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CREATING A TWO-WAY MARKET VIA SHORT SELLING AND ITS POTENTIAL USE IN THE ISLAMIC PARADIGM

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ABSTRACT

Short selling is the selling of a security that the seller does not own. In conventional finance, the ability to short is considered an important element of an efficient and complete market. For most Muslim scholars, however, short selling is deemed undesirable when read in conjunction with the HadÊth *lÉ tabiÑ mÉ laysa Ñindaka,* which carries a verbatim meaning of *sell not what is not with you.* There are, however, alternative interpretations of this Hadith that may justify the use of covered short selling as one of the legitimate instruments in the Islamic paradigm. Covered short selling, which entails borrowing a security for the purpose of shorting it, may be used efficiently to lower asset prices, as theorized by Miller (1977). This paper discusses about the short selling mechanism and argues that short selling may be beneficial to consumers in an Islamic market as it creates a two-way market mechanism and can be used to stabilize asset prices.

JEL classifications: G14, G18, G32

Keywords: Short selling, Islamic paradigm, Islamic finance, Market, *Fiqh*

1. INTRODUCTION

Generally speaking, the average person in the street associates short selling with stock market crashes and perceives it as bad news. In September 2008 during the recent financial crisis, stock market regulators in 30 countries, including Australia, France, Germany, the UK and the US, imposed a ban on short selling in order to stabilize the stricken financial markets, only to find that the ban was detrimental to market liquidity (Beber and Pagano, 2013). Little does the public know that, contrary to what they believe, short selling may assist in price discovery. When short selling is allowed in a stock market, the stock market becomes a two-way, and therefore complete, allowing market players to participate on both sides hence promoting full price discovery (Lamba and Ariff, 2006).

The history of short selling can be traced back to the seventeenth century. According to Bris, Goetzmann and Zhu (2007), the practice was first discovered in February 1609 in the Netherlands, when a group of Dutch businessmen sold short shares in the East India Company. A year later, the East India Company's shares dropped by 12% and, while the shareholders suffered, the Dutch businessmen made huge profits. The Amsterdam bourse later imposed a ban on short selling, although the regulator argued that the drop in the East India Company's share price had been due to poor business decisions rather than the short selling.

In Malaysia, short selling was made legal on certain approved stocks in October 1996. It was then banned in August 1997 before the ban was lifted once more in January 2007. Prior to October 1996, the Malaysian Finance Ministry had proposed mandatory caning as a punishment for short selling, but the proposal was not passed by Parliament (Lamont, 2004). Since January 2007, covered short selling on certain approved stocks is allowed, although only to big institutional investors and not to small retail investors.

Short selling is considered impermissible by most Muslim scholars. Recently, however, some Muslim scholars have reexamined the permissibility of futures transactions (which includes short selling) Kamali (2007) wrote:

> "Part of the problem is also due to the fact that the *SharÊÑah* advisors to Islamic banks and institutions are inclined to limit their understanding of *SharÊÑah* only to the *Fiqh* textbooks at the expense often of the dismaying economic predicament of the Muslim masses".

The key argument against selling short in the minds of Muslim scholars is the interpretation of the HadÊth *lÉ tabiÑ mÉ laysa Ñindaka (*sell not what is not with you*).* Some Muslim commentators argue that the subject matter of a sale must exist and be owned at the time of the contract, failing which the contract is deemed null and void.

This paper takes an optimistic view on short selling. There are many benefits that can be offered by short selling in terms of helping price discovery and stabilizing asset prices in the marketplace. According to Mohamed Ariff (1997), the marketplace in in an Islamic paradigm is the one that is restrained by Islamic morality and ethics. We believe with a proper short selling regime, the marketplace efficiency can be enhanced without compromising Islamic morality and ethics. Thus, the main aims of this paper are several fold. First and foremost, we attempt to discuss the arguments made by both the proponents and opponents of short selling. There is much we can learn from the conventional wisdom given by the two factions. On the one hand, proponents of short selling believe that, without it, the market will be a one-way market and that asset prices will be biased upward, artificially, making asset bubbles inevitable. On the other hand, opponents argue that the practice gives a false impression as to the supply of shares on offer, thus depressing the stock price artificially. In addition, we shall look at Miller's (1977) argument on why short selling will result in a lower stock price. Secondly, we attempt to explain the potential use of short selling within the realm of possibility of the *SharÊÑah*. Our argument is in line with Kamali's (2007) interpretation of the Hadith *lÉ tabiÑ mÉ laysa Ñindaka (*sell not what is not with you*)*. Finally, we attempt to draw a line between the two types of short selling, namely, covered and naked short selling. In particular, we want to explain the institutional setting of short selling and its mechanism by which the clearing house, being the central depository of stocks, assumes the counter-party risks and ultimately eliminates the element of risk and uncertainty in the practice.

