reclassified by the US-based financial services MSCI from a frontier market to an emerging market. The Qatar Financial Market Authority adopted four new regulations in order to meet the international requirements to be classified as an emerging market. Amongst these regulations was the launch of Lending and Borrowing of Securities facility for the purpose of covering settlement failures when stock which has been sold cannot be delivered at the time of the transaction. Due to the similarities between short selling and the newly launched facility, i.e. Lending and Borrowing of Securities, we believe that the Qatar Exchange will launch the short selling in the near future. Therefore, the researcher was motivated to examine short selling and investigate its impact on the market.

(2) Research Importance

This research paper is important in two ways:

Academically

Although short selling is not a new financial tool, however, it is still a misunderstood concept. There is a longstanding controversy on short selling and it is usually discussed when a financial crisis occurs. The practice of short selling is a subject of debate among Shari'ah scholars, where they are still divided on its legitimacy. The study will provide an insight into this debate by investigating various Shari'ah aspects of short selling. Due to the scarcity of books and research papers written on this subject from a Shari'ah point of view, the study will contribute in the literature of short selling for Islamic capital markets.

Practically

Given the belief that the Qatar Exchange will be implementing short selling in the near future, this study will benefit product developers in understanding the impact of short selling on the market and the risks associated with it. Since Qatari investors have been

¹ "Regulated" means, among other things, that "naked" short selling is not allowed (Calder, 2010). A naked or uncovered short selling is selling a stock short without first borrowing or arranging to borrow it (Boulton & Braga-Alves, 2009).

² As a result of the Asian Financial Crisis, Regulated Short Selling (RSS) and Securities Borrowing and Lending (SBL) were banned from 5th September 1997. The ban on RSS was lifted in March 2006 on the condition that Bursa Malaysia Securities Berhad (the Exchange) would control all the short selling transactions. (<http://www.skrine.com/regulated-short-selling>)

demanding more investments and financial instruments that are Shari'ah compliant, this study will help investors as well as Islamic mutual funds, Islamic brokerage companies, and other stakeholders understand Shari'ah issues as they pertain to short selling.

(3) Research Hypothesis

Based on the literature review, we test two-hypotheses (H1 and H2):

Hypothesis 1 (H1): No benefit is derived from short selling.

Hypothesis 2 (H2): Short selling does not comply with Shari'ah principles.

(4) Research Objectives

- Investigating the impact of short selling on the stock market.
- Investigating Shari'ah issues surrounding short selling.
- Investigating the models offered as Shari'ah compliance short selling alternatives.

(5) Research Methodology

A descriptive research method will be used to examine the impact of short selling on stock market. The descriptive method will be also used to describe and reveal various Shari'ah issues related to short selling. In order to achieve this, a literature survey will be conducted to survey various studies. An analytical study will be conducted in which the conventional short selling contract will be analyzed in order to identify the points that are possibly contrary to Shari'ah principles. We will also analyze the mechanisms of the methods introduced as Shari'ah alternatives to the conventional short selling to investigate their compatibility with Shari'ah principles.

(6) Research Structure

In the subsequent sections, this research is further developed to test the research hypotheses in order to achieve the objectives identified above. Following the introduction in **Section One**, the remainder of this research is organized as follows: **Section Two:** Reviews the relevant literature in order to examine the impact of short selling on the stock market and explores Shari'ah issues related to the short selling transaction. This section also outlines the motivations to short selling and the mechanism of a conventional short selling. The risks associated with short selling will also be discussed.

Section Three: Since many Shari'ah scholars do not permit short selling, some institutions and hedge funds claim offering Shari'ah compliant shorting solutions. This section outlines these solutions that are offered as Shari'ah alternatives to conventional short selling.

Section Four: Since Malaysia claims offering short selling that complies with Shari'ah principles, Section Four discusses short selling as applied in Malaysia and examine its compliance with Shari'ah principles.

Section Five: In this section we discuss our study

findings and present some recommendations to decision makers at the Qatar Exchange.

1. LITERATURE REVIEW

There is a longstanding controversy on short selling. History shows that market crashes are usually followed by public attacks against short sellers, resulting in banning or restricting short selling transactions. On one hand, governments, regulators and media argue that short selling causes high price volatility and market disaster. On the other hand, economists and practitioners argue that short selling contributes to the efficiency of the market.

In order for the reader to understand the Shari'ah debate related to the practice of short selling, we will first outline the motivations to short selling and explain its mechanism. The risk associated with short selling will be also discussed. We will then survey the literature to examine the impact of short selling on the stock market. From our survey, we found that most journal articles and research papers are supporting short selling. Many of these papers were conducted to study the impact of short selling bans after the financial crisis of 2008, and the results show that stock markets were less efficient during the bans. The researchers argue that without short selling, prices would be wrong and market liquidity would be reduced. They also argue that the ban was not a good decision as it did not achieve the results planned for.

The practice of short selling is also a subject of debate among Shari'ah scholars who are still divided on its legitimacy. The last part of this section will provide an insight into this debate by surveying the relevant literature that attempts to identify Shari'ah issues in short selling.

1.1 Motivations to Short Selling

Speculation: Speculation is one of the reasons for engaging in a short selling transaction. An investor expecting the price of a stock to decline may want to benefit from his assessment by short selling that stock to a counterparty who expects the opposite.

Hedging: The investor can use short selling to hedge the risk of a long position in the same or related security. For example, an investor who is unable to forecast the performance of an industry, but able to estimate the performance of individual companies, can use a hedged position within that industry to improve his portfolio performance (Renshaw, 1977).

Arbitrage: An arbitrage strategy is to purchase and sell the same security at the same time in different markets to take advantage of price difference between the two separate markets. An arbitrageur would short sell the higher priced stock and buy the lower priced one. The profit is the spread between the two assets.

1.2 Mechanism of Conventional Short Selling

The following are the basic steps in a short sale transaction:

Negotiating the short sale transaction: The two parties, i.e. the short seller and the broker, will negotiate the terms of the short sale transaction, in particular the type and the amount of stocks to be lent, the collateral to be delivered, delivery date, and lending fees.

Initiating the short sale transaction: The short seller (stocks' borrower) provides the lender with collaterals; the borrower will deposit a certain amount (initial margin) with his broker for borrowing stocks. Simultaneously, the broker will lend the stocks to the short seller. The broker can get the loaned stocks from different sources such as the brokerage firm's own inventory, other brokerage firms, customers that hold long stocks in their margin accounts and from institutional investors.

Executing the short sale transaction: The borrower will order his broker to sell short the stocks in the market. The proceeds from sale will be credited to the borrower's brokerage account. Both, the proceeds and the initial margin paid by the investor represent the investor's total assets and he has no right to withdraw any amount from this account until he returns the borrowed stocks.

Maturity of the short sale transaction: Once the stock price drops (borrower will only make a profit when he can buy back stocks cheaper than he sold them), the borrower will buy back the stocks from the market and return them to the broker; this is called "covering short position". Then the broker will return the collaterals to the borrower.

Margin requirement: The borrower has to deposit an initial margin in order to sell a security short; this margin amount should be deposited when borrowing the security. The value of the shorted stock is marked to market daily. If the price of the stock begins to rise, the broker will move the money from the short seller cash balance (which contains the sale's proceeds and initial margin) to the margin balance. If the stock price continues to rise and the short seller does not have sufficient funds in his cash account to cover the position, then the short seller will begin to borrow on margin, thereby accruing margin interest charges.

1.3 Short Selling Risk

There are several risks attached to conventional short selling for both the lender and the borrower:

1.3.1 Lender's Risks

Counterparty risk: The risk that the borrower fails to provide additional collateral or fails to return the borrowed stocks. As mentioned in Chapter Two, the value of the shorted stock is marked to market daily. If the market value of the borrowed stocks and collateral differ from their market value on any day before the maturity date of the short selling transaction, then the borrower will be required to put additional collateral when the stock rises in price.

