



Shari'ah Issues in Short Selling: Critical Analysis and The Alternatives

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ABSTRACT

This study aims to investigate the Shari'ah issues related to short selling and a discussion on its alternatives. Short selling refers to selling the stocks that the seller does not own, expecting a price decline, and then the seller will be able to repurchase it and profit from the price difference. The study critically discusses three Shari'ah issues related to short selling: the issue of selling something without having possessed, the issue of getting any benefit out of a loan, followed by the issue of gambling and speculation in short selling. This is a library research study, which critically analyses the issues with the help of secondary data comprising the related academic materials in both English and Arabic languages. The study finds that with the presence of few Shari'ah issues, the practice of short selling does not comply with Shari'ah injunctions. Furthermore, in the context of Malaysia, though the inclusion of Securities Borrowing and Lending (SBL) principles in Regulated Short Selling (RSS) reduce uncertainty (*gharar*), it does not make the practice of short selling fully complied with Shari'ah principles. Finally, the study discusses the incorporation of *wa'd* (promise) and *salam* (forward delivery sale) in the practice of short selling.

Keywords: Gharar, Short Selling, Shari'ah, SBL, RSS

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INTRODUCTION

Short selling is the execution of the sale of securities that one must buy in the market for completing a sale. Consequently, the seller does not own what he has sold. After completing the sale, the seller hopes the market prices will drop, which let him buy low what he has sold high. This transaction does not comply with Islamic principles since it involves selling what one does not own. Also, other issues contradict the Shari'ah principles, which are benefiting from a loan contract and the issue of gambling and speculation in short selling.

From financial and economic perspectives, short selling has its good and bad. It helps to get rid of market inefficiencies, which makes arbitrage possible. Other than that, investors can use short selling as a tool for hedging with vulnerability to falling prices of stocks but cannot to sell promptly. The thing that is bad in short selling from the perspective of trading is the potential loss from its strategy is hypothetically boundless. Based on the macroeconomic perspective, unrestricted short selling pressure could bring to a slump in share prices.

The prime reasons for short selling are speculation and hedging. Financial managers and investors basically focus on the overpriced stocks in the market. They speculate that their prices will drop and accordingly, they sell short. Due to various risks involved, few managers just do not simply depend on speculation. Instead, they use short positions to offset the long

positions they hold and thereby hedging their investment and future (Ramli, et al., 2013).

Therefore, the Securities Commission (SC) of Malaysia has ratified the new securities borrowing and lending guidelines (SBL) in view of the launching of the Malaysian financial futures and options market. SBL is a form of short selling that one borrows a security and then sells it, and later he must buy it back in the market to return to the lender. SC Malaysia introduced SBL at the end of 1995 to regulate short selling. However, it was suspended due to financial crisis at the end of 1997. Then, SBL is reinstated and during the 69th meeting on 18th April 2006, the Shari'ah Advisory Council (SAC) of SC sorted out that regulated short selling (RSS) is Shari'ah compliant as the addition of SBL principles in RSS reduces the element of uncertainty (*gharar*). The permissibility of short selling is based on public well-being (*istihsan* with *maslahah*), and this is to provide a clear advantage to the actual shareholders and to inject liquidity into the market. Also, short selling is allowed based on specific customary practices (*urf khass*) and particularly based on the market norms (*urf iqtisadi*), as short selling is a normal practice accepted in economic activities (Resolution of the SAC of SC Malaysia, 2007).

However, there are a couple of Shari'ah issues been raised against the validity of short selling. The practice of short selling goes against the known Shari'ah ruling that says selling

something that is neither available nor possessed is invalid. Also, the practice of short selling does not comply with the Shari'ah maxim says, 'any loan that brings benefit is riba'. In the coming sections of the paper, a few Shari'ah issues related to short selling have been critically examined along with a discussion on the alternatives to short selling. This is a library research study, and it has been accomplished based on the secondary data including the related academic materials in both English and Arabic languages.

LITERATURE REVIEW

Definition of Short Selling:

Short selling is a sale of a security such as common stocks that does not own by the seller at the time of sale. To simplify, short selling is regarding to sell what a person does not own. Short sellers usually expect that they have a possibility to buy the stock at a price lower than the price that they sold short. Hence, to have an understanding about Islamic position on short selling, one needs to know about the practical operation and investors' profit-maximizing behaviour.

Bursa Malaysia defines short selling as 'the action of a person selling shares which he does not own at the time of selling'. In addition, BNM (2014) defines short selling as 'a sale of eligible securities where the seller does not have presently exercisable and unconditional rights to vest the eligible securities in a purchaser at the time of the sale' (ISRA, 2015).

Regulated Short Selling:

In Bursa Malaysia, short selling is regulated under Regulates Short Selling (RSS) and Securities Borrowing and Lending guidelines (SBL), which were introduced to the market in January 2007 (ISRA 2015). Bursa Malaysia defines Regulated Short Selling (RSS) as "the selling of approved securities where the seller does not, at the time of the execution of the sale, have an exercisable and unconditional right to vest such securities in the purchaser but has, prior to the execution of the sale, executed an agreement to borrow the approved securities as will enable delivery of the same to be made to the purchaser under the said sale, in accordance with the Rules relating to delivery and settlement" (Bursa Malaysia, 2006).

In other words, RSS means investors sell a share that he does not own but have to borrow from the Central Lending Agency (CLA). It is managed by Bursa Clearing which lending and borrowing activities take place. As mentioned above, short selling indicates sale of a security that does not own by the investor during the transaction. Its concept involves borrow stock that investors do not own and then sell it. Then, investors buy and return the stock when the price falls.

Operation of Short Selling:

This section explains how short selling is transacted in the stock market. Let say Nurul foresees that Mudajaya Group Berhad common stocks, and it is overpriced at RM 20 per share. She wants to benefit from it if her judgment is correct. Then, she calls her broker, Mr. Afif, specifying that she wants to sell 100 shares of Mudajaya which is she does not own. As Nurul's broker, Mr. Afif will do two things which are to sell 100 shares of Mudajaya on behalf of Nurul and set out to borrow 100 shares of the stock to deliver to the buyer. Proceed at the second option. Mr. Afif manages to sell the stocks for RM 20 and borrows them from Ain. Then, the shares will be delivered

to the buyer. This kind of activity is allowed in the Malaysian stock market under SBL guidelines.

From the above sale, the proceeds will be RM 2,000. But it does not go to Nurul since she did not give yet to Mr. Afif the 100 shares. Therefore, Nurul is considered to be "short 100 shares". Let say after five days, Mudajaya's price falls to RM 15 per share. Nurul may order her broker to buy 100 shares of Mudajaya which will cost her RM 1,500. Then, those shares will be delivered to Ain, who was lending out her 100 shares at the first place. Hence, Nurul does not has any commitment towards her broker, Mr. Afif or to Ain. In other words, Nurul has covered her short position. She then now authorized to the funds in the account generated from the selling and buying activities.

As a summary from the example, Nurul sold the stock for RM 2,000 and bought it for RM 1,500. So, she made a profit amounted to RM 500. She has no exception to pay some fees like commissions, fees charged by Ain as the lender of the stock and also dividends paid by Mudajaya Group Berhad. If let say the share price increases to RM 28, Nurul will lose RM 800 since she has to cover her short position (adapted from ISRA, 2015; Farj, 2013).

CRITICAL ANALYSIS

Issues in Short Selling:

One needs to understand that there are two contracts involve in short selling which are sale and loan contract. Sale contract happens when the seller sells the stock that he does not own, meanwhile, loan contract happens when the seller borrows stock from the original owner of the stock through a broker as an intermediary and then sells the stock to the buyer. The owner of the stock may charge fees and gets some profit from the transaction out of lending the stocks. Hence, this section will discuss about three main issues. They are selling of what one does not own, benefiting from a loan contract, and the issue of gambling and speculation in short selling.

Selling what the seller does not own:

The first issue to be discussed is selling what the seller does not own. In order to validate a sale contract, *mahall al-'aqd* or the other name is *ma'qud 'alayhi* (objects in trade) must be existed. It is also must be owned at the time of the contract.