Operational risk: This type of risk involves the failure of the broker or the borrower to meet their responsibilities.

This includes among others, the failure to collect dividends, the failure to mark the loan to market and the failure to return the stocks in case they are recalled.

Investment risk: It is the choice of investments that the lender or his agent (the broker) takes when investing borrower's collaterals. Some lenders are risk averse and they will only invest in low risk investments. Other lenders looking for high returns will invest the collateral in high-risk investments that potentially yield high profit. In case the investment was not successful and there was loss, the lender is still responsible for returning the collateral to the borrower when the stock is returned.

1.3.2 Borrower's Risks

Recall risk: The recall risk is the risk of the stock being recalled by the lender before the borrower is prepared to close his position (Nejad, 2009). If the broker recalled the stock when the price is much higher than the price at the time of shorting, then the borrower will end up making huge losses. In his paper, Nejad (2009) mentioned that in a sample of one study, it was found that this happens in approximately 2% of the loans.

Margin account risk: Shorting stocks involves using a margin-trading account. When the borrower account slips below the maintenance margin level, he will be subject to a margin call, where he will be forced to put in more cash or liquidate the short position. It can be explained in this way: the investor borrowed the stocks from his broker, so he needs to put a percentage of equity value in his account for granting him the stocks. If the stocks go against him, that is, go higher in price, he will have to put more margin in his account in order to maintain the short position. If he does not have enough margin to maintain the position, he will be receiving a margin call, which will force him to put more cash that will give him more margin, or he will have to cover or liquidate his position.

Corporate action risk: In the event that the corporation whose stocks were sold short paid dividends, then the borrower must pay these dividends to the lender, as the lender is still the owner of stocks.

When a company splits its existing stocks for example, two-for-one, in this case the borrower owes the lender twice the borrowed shares. Although the number of stocks increases, however the value of stocks remains the same compared to a pre-split.³ In a developed market the split does not affect the total value of stocks because it increases the number of stocks but at the same time decreases the value of each stock. However, in an emerging market, the split normally leads to increases in

³ For example, if an investor short 100 shares of XYZ Company at \$40, at maturity, he will be required to return 100 shares of XYZ Company. When shares split 2:1, the number of shares doubled and the shares trade at \$20 instead of \$40. In this case, the investor will be short 200 shares at \$20. So, the investor does not gain or lose on the split. Prior to the split, the value of the investor's position was \$4,000 (100 × \$40), and after the split, the value is still \$4,000 (200 × \$20).

the price for each stock, due to high speculation, rumors, and uneducated investors⁴.

Another corporate action that may cause risk to the borrower is when a spin-off occurs⁵. In this case the borrower would be short of two stocks, where he will be owing the original stocks and the spin-off stocks to the lender.

Market risk: In general, the market has a bias towards upward prices, where over the long run most stocks appreciate in price. What this means is that the short seller is betting against the overall direction of the market. Therefore, the short seller can lose more than what he initially invested.

Short squeeze risk: If a stock starts to rise and a large number of short sellers try to cover their positions at the same time, this will cause the demand for the stock to exceed its supply in the market, which will in return cause the price to rise further. This phenomenon is known as a "short squeeze".

1.4 Impact of Short Selling on Stock Markets

The effect of short selling constraints on stock prices was first discussed by Miller (1977). Miller finds that stock prices tend to reflect an optimistic valuation when short selling is restricted, which could push stock prices to increase above their fair value. Short selling restrictions prevent pessimists from shorting stocks that they believe to be overpriced. Harrison and Kreps (1978) confirm the findings of Miller and demonstrate that restricting short selling can push stock prices to increase beyond the prediction of optimistic investors.

Another study conducted by Diamond and Verrecchia (1987) demonstrates that short sale constraints reduce the speed of price adjustments. However, they do not agree with Miller in that the constraints will result in an upward bias. They argue that investors are rational and will adjust their valuations before making trading decisions. Diamond and Verrecchia also distinguish between short selling restriction and short selling prohibition. They give an example of a restriction where an additional cost is imposed when borrowing stocks to conduct a short selling transaction. They argue that such an additional cost will make short selling less attractive, so only well-informed investors will engage in short sales. Therefore, the restriction tends to drive out uninformed investors. On the other hand, short selling prohibition or a short selling ban keeps out both informed and uninformed investors, which result in reducing the informational efficiency, and thus reducing market quality.

A study conducted by Brent et al. (1990) sought to

find the main motives for shorting stocks. The researchers conducted a study on the New York Stock Exchange (NYSE) outstanding 200 companies with active short selling investors and found that hedging and arbitrage are the main motives for short selling; tax based and speculations are the least common motives for shorting.

Asquith and Meulbroek (1995) found a strong negative relation between short selling and abnormal stock returns. The researchers used the monthly short positions data for the NYSE from 1976 to 1993, and they confirmed that short selling does convey negative information.

Ho (1996) studied the impact of short sale constraints on market volatility in Singapore during the Pan Electric crisis in 1985-1986. He found that the volatility of stock return was higher when short sale was restricted. This implies that restricting short sale does not prevent speculation and volatility, but actually increases market volatility.

Beber and Pagano (2009) conducted a study on the impact of short selling restrictions in thirty countries during the period from 2007 to 2009. They found that the bans had negative impact on liquidity, especially for stocks with small market capitalization, high volatility and lack of options derivatives. This slowed down the price discovery especially in bear market phases, which failed to support stock prices.

According to Hasan et al. (2009), short sale bans may have adverse effect on market discipline, mainly because they may mute the disciplining effects of investors on those financial companies with greatest risk exposures. The researchers examined the rationale for short selling and whether it is purely speculative or driven by responses to the financial firms' risk exposures. In particular, they looked to a firm's holdings of risky assets such as subprime related mortgages and its overall credit risk exposure. They found that the amount of short selling was large for those companies that exhibit greater exposure to the subprime mortgage market. They also found that the higher the average 5-year Credit Default Swap (CDS) spread and/or the 1-year change in the average daily 5-year CDS spread, the greater the short-selling activity of a financial firm's equity.

The former Chief Executive Officer of Lehman Brothers, Richard Fuld, blamed short selling for the collapse of the largest investment bank in the US, Lehman Brothers (Kolasinski et al., 2009). However, a study by researchers at the University Of Oklahoma Price College Of Business showed that short selling was not the cause of the decline of Lehman Brothers stock price (Fotak, Raman, Pradeep & Yadav, 2010), as the short selling took place after the decline of its stock price and not before.

Another study conducted by the Cass Business School in London to evaluate the performance of stocks before and after the bans of short selling in the US, UK, Germany, Italy, and France. The study compared the returns of those stocks that were under the short sale

⁴ From our discussion with Elsiefy he stated that the split in an emerging market increases the stock price.

⁵ In a "spin-off", a parent company distributes shares of a subsidiary to the parent company's shareholders so that the subsidiary becomes a separate, independent company. The shares are usually distributed on a pro rata basis. (U.S. Securities and Exchange Commission)

bans with the returns of stocks that were not under the bans. The study found that stocks subject to the bans behaved very similarly to those stocks not subject to the bans. In addition, they behaved similarly to how they behaved before the bans. The research also compared the behavior across the mentioned countries and found that no systematic patterns consistent with the expected effect of the bans; there was no reduction in price falls.