According to Imam Abu Hanifah, Imam Shafi'i and Imam Malik, the meaning of the hadith "do not sell what you do not possess" is that one cannot sell what he does not own (Ministry of Awqaf and Islamic Affairs, 1987). However, owning something or possession is not the main issue according to Imam Ahmed Ibn Hanbal, Imam Ibn Taymiyyah and Ibn Al-Qayyim but, the ability to deliver it is the issue. According to majority of the jurists, the meaning of "do not sell what is not with you" is not to sell what one does not own during the time of sale. In short selling concept, this hadith explains that nobody whether the short seller or the broker are possessing the stocks. Hence, the transaction cannot be proceeded. This argument is arguable in case of naked or uncovered short selling where the stocks is sold by the seller that he does not own or that he borrowed them (Dusuki & Abozaid, 2008).

In Arabic term, *qabd* is taking possession of an object of sale or exchange. *Qabd* is not an essential element in sale but a supplementary condition, according to Hanafis. An authentic sale by uncertified person that does not own the object but sell

it is considered plainly validate. The sale is considered valid but only becomes effective after getting permission from the owner. Therefore, as mentioned above, *qabd* is not a precondition for a contract to be valid. In other words, it can be delayed later. However, *qabd* is a precondition for a contract to be valid in *ribawi* items' transactions (Rahman, 2020).

According to Maliki, *qabd* is only pertain to food grains. Other than that, which means non-food grains, even before taking possession on it, it can be sold. Maliki has two viewpoints regarding to non-*ribawi* food. Firstly, it is forbidden before taking possession based on the opinion of Ahmad and Abu Thawr that food should be measured and weighed. The second viewpoint is that it is allowed. The real meaning behind 'do not sell what is not with you' based on the understanding of the latter jurists is not sell what one cannot deliver, and it is does not necessarily what one does not own. *Salam* and *istisna'* have no exceptions to the rule but are authorized contracts in their own right (Dusuki & Abozaid, 2008).

Salam is a contract where the seller is received payment in advance from the buyer. However, the purchased goods are delivered later at a certain date. The seller does not have to possess the goods that he sells, but there are certain conditions to be followed. Firstly, in *Salam* contract, the delivery date of the goods must be fixed. Secondly, the goods do not have to be necessary in the possession of the seller and also the payment must be made during the time of transaction. Other than that, it is only permissible for the goods that can be determined by quantity and quality (Rahman & Amanullah, 2020). Meanwhile, *istisna'* is an order-to-manufacture sale contract where a buyer gives instruction to produce something based on his preferences to the manufacturer. The subject matter is a product that must be made, and the buyer can pay anytime during the contract, which has been agreed during the time of contract (Rahman & Amanullah, 2019).

Non-existence of an object does not form a reason for banning, according to Ibn Qayyim. He said that because there is no prohibition in al-Quran and Sunnah on the selling of on-existing object. Also, based on the mentioned hadith, it shows that the legal effective cause is not non-existence but the uncertainty which indicates the incapacity to deliver it. Referring to Imam Shafi'i and others, it is only applicable to non-fungible objects, meanwhile, according to Ibn Taymiyyah and Ibn Qayyim, the prohibition to sell something is what the seller is incapable to deliver (Dusuki & Abozaid, 2008).

However, the prohibition of the hadith is no longer exists, according to Yusuf al-Qaradawi and some well-known contemporary jurists. It is because they compared the market of Madinah with nowadays market. It is obviously a different situation and reality. The instruments and equipment that is convenient nowadays reduce the inability to deliver.

This is in line with the question from Hakeem Ibn Hizaam that was responded by the Prophet SAW. Hakeem Ibn Hizaam inquired whether he can enter into a contract to supply goods which he did not have, and the Prophet SAW prohibited it. The jurists sense that Madinah was a small market and the probability of Hakeem entered into the contract to provide goods but unable to deliver it was the reason that Prophet SAW prohibited it. That is how the contemporary jurists came up with reasoning that behind the real meaning of "do not sell

what is not with you" is that it does not necessary what one does not own but, not to sell what one is unable to deliver (Dusuki & Abozaid, 2008).

However, the concept of *bay' al-fudhuli* were applied by some in the implementation of short selling. *Al-fudhuli* is the person who makes a transaction or signs a contract without a permission or *wakalah* from the owner. It is clearly forbidden in short selling since *bay' al-fudhuli* is forbidden, because the seller does not own the stocks he is selling. However, it is invalid to argue because the comparison of both concepts which are short selling and *bay' al-fudhuli* are different (Ramli, et al., 2013).