Marsh and Payne (2010) studied the impact of the UK ban on short selling. They found that the UK's stock market was less efficient during the period of the ban. The ban resulted in price volatility, but once the ban was lifted, these effects were reversed. A similar result conclusion was found by Abraham Lioui when he studied the impact of the 2008 short sale ban in France. Lioui stated that the ban was followed by an increase in the market volatility, where stock prices deviated from their fundamental value. In another research paper (Lioui, 2010a), Lioui studied the impact of the ban on the broader market and found that the ban had a broad impact on the markets, where it increases market volatility.

Lobanova, Hamid and Prakash (2010) conducted a study to examine the impact of short sale ban in the US on the volatility of stock returns, stock liquidity, and market efficiency. They studied the banned short selling stocks listed on the NYSE, AMEX and NASDAQ exchanges to see how the ban impacted the market. They concluded that the ban led to a significant decline in market liquidity⁶, and a significant increase in stock return volatility.

In a research paper published by Deutsche bank (Deutsche Bank Research, 2010), it is argued that short selling is important for a well-functioning stock market because it offers a number of advantages which include efficient price discovery, better market liquidity, and enhance risk management.

In his paper, Mckenzie (2012) discussed some of the arguments made against short selling, including concerns related to excessive volatility, market stability, market abuse, and settlement disruption. The researcher found that there is very weak evidence supporting these claims.

The CFA Society of the UK published a paper in 2013 in support of short selling (CFA Society, United Kingdom, 2013). The paper states that short selling enhances market efficiency, imposes market discipline, contributes to price discovery, enhances market liquidity, facilitates stock lending, and enhances the returns of passive portfolios. The paper argues that policymakers hindered short selling without supporting their decisions with evidence.

Sobacl, Sensoy and Erturk (2014) studied the relation between short selling and three variables, namely market return, liquidity, and volatility in the Turkish stock market, for the period Jan, 2005 to Dec, 2012. The researchers found that when short selling increased, market liquidity

was increased and the volatility decreased. The researchers stated that even though Turkey did not ban short selling during the financial crisis of 2008, the correlation between shorting, volatility, and market illiquidity remained negative.

However some studies argue that short selling can have a negative impact on stock prices, especially on a secondary offering⁷. The stock prices for the secondary offering are benchmarked against the closing price of previous day, and the secondary offering is fixed at a lower price. Pontiff (1996) argues that this discount drives investors to short sell the offering stocks prior to the secondary offering because they expect the offering to be at a lower price. In such a situation, short selling will not benefit price discovery; instead, it can damage the secondary offering because its price will be pushed down.

Researcher's Comment

From above we see that the finance literature asserts that short selling is important for a well-functioning financial market because it offers number of advantages which include better market liquidity, efficient price discovery, and enhance risk management.

Claiming that short selling as well as speculative activities benefits the stock market through increasing the market's liquidity is incorrect. Analysts and economists use the concept of liquidity as a measure of market efficiency, claiming that a high market liquidity helps in expanding investments in the society through opening opportunities to investors who are willing to buy and sell at prices that would give them short term gains. This claim is incorrect, because the speculative activity in the secondary market is a tool to transfer capital gains among stockholders. This means that it transfers the capital gain that is expected to accrue to a stockholder, to another who is waiting for a rise in the price of such stocks in order to buy them from the stockholder and resell them at a higher price after a short period. So what is happening here is selling and buying the same existing stock, which is just an exchange of positions of liquidity among the sellers and the buyers; i.e. there is no liquidity generated to the society.

We think that claiming that short selling and speculative activities increase market liquidity was mainly created by the brokerage firms who are the beneficiaries from the high liquidity. The profit of these firms depends on the volume of transactions they process; the more are the transactions in the market the higher is the profit of these companies. And the more are the transactions, the more is the fluctuation in stock prices, which has in turn a negative effect on the market and particularly, on the long term investors. The market authorities also benefit from this high volume of transactions as they receive a percentage from the profit gained by brokerage firms.

⁶ Decline in market liquidity means: smaller turnover, smaller trading volume, and larger bid-ask spread.

⁷ In secondary offerings, existing stockholders sell their outstanding shares and the firm issues no new shares.

The most provocative rationale to justify the use of short selling is the claim that without short selling prices would be wrong. The stock market does not need short selling to correct its prices, because we can achieve this by introducing regulations that enhance market efficiency, and prevent such overvaluation of securities to occur.

Claiming that short selling is an important hedging tool that can be used by hedge funds is another justification presented by the academic economists to justify its use. Hedge funds may deliberately cause a reduction in the value of shorted securities when they short them in high volumes. By selling the borrowed stocks, short sellers create an excess market supply of the shorted stocks. Selling the borrowed stock causes the stock price to decline even if the actual market demand for the stock does not change. And by bringing a company's stock price down, this may create a problem for the company by undermining the confidence in the company. Why should the whole market suffer from such act so that hedge funds gain! Why should we allow fund managers and trustees of pension funds to lend shares of companies knowing that these loans will facilitate short selling in a manner that could affect the value of those shares?

Academic economists failed to predict the financial crisis of 2008 and in fact they helped in creating the crisis through presenting articles that mislead the public. It is the academic economists who promoted the use of derivatives and exaggerate their advantages, which eventually lead to the crisis. Moreover, it is the academic economists who supported the deregulation and recommended policies that served their interests, at the expense of the society and the whole economy. It was found that many academic economists exhibit conflict of interest, where they were consultants in institutions that were involved in creating the crisis. In fact, some academic economists and analysts are paid to write articles that serve the interest of some groups. Therefore, it is not surprising to find many articles and research papers that support short selling despite its negative effects.

1.5 Shari'ah Issues in Short Selling

Generally, most Muslim scholars consider short selling as undesirable practice. Some of the main concerns that Muslim scholars have against short selling are: 1) whether stocks can be subject to a loan contract; 2) the fact that the seller does not own or possess the stocks he sells; 3) it is an interest-based transaction; 4) obligating the borrower to pay the dividends; 5) the lender/ broker is benefiting from the collateral which is not allowed from a Shari'ah view; 6) it involves gambling; and 7) it violates the *maslahah* (benefit) of the society.

1.5.1 Whether Stocks Can be Subject to a Loan Contract

The question here is: can stocks be lent without interest? Scholars discussing this Shari'ah issue can be divided into three categories: scholars looking to stocks as fungible or non-fungible objects, scholars looking to the company's

assets that issued the stocks, and scholars looking to the stock as a financial value.

First: When judging whether stocks can be subject to a loan contract or not, researchers usually present *Fuqaha's* opinions on objects that are permissible to be subject to a loan contract:

- *Hanafis* rule that only fungible (*mithli*)⁸ properties can be lent. They argue that a loan contract cannot be tied to non-fungible (*qimi*)⁹ properties because it is impossible to find an equivalent object to repay the loan (Al-Kasaani, 1986).

- *Malikis* (Al-Mouaq, 1996) and *Shafi's* (Al-Nouri, 2005) rule that all objects eligible for a salam contract can be subject to a loan contract. This means that both fungible (*mithli*) properties and non-fungible (*qimi*) properties can be subject to a loan contract.

- *Hanbalis* rule that any object that is sold can be subject to a loan contract, whether the object was *mithli* or *qimi*, and whether it was eligible for a salam contract or not (Al-Maqdisi, 1999).

Second: Other scholars such as Alsiddiq Mohammed Alameen Al-Darir and Mubarak Al-Sulaiman do not look to stocks as fungible or non-fungible objects, but to the company's assets that issued the stocks. They focused their ruling on the permissibility of lending a stock based on the underlying asset that represents the stock¹⁰. They divided the company's assets into four categories: cash, tangible assets, debts, and a combination of cash, tangible assets and debts.