To recap back from the above discussion, it is only valid according to Ibn Taymiyyah and Ibn Qayyim regarding to the sale of what one does not own during the transaction in other than *Salam* contract. However, majority of scholars were unanimous that it is invalid. This is because, the element of uncertainty (*gharar*) that is very clear will bring argument between the parties involved. Islam is very meticulous. Because the element of uncertainty is high and to avoid any damage from occur, any transactions relating to *bay' ma'dum* (sale of something that does not exist) is clearly forbidden.

Nevertheless, the Shari'ah Advisory Council (SAC) of the Securities Commission (SC) of Malaysia has its own perspective that the element of uncertainty can be dealt in and therefore, get rid of it in the Regulated Short Selling with an incorporation of Securities Borrowing and Lending (SBL) principles. Thus, the SAC of Securities Commission sorted out that RSS is Shari'ah-compliant as the addition of SBL principles in RSS gets rid of the element of uncertainty (Resolution of the SAC of SC Malaysia, 2007).

Since with RSS the short seller sells stocks that he does not own but have to borrow it, hence, it can be borrowed from the Central Lending Agency (CLA). It is managed by Bursa Clearing which lending and borrowing activities take place. In other words, the sold stocks will be delivered without worrying the element of uncertainty. Therefore, it can be classified as Shari'ah-compliant since the uncertainty can be removed from the transaction.

Benefiting from a loan contract:

This is the second issue to be discussed. The issue raised because the original owner loans his stocks to the broker that is appointed by a short seller. It concerns whether the benefit that the original owner gets from lending the stocks is permissible or not.

There is an Islamic legal maxim states, "every loan resulting in a benefit is *riba*." Thus, no benefit shall be taken by the lender in return for a loan. Any form of benefit, whether tangible or intangible, shall be considered interest (al-Zuhayli, 2009). Irvine (2002) argues that profits are ill-gotten when they involve the misery of others. This argument is refined for the short selling setting by Angel and McCabe (2009), who posit that the profits from short sellers come from the financial suffering of other investors.

As Bursa Malaysia acts as a counter party, a minimum of 50,000 shares to a central lending pool will be given two percent return on lending to the original owner of the stocks which is based on the new Malaysian Short Selling regulation.

Any extra amount that is more than the loan is obviously forbidden even though the extra is the same type to the loan belongings or from contrasting type. The extra amount nullifies the consideration as the basis in a loan contract, although the extra is the smallest amount.

There are many sayings from the well-known regarding to this. According to Ibn Hazm, *riba* in loan can be in *ribawi* and non-*ribawi* belongings. Hence, it is illegal to return the loan less or more than the quantities or in a different type. As mentioned above, the basis in a loan contract is not to nullify the consideration as it is to help the borrower. That is why any extra amount is forbidden. Any increase or extra amount charged by the lender is contradict with the purpose of benevolent contract, even though the gain is only in particle size.

As stated, "any loan contract which benefits the lender amounts to *riba*", a maxim that is established by the scholars. It was initially described as hadith. However, the reliability of the hadith and its narrations was in questions and has been criticised. It is considered as a weak hadith, but scholars have endorsed its meaning. Majority of scholars allowed benefits on a loan contract only if it is not specified by any party and is given based on one's free will. However, Malikis School did not agree with the majority of scholars. According to Malikis, it is prohibited for the borrower to give any benefit or gift just to defer its debt. This also applies to the lender, which cannot accept the benefit or gift given by the borrower. But Malikis permit any increase in the repayment of debt without any condition if the debt is from a sale. It is clearly prohibited if the debt is from a loan, and it is specified by any party and was promised (Dusuki & Abozaid, 2008).

To be short, if the lender puts condition for any increase or profit as a return of the loan he gives, it is obviously prohibited and illegal. For any increase that is specified, Hanafis said that the condition for any increase in a loan contract that is specified is clearly invalid, but the contract is considered valid. However, according to Shafi'is, both the condition and the contract are invalid.

In the case of short selling, the stockbroker borrows the stocks from someone else in the market while the lender charges a fee for this service. Typically, this happens in the form of margin interest which the seller pays continuously to the stakeholder, until he has covered the position. Thus, this would be a prohibited practice as it falls under the category of a loan that brings benefit (Resolution of IFA-MWL, 2006; Ramli, et al., 2013).

Speculation and Gambling:

Speculation is one of the key issues that have been critically discussed with relation to the short selling. Although it is generally agreed that speculation is somewhat inevitable in business, particularly in the trading of stocks, many scholars argue that in short selling the speculative behaviour could leads to the uncertainty and gambling (Ramli, et al., 2013). 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). In short selling, it involves the speculation that is virtually the same as gambling. Similarly, within the gambling field, population surveys of gambling participation sometimes include questions about high-risk stocks,

speculative investments, and/or day trading in addition to traditional forms of gambling (Williams, et al., 2012).

Short selling resembles gambling when one party obtains gain on the losses or suffering of the other party. The issue of gambling is not only associated with short selling, but it is also related to the market regulations. Short selling may be misapplied if it is not handled properly, merely the same as other financial instruments. When the speculation is not used properly, it will make the market as a gambling place. Therefore, it is important to have a sufficient market structure designed in a proper control and ruling to stop misapply of the instruments in the market. Mostly, the short selling arrangement includes fraud, deception, misrepresentation, hoarding, artificial price hiking, which ultimately makes the contract falling under the category of consuming other people's wealth unjustly which is undoubtedly prohibited by Islamic rulings (Resolution of IFA-MWL, 2006; al-Sharif, 2006).

To sum up, there is a difference between a commercial speculation and that which is tantamount to gambling and transgression. If speculation has been done based on an educated guess depending on the careful consideration in the market movement, then it shall not be objectionable in Shari'ah. On this ground, speculation in short selling could be lawful as typically it is based on the learned consideration, subject to that it shall be intended for trade only and not for unnecessary speculation and gambling (Ramli, et al., 2013).

SHARI'AH-COMPLIANT ALTERNATIVES TO SHORT SELLING

This section discusses the alternatives to the short selling. Though short selling is not allowed by the jurists, there are perspectives that may result Shari'ah compliant alternatives to conventional short selling. They are known as *Wa'd* and *Salam* based structures.

Wa'd Based Structure

The structure of *Wa'd* is a merge with *murabahah* contract which is based on two irrevocable promises. The first step in *Wa'd* based structure performs as the stocks will be bought by the short seller from a broker for a *murabahah* price in a *murabahah* contract. After that, the stocks will be sold based on market price to the other party. Then, the broker will act his role by preparing a unilateral promise and give it to the short seller. The unilateral promise contains that the stocks will be bought back in the future by the short seller at a pre-agreed price. A unilateral promise will also be given by the short seller to the broker to sell the stocks at that date at the agreed price.

Bursa Malaysia adopted the based structure as presented by Calder (2010) to duplicate short selling by using *Wa'd* based structure. The based structure has two prime characteristics. The mechanism as presented by Calder (2010), there is no lending and borrowing transaction take place, in fact, the stocks will be sold by the stocks' supplier to a central facilitation agency (CFA). Then, the supplier of the stocks will sell to the user of stocks. After that, the stocks will be sold back to the CFA by the user and the supplier will receive the stocks back as the CFA sell them back to the supplier. Based on the example, *Wa'd* based structure will make sure that at the end of the agreement, the supplier will buy back the stocks from CFA at a pre-agreed price. It is known as a binding unilateral promise in Bursa Malaysia (Al-Yahri, et al., 2015).

Salam Based Structure

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). *Salam* based structure explains that the owner of the stocks sells his stocks for cash to the short seller. Concurrently, the same number of stocks will be bought by the owner from the short seller at an agreed price through *Salam*. Dividends and an amount equal to interest on proceeds of shorted stocks are included in credit purchase price. The ownership of the shares is transferred to the short seller instead of paid cash, so he can now sell them to a third party at market price (Al-Yahri, et al., 2015).

Constriction the use of *Salam* for shares by AAI OFI has been greatly criticised as a Shari'ah alternative to conventional short selling. The stock does not stand-alone, in fact, it involves the assets of the company. Therefore, a seller is unable to deliver to the buyer that requested for the same stocks since the assets of the company's value is changing. But the use of *Salam* for shares has been allowed by the Malaysian Shari'ah Advisory Council (SAC) of the Securities Commission. Shares can still be considered as item in *Salam* if it is obtainable at the execution of the *Salam* contract. Based on that reason, SAC permits the *Salam* based structure to be applied in Malaysia.