In the following we summarize the view of Al-Darir and Al-Sulaiman (2005):

The company's assets are all cash: Both Al-Darir and Al-Sulaiman argue that if the borrowed stocks represent a company whose assets are only cash then, lending stocks in this case is permissible. They argue that since the company's assets are cash then, the stocks represent cash, hence, at maturity, the borrower has to return the borrowed stocks in form of cash. However, they both state that this ruling is valid if the company's assets remain unchanged.

The company's assets are all tangible assets: Al-Darir argues that lending stocks is permissible only when the assets are *mithli*. On the other hand, Al-Sulaiman argues that lending stocks is permissible whether the assets are *mithli* or *qimi*. However, they both state that this ruling is valid if the company's assets remain unchanged.

⁸ Fungible (*Mithli*) goods: all units of which are similar, so that if the seller is not able to produce the goods by himself, he can get the same from the market. Examples: gold, silver, wheat, all currencies, etc. (Ayub, 2007).

⁹ Non-fungible (*Qimi*) goods: all units of which are different from one another in terms of price and specification. (Ayub, 2007).

¹⁰ In its Shari'ah Standard No. 21, AAOIFI defined the share as follows: A share represents an undivided share in the capital of a corporation, just as it represents an undivided share in its assets and the rights associated with it upon conversion of the capital into tangible things, benefits, debts, and so on. The subject matter of the contract at the time of trading of shares is this undivided share.

The company's assets are all debts: As per Al-Darir, lending stocks is permissible provided that the loan is the market value of the stock. This means that, when the loan is due, the short seller has to return the stock's value at the time of signing the contract. Al-Sulaiman also permitted lending stocks when the company's assets are all debts provided that the amount of debts is known in order to return the same when the loan is due.

The last category occurs when the company's assets are a combination of the three, i.e. cash, tangible assets and debts: Al-Darir argues that in this case, the ruling would be according to what represent the majority of the company's assets, which is more than one-third of the assets¹¹. If there was no dominant asset class, then the ruling would depend on the stock's nominal value, and in this case the ruling applies in first category (i.e. the company's assets are all cash) would be applied here.

One researcher has reported the following observations on this opinion of Al-Khudairi (2008):

- Looking at the dominant class asset that represents 33% of the asset is not applicable in lending stocks because the borrower has to return the same borrowed stocks. This implies that each type of assets must be considered regardless whether it represents the majority or not.

- Looking at the stock's nominal value when there is no dominant class asset is unjust to the lender. Based on this opinion, this implies that if the nominal value is \$10, then the borrower has to return \$10 only, even if the value of the stock now is tripled.

On the other hand, Al-Sulaiman argues that in case that the company's assets are cash, tangible assets, and debts, or cash and debts, or tangible assets and debts, then lending stocks is permissible provided that the amount of each, cash, assets and debts is known so that the borrower can return the same. He also mentioned that lending stock is usually not permissible because most of companies' assets are a combination of these three, and usually it is hard to know how much each one of them represents the

borrowed stock.

There is another category of asset that was stated by Al-Sulaiman—the **company's assets are cash and tangible assets**. He argues that lending stocks in this case is permissible provided that the amount of each the cash and the assets are known. The rules applied in first and second categories above would be applied here.

Al-Darir also argues that it is permissible to lend the market value of a stock, and at maturity, the borrower has to return the stock's market value at the time of signing the loan contract. He states that if at maturity the market value decreased, and the lender of stocks accepted this declining, then the borrower can return the stocks. On the other hand, if the market value at maturity increased, then returning the stock in this case is not permitted if this increase was a condition in the contract. This implies that Al-Darir looks to the market value of the stock, and not to the assets that represent the stock. This contradicts his view when he stated that the permissibility of lending a stock depends on the assets that represent the stock. It should be also noted that the borrower did not borrow money or stocks that represent money, but he borrowed stocks that represent a company's assets. So by returning the borrowed stocks in form of cash, it means that the borrower returns something he did not borrow.

When we discussed the issue of the eligibility of stocks as object of a loan contract with Monzer Kahf, he argued that stocks cannot be subject to a loan contract because a stock does not stand-alone but represents the company's assets. Since the value of the company's assets is changing, the borrower will not be able to return the same stocks he borrowed. For this reason, it is prohibited to lend stocks. The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) also rules that stocks cannot be borrowed mainly because a stock of a company today is not equivalent to a stock of the same company tomorrow.

Third: Some researchers such as Al-Salami did not look to stocks as fungible and non-fungible, neither to the company's assets. Al-Salami argues that lending stocks without interest is permissible and he considered lending stocks to be the same as lending paper money.

It is argued that a stock's buyer does not care about the company's assets and liabilities, but what matters is the market capitalization of the company which is represented by the company's stock price. Investors look at the value of the stock, whether its price is moving up or down.

Al-Masri, another contemporary researcher, did not explicitly permitted lending stocks. However he stated that dividing a company's assets into the above categories and building the ruling on the permissibility of lending stocks based on these categories is very complicated and not applicable. He added, that this complicated opinion means that lending stocks is not permissible, and it implies that the subject of the loan contract is the company's assets and not the stock itself.

¹¹ **The one-third rule:** It is a standardized investment screening measure that excludes companies with excessive debts or excessive interest income. It was justified in the grounds that if we did not allow any level of debt or interest, the universe of permissible equity instruments would be too small, leading to huge inefficiency relative to the overall universe of such instruments exploitable by conventional fund managers. The rule derives from the Hadith: Amir bin Sa'd bin Abi Waqqas narrated from his father, who said: "I was ill during the year of the Conquest (of Makkah) with an illness bringing me to the brink of death. So The Messenger of Allah (S. A. W) came to visit me, and I said: 'O Messenger of Allah (S. A. W)! Indeed I have a great deal of wealth and I do not have any heirs except my daughter, so should I will all of my wealth?' He said: 'No.' I said: 'Then two-thirds of my wealth?' He said: 'No.' I said: 'Then half?' He said: 'No.' I said: 'Then a third' He said: 'No.' A third and a third is too much. If you leave your heirs without need it is better than to leave them in poverty begging from the people." (Jami' al-tirmidhi, chapter on Wasaya). Although the rule has unrelated origin in inheritance law, it has been used by some contemporary Shari'ah scholars in other contexts. Based on this Hadith, scholars derive that income from non-permissible sources should account for less than 33%.

1.5.2 Sale of Objects Not Owned or Possessed by the Seller

There are four main arguments under this Shari'ah concern:

- Most scholars build their judgments on short selling based on the Hadith: "Do not sell what you do not possess"¹². This Hadith implies that a short seller cannot instruct his broker to sell short since neither the short seller nor the broker owns the stocks. We argue that this argument is not valid, because as stated in *Al Mahala* by Ibn Hazm (1960), and which is agreed upon in all Shari'ah texts: a borrowed item is the borrower's property; he has the right to dispose of the object by selling, renting, granting or endowing it. It should also be noted that the broker usually has permission to lend the stocks as it is usually stated in the contract signed between the brokerage firm and those who placed the stocks with the firm.

However, this argument is valid in case of naked or uncovered short selling, where the short seller is selling stocks that neither he originally owns, nor he borrowed them.

- It is also argued that short selling is prohibited because it is selling an object before taking possession (*qabd*), where the lender/ broker does not deliver the stocks to the short seller.

This argument is valid in naked short selling, where the broker sells the stocks short without arranging to borrow them, in the hope that before the maturity date he will borrow the stocks and deliver them to the buyer. In this case, the short seller is selling what he does not own or possess. However it is not valid in a covered short selling transaction because the possession (*qabd*) is satisfied. In a short selling transaction the seller first borrows the stocks before selling them. Borrowing stocks implies that the stocks are in the possession of the seller, which is evident by the loan contract.