SAC believes that with regulated short selling (RSS), the existence of the shares in the market and the ability to delivery upon maturity can be ascertained. Based on the characteristic of RSS, if the investors who sell the shares that he does not own, they can borrow from the Central Lending Agency (CLA). It is managed by Bursa Clearing where lending and borrowing activities take place. If stock does not exist during the time of the delivery for a reason such as a company decides to discontinue for a while the trading of its stocks, buyer will have two options to decide. Firstly, buyer may decide to terminate the contract. Or secondly, buyer may decide to wait until the company continues the trading of its stocks. Conversely, if the seller knows in advance that the stock is not available before the delivery date, in this case, the contract must be terminated by the seller.

Short-Selling Application in Malaysia

This section discusses Shari'ah compliant short selling in Malaysia since Malaysia offers short selling that complies with Shari'ah principles. In Malaysia, there are two principles namely 'Securities Borrowing and Lending (SBL)' and 'Regulated Short Selling (RSS)' have been incorporated to offer a Shari'ah compliant short selling product. The inclusion of both SBL and RSS principles reduces the element of uncertainty (*gharar*) in short selling. Accordingly, application of these principles increases the possibility of delivery of the shares sold in short selling arrangement. Since the probability of delivery of the shares is high, the amount of *gharar* becomes minor and insignificant (ISRA, 2015).

Shari'ah Advisory Council (SAC) has its perspective that the element of uncertainty can be dealt in and therefore, get rid of it in the Regulated Short Selling with an incorporation of Securities Borrowing and Lending (SBL) principles. As mentioned previously, during the 69th meeting on 18th April 2006, the SAC of Securities Commission sorted out that RSS

is Shari'ah compliant as the addition of SBL principles in RSS that get rid of the element of uncertainty. Since with RSS the short seller sells stocks that he does not own but must borrow it, hence, it can be borrowed from the Central Lending Agency (CLA). It is managed by Bursa Clearing where lending and borrowing activities take place. In other words, the sold stocks will be delivered without worrying the element of uncertainty. Therefore, it can be classified as Shari'ah compliant since the uncertainty can be removed from the transaction (Resolution of the SAC of SC Malaysia, 2007).

Obviously, the application of naked or uncovered short is not permitted and not applicable in Malaysia. To make sure that seller can realize his deal obligations with respect to short selling, the Securities Borrowing and Lending (SBL) agreement must support the Regulated Short Selling (RSS). As mentioned previously, investors can borrow the stocks from the Central Lending Agency (CLA). It is managed by Bursa Clearing where lending and borrowing activities take place. CLA will charge 2% as a charge fee. Other than that, investors can borrow from over the counter and may negotiate the fees among the borrower and lender.

CONCLUSION

To sum up the transaction of short selling is where the investors borrow stocks and sell them. After that, the investors must return the same stocks. Based on these three issues discussed, we can conclude that there is still defenceless issue that need further study and resolution. Even though the issue regarding to the ownership of stocks could be resolved, other issue still need an attention. As discussed, the issue regarding benefiting from the loan contract is considered *riba*. This is because any increase that has been specified is disallowed. Hence, Shari'ah Advisory Council (SAC) needs to look again into the permission of the Regulated Short Selling (RSS) transaction.

SAC should investigate every aspect so that there will be no issue arises in the transaction. SAC needs to overcome other issue which is the *riba* issue since what SAC considered was only regarding to the issue of *bay' ma'dum*, i.e., sale on non-existent item. The Shari'ah alternatives to short selling could be implemented frequently as it will become common with people involve in short selling. However, SAC needs to come with resolution on the issue of benefiting the lender as it is should be top priority of concerned. This is because it is clearly forbidden for a specified profit. But it seems that this issue has been settled but still, there is a need to investigate again and to come up with a new regulation to all the players in the market. Nevertheless, further studies need to be done to work out on the alternatives to short selling as found that the current practice of short selling does not fully comply with Shari'ah injunctions.

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