- Some argue that since the short selling transaction involves selling stocks not owned or possessed by the seller, thus, such a transaction fall under the category of *bai' ma'dum* which is prohibited in Islam. The reason for the prohibition of *bai' ma'dum* is due to the presence of *gharar* because the delivery of the subject matter cannot be effected. As explained above, in a covered short selling transaction (which is the subject of this research paper), the seller owns and possesses the stocks, so *bai' ma'dum* does not exist here.

¹² Narrated by Abu-Dawud in his book (*Kitab Al-Ijarah*), Chapter: Regarding A Man Selling What He Does Not Possess: Narrated by Hakim Ibn Hizam: Hakim asked (the Prophet): Messenger of Allah, a man comes to me and wants me to sell him something which is not in my possession, I buy the goods for him from the market and then sell it to him. The Prophet replied: "Do not sell what you do not possess."

- Some applied the concept of bay' al-fudhuli¹³ to the practice of short selling, this is because the seller is selling stocks he does not own. Accordingly, it is argued that short selling is prohibited because bay' al-fudhuli is prohibited. This argument is not valid, because the concept of short selling differs from the concept of bay' al-fudhuli.

1.5.3 Interest Based Transaction

Evidence of interest or *riba*¹⁴ can be found in a short selling transaction:

- In a conventional short selling transaction, a stock is lent for fees. The imposition of charges for lending stocks in a short selling transaction is apparently against the Shari'ah principles. All jurists ruled that any additional amount over the loan is prohibited, whether the additional amount is minimum or excessive.

- As mentioned earlier in this Chapter, if the stock price continues to rise and the short seller does not have sufficient funds in his cash account to cover his position, then the short seller will begin to borrow on margin, thereby accruing margin interest charges.

- A broker may not impose fees for lending stocks, however, he may lend his own stocks to an investor and at the same time offers him a brokerage service for fees that exceed the fees in the market. In this case, a combination of a loan contract and *mua'awadah*¹⁵ exists, which is prohibited. The extra fees would be considered for granting the loan, which is deemed *riba*.

1.5.4 The Obligation of the Borrower to Pay the Dividends

As mentioned before, the loan transfers the ownership to the borrower. A borrowed item is the borrower's property; he has the right to dispose of the object by selling, renting, granting or endowing it. This implies that all benefits associated with the borrowed stocks should be transferred to the borrower. In the case of a company whose stocks have been shorted and the company is paying dividends, the dividends are in favor of the borrower. If the borrower sells the stocks, then the dividends should be in favor of the new owner. However, in a conventional short selling the investor holding an open short position is obliged to pay the amount of dividends to the lender of the stock.

1.5.5 Benefiting from the Collateral

Another issue in short selling is whether the lender/ broker

¹³ Al-fudhuli is the person who makes a transaction or signs a contract without a permission or *wakalah* from the owner. Example, when someone buys or sells for another, or rent on behalf of another, without being a legal proxy, guardian, or agent to conclude such a transaction. (Abu Zahra, 1976, pp. 394-395)

¹⁴ *Riba*, in Arabic, is increase or increment. With respect to financing, it is defined in Shari'ah as: any conditional or customary increment in debt (Kahf, n. d.).

¹⁵ *Mua'awadah* contract is a contract whereby a contractor delivers a value in return for a counter value. It is the opposite of gratuity contract where the value is not delivered or paid in exchange for a counter value. A sale or a lease contract is an example of a *mua'awadah* contract.

is entitled to benefit from the pledged money or collateral item. Some cite the Hadith of Ali (May Allah be pleased with him): "Every loan resulting in a benefit is riba."¹⁶ They argue that according to this Hadith, the lender is not entitled to draw any benefit from the pledged object in a loan contract. Moreover, in a short selling transaction, both proceeds and initial margin paid by the investor are held as collaterals with the broker until the investor returns the borrowed stocks. The broker may deposit the amount from proceeds and initial margin in a bank account that grants him interest. Alternatively, the broker may lend on interest the amounts to another investor who is buying on margin¹⁷. In case the collateral is stocks, the broker may lend these stocks on interest to another investor who is selling short. All these forms of investing the collateral include riba, which is against the Shari'ah principles.

Whether the lender is benefiting from the collateral or not, this argument should not be tight to the permissibility of lending stocks. Such an argument does not affect the ruling of lending stocks, the borrower is not responsible of how the lender is going to use the collateral.

1.5.6 Gambling

One of the criticisms against short selling is that the speculation involves in short selling transactions makes the transactions tantamount to gambling. Gambling is defined as a two or multi person game of chance which ends up in redistributing total stakes committed by the game's players among only one or a few of them (Tag El-Din and Hassan, 2007). It is argued that short selling is gambling because it is a zero sum game, that is, the gain of one party is at the expense of the loss of another party.

Like any financial instrument, short selling is subject to abuse when it is misused. Moreover, the problem here is not only with short selling, rather it is a problem with market regulations. The improper use of speculation turned the market into a place of gambling. Thus, an adequate market structure created through appropriate control and regulations is required to prevent the misuse of any instrument in the market.

1.5.7 Violates the Maslahah of the Society

Another criticism against short selling and in general the speculation activities in stock markets, is that these activities do not generate economic benefit. It is argued that speculation means the rotation of capital away from the production cycle, where the owners of capital will not invest their money in economic projects which benefit all members of society, but instead they will be

placing their capital in opportunities that may increase their own money. Speculators may lose when conducting such activities as short selling, where the liquidity may evaporate from the hands of speculators in hours, and the damage will return to the society as a whole if people lost their money in the financial markets. It is also argued that short sellers may attempt to bring a company's stock price down so much that it may create a problem for the company by undermining the confidence in the company. This is true, however, we find the shares' prices of some loss making companies are higher than the shares of winning companies, but surprisingly nobody is complaining or questioning the reason for the artificially high stocks' prices. There are many forms used in stock markets that attempts to bring a company's stock price to rise, guaranteeing a substantial profit to market players and the investors would bear a significant loss.

Moreover, short selling affects negatively the morality of members of the society. It feeds the bad side of the human being, where a collapse of a company or a collapse of the country's economy will be a source of happiness to the individual who will gain money from the misery of others and his country.

2. SHARI'AH COMPLIANT ALTERNATIVES TO SHORT SELLING

Since Shari'ah scholars do not permit short selling, some institutions and hedge funds claim offering Shari'ah compliant short selling solutions. This section outlines four approaches based on Ijarah, Salam, Arbun, and Wa'd as Shari'ah alternatives to conventional short selling. We will review the mechanisms of these approaches in order to find if they solve the Shari'ah concerns on short selling.

2.1 Ijarah Based Structure

In the mid of 1990s, the Malaysian Securities Commission looked to Ijarah as Shari'ah compliant alternative solution to SBL. The mechanism of Ijarah based short selling is as follows: instead of borrowing a stock, the investor will rent it and pay rental payments to the owner of the stock to compensate the owner for using his stock. At the end of the rent period, the investor will return the stock to the owner.

There are some criticisms against using Ijarah based structure as an alternative to conventional short selling:

- It is argued that the main character of Ijarah is that the lessor must own the leased property for the duration of the lease, therefore, the lessee cannot sell the stock to a third party because the ownership of the stock is under the lessor.
- Another problem with the Ijarah based structure is related to the validity of leasing financial and monetary assets.
- As stated by Nejad (2009), the main distinctions between Ijarah and short selling are: i) in Ijarah, the right

¹⁶ This Hadith is weak, however, that which alludes to its meaning has been reported from a group of the Companions.

¹⁷ When you buy securities on margin, you pay only a portion of the total cost, and a brokerage firm extends credit to you on the balance. An interest charge is made monthly to your account on the amount you borrow. From then on, the price of your security may go up or down, but the amount you owe your brokerage firm should remain relatively unchanged, varying only with the interest charges. (TD Ameritrade, 2013)

to benefit from the underlying asset is sold, but not the right to sell the asset itself as the case in short selling, and ii) in Ijarah, all the benefits associated with the leased asset are transferred to the lessee, while in short selling some benefits such as receiving dividends and participating in rights offering are not transferred to the short seller.

- Muslim scholars define an Ijarah contract as a contract for utilizing the usufruct of a specific object against a determined consideration. We think that in order to derive the benefit of a usufruct of an object, then the object that is subject to the Ijarah contract must be in the form of a tangible asset. An object that has no usufruct cannot be a subject to Ijarah contract and cannot be leased, which is the case with stocks. Let us think, what is the usufruct of stocks? Stocks are consumable objects; they cannot be leased.

2.2 Salam Based Structure

The Newedge Group launched its Shari'ah compliant platform for hedge funds in October 2005, and employed the Salam based short selling structure (Calder, 2010). Salam is a sale whereby the seller undertakes to provide some specific commodities to the buyer at a future date for an advance, mutually agreed price paid in full (Dar, 2007). The salam based short selling is a simultaneous cash sale and salam purchase of a stock (Nejad, 2009). In this structure, the owner sells his stocks to a short seller for cash. At the same time, the owner buys on salam the same amount of stocks from the short seller at an agreed price. Dividends and an amount equal to interest on proceeds of shorted stocks are included in credit purchase price. The ownership of the shares are transferred to the short seller instead of paid cash, so he can now sell them to a third party at market price.

The main criticism against the use of salam structure as a Shari'ah alternative to conventional short selling is that AAIOFI, in Standard 21 Financial Paper (Shares and Bonds) restricted the use of salam sale for shares. AAIOFI's justification is that a stock does not stand-alone. Instead, it represents a company's assets, and since the value of a company's assets is changing, a seller cannot deliver the same stocks requested by a buyer. However, the Malaysian Shari'ah Advisory Council (SAC) of the Securities Commission permits the use of salam sale for shares. The SAC view that shares can be considered a salam item as long as the shares are available in the market during the time of signing the salam contract. SAC argues that Regulated Short Selling (RSS) ensures that the shares can be found in the market and they can be delivered at the date of delivery. One of the criteria stated in the RSS is receiving a confirmation from an approved securities borrowing and lending agent that the share to be shorted is available or ready to be borrowed. In case the salam item (i.e., shares) is not available in the market at the date of delivery for some reasons such as a company

decision to suspend trading its shares, then the buyer has two options; either terminating the contract, or wait till the trading of shares is resumed. There is another situation where before the time of delivery, the seller is informed that the item is no longer available in the market. In this case, the seller has to terminate the salam contract.

The problem here is not only in the ability to return the stock, but rather in whether the delivered stock is similar to the sold stock given its underlying assets. However, SAC considered stocks as fungible items that can be lent, and does not look to the company's assets that represent the stock.

Salam based short selling covers the aim of conventional short selling, namely, benefiting from a decrease in stock price. There are some differences, however, which can be summarized in the following points: i) short selling involves borrowing stocks at interest, while in salam there is a sale, so no borrowing involved, ii) the dividends during the borrowing period belongs to the lender in short selling, while in salam the dividends are estimated and included in the price. The major concern over this salam based structure is its involvement of *Eina* sale. The owner sells via his broker the stock to a short seller, then buys them back through a salam contract on a different price, which is a clear *Eina*. Therefore, this structure involves borrowing on interest, because *Eina* sale boils down to borrowing on interest.

2.3 Arbun Based Structure

In 2008, Barclays Capital together with Shari'ah Capital launched Al Safi Trust Platform for hedge funds. Its short selling mechanism was based on Arbun structure (Calder, 2010), where Al Safi facilitates the transaction as a purchase and not as a loan¹⁸. Arbun sale is defined as a sale of present goods on down payment (earnest money) with the condition that delivery depends on payment of balance. Failure to pay the balance creates a right to seller over earnest money (Kahf, 2013).

A simple Arbun based shorting works as follow: The broker provides short seller the stocks at market price for a down payment (Arbun). This payment is equal to the margin account deposit in the conventional short sale. The short seller now has the ownership of the shares instead of the down payment, so, he can sell them to a third party at market price. At maturity, if the short seller decides not to complete the sale, he will return the shares and forfeit the Arbun earnest money. That is because in Arbun sale, if the buyer returns the Arbun item and decides not to take it, then the seller has the right to keep the earnest money. The short seller will close out the transaction by buying back the shares from the market and then returning them to the broker, who retains the down payment.

¹⁸ Shari'ah scholars approving Arbun short sale are: Shaykh Nizam Yaquby, Dr. Mohamed Daud Bakar, Dr. Mohammad Abdul Rahim Al. Olama, and Shaykh Yusuf Tala lDeLorenzo (Shari'ah Capital Inc, 2008).

The arguments against using Arbut based structure as a Shari'ah alternative to conventional short selling are as the following:

- Some argue that the arbut sale itself is prohibited by *Malikis*, *Shafi's* and *Hanafis* (Al-Salos, 2004). However, Imam Ahmed has allowed Arbut sale¹⁹. The OIC Fiqh Academy also approved the use of Arbut for Islamic banks and finance houses for the purchase of goods and shares²⁰.

- The broker is not entitled to sell shares on Arbut, because he does not have their ownership. He is only permitted to lend the shares not to sell.

- When the short seller sells the shares that he bought on Arbut sale, this is an explicit indication of conducting the contract, which means that the down payment is part of the price. This means that the short seller has to pay the net amount due to seller.

- Both the broker and the short seller entered into Arbut sale contract with intention of not completing the sale, because it was agreed at the time of entering Arbut sale contract that the short seller will return the shares. Therefore, this structure does not satisfy the purpose of classic Arbut sale, where returning purchased item is not certain as it is in Arbut short selling structure.

We think that naming this structure Arbut Based Short Sale is an attempt to mislead those who are looking for shari'ah compliant short sale alternative. This structure is far from the arbut sale; the mechanism of this structure differ from the classic Arbut sale. In Arbut sale, the buyer receive the goods only if he paid the reminder of the payment, while in Arbut based shorting, the buyer receive the goods after making the down payment. In this structure, the buyer does not have to complete the payment in order to receive the goods.

2.4 Wa'd Based Structure

The Amiri Equity Alternative Strategies Fund (AEAS), which was launched by the London based Amiri Capital as its Islamic fund, uses the concept of Wa'd to enable short selling²¹. The structure is based on two binding promises (Wa'd) in combination with amurabaha contract²². A Wa'd based structure works as follow: The short seller buys stocks from a broker through a murabaha contract, for a murabaha price. Stocks will then be sold to another party

¹⁹ Some contemporary Shari'ah scholars such as, Al. Qaradawi, Al. Sanhoori, Wahab Al. Zuhaili, and Rafiq Al Masri also allowed the Arbut sale (Dirir, 2010).

²⁰ This was documented in the Journal of the Islamic Fiqh Academy, vol. 1, Number 8, p. 641.

²¹ This mechanism was approved by Shaykh Ali Al-Qaradaghi, Abdul Sattar Abu Ghuddah, Daud Bakar, and Aznan Hasan (Calder, 2010).

²² Murabaha contract is a sale at a specified profit margin. The term is, however, now used to refer to a sale agreement whereby the seller purchases the goods desired by the buyer and sells them at an agreed mark-up price, the payment being settled within an agreed time frame, either in instalments or lump sum. The seller bears the risk for the goods until they have been delivered to the buyer. Murabaha is also referred to as *bay'mu'ajjal*.

at market price. In addition to this, the broker will give a unilateral promise to the short seller to buy back the stocks in the future at a pre-agreed price. The short seller will also give a unilateral promise to sell the stocks to the broker at that date at the agreed price.

In his paper, Calder (2010) presented the mechanism adopted by Bursa Malaysia to replicate short selling using Wa'd structure. The mechanism has two main characteristics: First, there will be no lending and borrowing, instead the supplier of stocks (i.e., the lender in the conventional scenario) will actually sell the stocks to a central facilitation agency (CFA), which will then sell it to the user of the stocks (i.e., the borrower in the conventional scenario). The user will then sell the stocks back to the CFA, and CFA will sell it back to the supplier. The Wa'd agreement ensures that the user will sell the stocks back to the CFA, and that the supplier will buy the stocks back from the CFA at a pre-agreed price. In the Bursa Malaysia system each Wa'd is *Mulzim* (a binding unilateral promise).

The criticism against the use of double Wa'd structure is that it involves a bilateral binding promises on executing a future sale for the same asset, and for the same price. This is tantamount to a future sale contract, which is prohibited. Most Muslim scholars, such as, Sulaiman (1982), Mahmassani (1983), Al-Basit (1985), Khan (1988), and Usmani (1999) consider future contracts that involve short selling as invalid contracts, except for future delivery of salam contracts.

3. APPLICATION OF SHORT SELLING FROM A MUSLIM COUNTRY: EVIDENCE FROM MALAYSIA

Since Malaysia claims offering short selling that complies with Shari'ah principles, we will discuss in this section the short selling as applied in Malaysia to examine its compliance with Shari'ah principles.

3.1 Securities Borrowing and Lending (SBL) and Regulated Short Selling (RSS) in Malaysia

In 2011, the index provider FTSE Group had upgraded the Malaysia market to "Advanced Emerging" from "Secondary Emerging". As per FTSE Group, the existence of short selling and SBL are among criteria set for a "Developed" stock market. Malaysia is looking toward becoming a leading market in the ASEAN, hence, Bursa Malaysia has been providing investors with products such as Regulated Short Selling (RSS), which the Bursa claims is compliant with Shari'ah principles.

RSS and SBL was first allowed on Bursa Malaysia in September 1996, but it was then banned in September 1997 due to the Asian financial crisis. RSS and SBL were revived in January 2007, facilitated by the Central Agency model. In August 2009, over-the-counter market was introduced.

The total trade value of RSS reached MYR293 million (\$79 million) in June of 2013 from a zero base in March 2012, which reflects the market interest in this area. The SBL market was more active, where the total value of borrowing and lending reached MYR640 million (\$174 million) in June 2013. This growth is anticipated to continue following the approval in July 2013 of the removal of the 100 stock cap. The Bursa increased the number of stocks available for RSS and SBL from 100 to 171.

The SAC, at its 13th meeting held on 19 March 1998 resolved that SBL will be aligned to Ijarah principles in order for SBL to comply with Shari'ah principles. Nevertheless, the SAC used the principle of *Istihsan* based on *Maslahah* as an exception to the general Ijarah principles. This means that an exception should be made to allow the lessee (short seller) to sell the leased stocks to a third party. SAC argues that in addition to its benefit to the original stockholder, short selling is also beneficial to the whole market as it provides it with liquidity. The principle of *Istihsan* based on '*UrfKhas*, that is a customary practice accepted in economic activities, was also used by the SAC as a basis for the permissibility of SBL.

In addition, at its 69th meeting held on 18 April 2006, the SAC resolved that RSS is in compliance with Shari'ah principles because the inclusion of the SBL principles in RSS removes the element of *gharar*. The SAC argues that a short selling transaction involves selling stocks not owned by the seller, thus, such a transaction fall under the category of *bai' ma'dum* (i.e. an item that does not exist) which is prohibited in Islam. The reason for the prohibition of *bai' ma'dum* is due to the presence of *gharar* because the delivery of the subject matter cannot be effected. The SAC argues that if the element of *gharar* could be eliminated in RSS transactions, then the transactions can be classified as Shari'ah compliant. Therefore, they argue that the inclusion of SBL can ensure that the shares can be found in the market and they can be delivered at the date of delivery, which will eliminate the element of *gharar*.

3.2 Regulated Short Selling (RSS) in Bursa Malaysia

In Bursa Malaysia, the short selling is regulated under the Regulated Short Selling (RSS) and Securities Borrowing and Lending (SBL) guidelines. Since the short sale is a sale of a security that the seller does not own then, in order to deliver the security to a purchaser, the short seller must first borrow the security. If one sells short without first borrowing the security to make delivery, then the naked short selling occurs. In Malaysia, naked or uncovered short is not allowed. RSS must be supported by a Securities Borrowing and Lending (SBL) agreement to ensure that the seller is able to fulfil his settlement obligations with respect to short selling. However, the opposite is not necessary and a SBL agreement can exist alone and be carried out for purposes other than RSS. In

RSS, investors will have to borrow the stocks from the Central Lending Agency (CLA)²³, which charges fees of 2%, or over-the-counter, where fees are negotiated between the borrower and lender.

Researcher's Comment

As discussed in section two, claiming that short selling and speculative activities benefit the stock market through increasing the market's liquidity is incorrect. That is because the speculative activity in the secondary market is a tool to transfer capital gains among stockholders. What is happening here is selling and buying the same existing stock, which is just an exchange of positions of liquidity among the sellers and the buyers; there is no liquidity generated to the society. It is the brokerage firms as well as the market authorities who benefit from the high liquidity. Their profit depends on the volume of transactions they process; the more transactions in the market, the higher the profit of these companies. And the more transactions, the more fluctuation in stock prices, which has a negative effect on the market and particularly, on long term investors. Therefore, there is no *maslahah* for the society as claimed by SAC. It is surprising the use of the concept of *Istihsan* based on *Maslahah* by the SAC to legalize short selling in its Islamic Capital Market, as this could dampen the credibility of Islamic finance. The stock market is supposed to serve the long term finance tools, so it is not acceptable to buy a stock and sell it within few minutes, then claim that this action is beneficial to the society.

CONCLUSION

Through surveying the literature to examine the impact of short selling on stock markets, we found that most journal articles and research papers are strongly in favor of short selling. It is argued that a complete market should be a two way market, enabling benefit from both the upside and downside of the market price. By banning short selling, we will have a one way market where prices will be biased upward, which lead to the existence of artificially high stock prices. The literature and empirical evidences analyzed short selling show that short sellers help in finding overvalued stocks. Short sellers also play a disciplining role for companies by detecting questionable practices. It is also argued that short selling is an important hedging instrument, where investors can use short positions to offset other long positions they hold, thereby protecting their long positions from any adverse price movements in the future. Therefore, based on surveying the literature, we find that our first hypothesis;

²³ CLA is an agency managed by Bursa Clearing where all lending and borrowing take place. Investors cannot deal directly with the CLA; they have to go through an approved Participating Organization (PO) (also known as Stock Broker, which is licensed to trade in Bursa Malaysia) or an investment bank.

(H1): No benefit is derived from short selling, can be rejected. However, based on our discussion in section two, where we showed that the claims made to support and promote short selling are not really convincing to us, hence our first hypothesis is valid.

In this paper, we discussed the potential permissibility of short selling under the condition that the short seller is borrowing the stock before conducting a short sale transaction, and provided that the activities of the company whose stocks being shorted are shari'ah compliant. We investigated how Muslim scholars view the practice of short selling. We found that the main concerns that Muslim scholars have against short selling are: 1) the eligibility of stocks as object of a loan contract; 2) the fact that the seller does not own or possess the stocks he sells; 3) it is an interest-based transaction; 4) the obligation of the borrower to pay the dividends; 5) the lender/ broker is benefiting from the collateral which is not allowed from a shari'ah view; 6) it involves gambling; and 7) it violates the *maslahah* of the society.

However, we found that the most discussed problems in short selling in the literature were mainly two problems: first, the seller is selling something he does not own; with the majority citing the Hadith, "Do not sell what you do not possess". Based on this Hadith, some shari'ah scholars argue that short selling is prohibited because one cannot sell what he does not own. We showed that this argument is not valid because before selling the stock short, the short seller first borrow this stock. And a borrowed item is the borrower's property: he has the right to dispose of the object by selling, renting, granting or endowing it. In addition, the broker has the permission to lend the stocks as it is usually stated in the contract signed between the brokerage firm and those who placed the stocks with the firm. The second most discussed problem in the literature is whether stocks can be subject to a loan contract or not. There is a long debate on this issue where scholars are divided between those who permit lending stocks and those who prohibit lending them. The debate is based on how shari'ah scholars look at the stock, i.e., scholars looking at the stocks as fungible or non-fungible objects; scholars looking to the company's assets that issued the stocks; and scholars looking to the stock as a financial value. Dividing the company's assets into categories, i.e. cash, tangible assets, debts, and finally a combination of the three (cash, tangible assets, and debts) and building the ruling of the permissibility of lending stocks based on these categories is not practical or logic. In fact this unrealistic opinion means that lending stocks is not permissible and it means that the subject of the loan contract is the company's assets and not the stock itself.

We also found that in short selling the lender/ broker imposes interest for lending stocks, which is apparently against shari'ah principles. Moreover, before an investor can enter into a short sale transaction, a margin account will be opened for him. If the stock price continues to

rise and the short seller does not have sufficient funds in his cash account to cover the position, the short seller will begin to borrow on margin, thereby accruing margin interest charges. In this paper we showed that the practice of short selling violates the *maslahah* of the society. That is because the practice of short selling and in general, the speculation activities in stock markets, do not generate economic benefit. Such activities rotate the capital away from the production cycle. In addition, the liquidity may evaporate from the hands of speculators in hours, and the damage will return to the society as a whole if people lost their money in stock markets. Short selling also cause a temporary reduction in the value of shorted securities when investors short them in high volumes. By selling the borrowed stocks, short sellers create an excess market supply of the shorted stocks. Selling the borrowed stock causes the stock price to decline even if the actual market demand for the stock does not change. And by bringing a company's stock price down, this may create a problem for the company by undermining the confidence in the company. Moreover, short selling affects negatively the morality of members of the society.

Therefore, since *riba* is used in conventional short selling, and since such facility violates the *maslahah* of the society, we find that our second hypothesis (H2): Short selling does not comply with shari'ah principles, is valid.

In this paper, we outlined four techniques to replicate conventional short selling based on *Ijarah*, *Salam*, *Arbun*, and *Wa'd* structures. These methods attempted to overcome shari'ah problems in conventional short selling, including the issue of ownership, the issue of interest involved in lending stocks, and the issue of eligibility of lending stocks. Based on our analysis of the mechanisms of each structure, we found that all the structures involve unresolved shari'ah issues. We found some shari'ah problems in the *Ijarah*, *Salam*, *Arbun*, and *Wa'd* structures, and we think that these techniques should not be considered as shari'ah alternatives to conventional short selling. In this paper we reviewed the short selling facility as applied in Bursa Malaysia and examined its compliance with shari'ah principles. In Bursa Malaysia, the short selling is regulated under the Regulated Short Selling (RSS) and Securities Borrowing and Lending (SBL) guidelines. Regulated means, among other things, that naked short selling is not allowed; the short seller must first borrow the security before conducting a short sale transaction. The SAC used the concept of *Istihsan* based on *Maslahah* to legalize the short selling in its Islamic Capital Market. They claim that short selling is not only beneficial to the original stockholder, but it is also beneficial to the whole market as it provides it with liquidity. We argued that what is happening is no more than exchanging of positions of liquidity among the sellers and the buyers; there is no liquidity generated to the society. It is surprising the use of the concept of *Istihsan* based on *Maslahah* by the SAC to legalize short selling

in its Islamic Capital Market. Such use to the concept to legalize what serves the benefits of the regulators could dampen the credibility of Islamic finance. Moreover, Bursa Malaysia charges fees for lending stocks, which is *riba*.

RECOMMENDATIONS

(1) The Lending and Borrowing facility was recently launched at the QE, the facility is available for use by liquidity providers and as a tool to cover settlement failure when sold stocks cannot be delivered at the time of the transaction. In order to avoid the penalties that can occur from settlement failure, stocks can be borrowed at fees. Moreover, during the writing of this research paper, the QE introduced another new facility which is, margin trading, in an attempt to diversify the market and enhance liquidity. Therefore, if short selling is to be launched in the near future, we believe that the QE should already have the regulations in place for this facility. This is mainly because most of the regulations set for the Lending and Borrowing facility and the margin trading can be applied to the short sale facility.

(2) We must keep in mind that short sellers are well informed investors and skilled in selecting companies that exhibit lower returns in the future. Such skilled investors are rare in the Qatari market, however. Some research shows that only 1% of investors in the Gulf Cooperation Council (GCC) markets have technical and fundamental analysis skills in the stock market. Since the QE is attempting to increase the ownership of foreign investors from 25% to 49%, many foreign investors will enter the Qatari stock market. These investors are very well educated and skilled, which means that they have technical and fundamental analysis knowledge in stock markets. So, the foreign investors will be the beneficial from introducing short selling in the Qatari market, and the Qatari investors will be the big losers in this case. Therefore, we have to educate the Qatari investors first before introducing the short selling facility.

(3) We cannot deny that stock markets became places for pure gambling and games of luck. There is a problem with the regulations in all stock markets that need to be adjusted. The markets' regulations need to be improved to bring the markets out from their current gambling image. With the current status of stock markets being a place for gambling, introducing short selling in the QE will facilitate and increase the opportunity of gambling. We understand that the QE is aiming to attract international investors thus, introducing new instruments that will attract these investors. However, if short selling provides some benefits in developed markets, this does not mean it will be beneficial for the QE. The market is still considered a small market comparing to other markets in the GCC, and the market is controlled by the sovereign funds and big investors. So, it is these big

investors who will likely use short selling and play with stock prices. What we need is a market stability through introducing regulations that enhance market efficiency, increase transparency, enhance regulators' responsiveness to market volatility and market failure, and enforce anti-abuse laws.

(4) Introducing short selling will affect negatively the morality of people. Is it moral to reap money from the decline and collapse of a company? Is it moral for fund managers and trustees of pension funds to lend shares of companies knowing that these loans will facilitate short selling in a manner that could affect the value of those shares? Introducing short selling will feed the bad side of human being, where a collapse of a company or a collapse in the country's economy will be a source of happiness to the individual who will gain money from the misery of others and his country.

(5) Investing in stock markets is notably increasing. People are buying and selling stocks whether it is for the purpose of long term investment, or for the purpose of short term speculation. Many of whom are unaware of shari'ah ruling in investing in stock markets, therefore it is incumbent on scholars to clarify to people what is permitted and not in such investments.

(6) Islamic stock markets have not developed as Islamic banking system. This is mainly due to: 1) lack of shari'ah compliant tools used in stock markets, 2) lack of clear shari'ah guidance in this sector, 3) lack of market infrastructure for Islamic securities, and 4) lack of innovations and researches related to this sector. We would like to point to the fact the some shari'ah scholars' interpretations of Islamic laws are applicable to the classical age of Islam, where there was no complex economic system. Scholars are far away from advanced tools of capital markets, so it is highly recommended to have scholars who possess the knowledge in stock markets along with the shari'ah knowledge. We have to encourage shari'ah scholars to introduce new tools that comply with shari'ah principles to fill the gap in Islamic capital market.

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