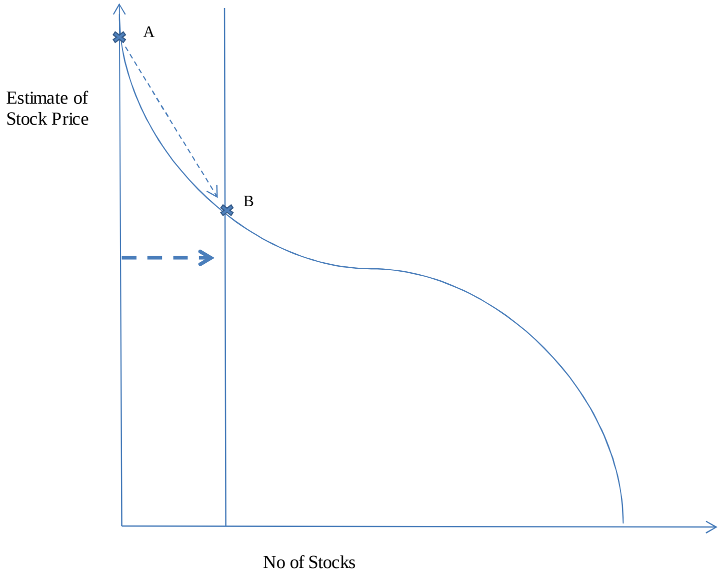
This paper contributes to the growing literature on short selling in several ways. To the best of our knowledge, there is hardly any research on the potential permissibility of short selling within an Islamic paradigm. Studies on Islamic legal analysis mainly discussed the permissibility of commodity futures, derivatives and options (see Kamali, 1996; 1997; 1999; 2007) within the futures setting in which researchers tend to compare futures with *salam* and *istisnÉÒ* (see Sulayman, 1982; Mahmassani, 1983; al-Basit, 1985; Khan, 1988; Usmani, 1999). In this paper, we discuss the potential permissibility of short selling as an instrument within the wide scope of *fiqh* opinion, on the conditions that the short selling is preceded by the borrowing of stocks, and that the stocks are *SharÊÑah*-compliant. Secondly, this paper looks at the interpretation of the Hadith "*lÉ tabiÑ mÉ laysa Ñindaka" (*sell not what is not with you*)*, as carrying a meaning of "sell not what you cannot deliver" and here we discuss at length the function of a clearing house that undertakes novation and assumes the counter-party risk, hence eliminating default risk between the buyer and seller. Finally, we claim that, with this paper, we are the first to discuss the potential use of short selling within an Islamic paradigm as a means to stabilize soaring asset prices, as developed by Miller (1977). We would like to reiterate that the disadvantage of having a one-way market without short selling is that there is a tendency for the buyers to corner the market, and the public are forced to pay the price. We argue that a regulated, covered short-selling regime, within the spirit of justice, is very much desirable as it can bring good to the Muslim *ummah* as a whole.

The remainder of this paper deals with related literature on the price effects of short selling. We provide a discussion of the interpretation of the HadÊth *lÉ tabiÑ mÉ laysa Ñindaka (*sell not what is not with you*)* with regards to short selling in Section 3. Section 4 offers some concluding remarks.

2. RELATED LITERATURE ON SHORT SELLING AND PRICE EFFECTS

The effects of short sale constraints on stock prices and market quality have been subject to a long and arduous debate between theoreticians, with discussions of the price effect being more dominant. Early analytical studies on short sale constraints, by Miller (1977) and Figlewski (1981), stress that it is pessimists who want to sell short. Constraining pessimists without constraining optimists will result in an upward bias in stock prices. Further, according to Miller, the effect of short selling on the supply of a particular stock is analogous to the effect of a bank on the supply of money. The bank borrows currency, agreeing to replace it upon demand, and lends it to a third party. The depositors act as if they still had possession of the money loaned, since they can regain it on demand. They do not care whether their deposited currency is loaned out. The immediate result is that short selling increases the supply of stocks on the market by the amount of the outstanding short position. Figure 1 shows the effect of short selling, whereby the vertical supply curve is moved to the right by the amount of the short position, lowering the stock price. Likewise, Miller specifically hypothesizes that, where stocks are subject to short sale constraints, the stocks will be overvalued. In short, Miller (1977) argues that short selling will result in lower stock prices, and constraining short selling will result in an overvaluation of stocks.

FIGURE 1
Supply and Demand Curve for Stocks under a Short Selling Regime



Note: This figure shows the demand and vertical supply of stocks curves under a short selling regime. According to Miller (1977), the effect of short selling on the supply of stocks is to increase it by the amount shorted. As a result, the vertical supply curve will move to the right, hence the stock price will drop from point A to point B.

Diamond and Verrecchia (1987), however, strongly challenge Miller's analytical work using the rational expectations framework. While they agree that short sale constraints eliminate some informative trades, they stress that this will not result in an upward bias because investors and traders, being rational, fully recognize the constraints and adjust their valuations accordingly before making any trading decisions. As far as the price effect is concerned, Diamond and Verrecchia's (1987) "no overpricing" theory clearly contrasts directly with Miller's overvaluation theory.

Further, Diamond and Verrecchia (1987) carefully demonstrate the distinction between short sale restriction and short sale prohibition. They give an example of a short sale restriction whereby an additional cost is imposed on borrowing in order to sell short. This restriction makes short selling less attractive, so that only investors that are relatively informed and have a strong belief that the price will decline significant will choose to short. Thus, a restriction changes the proportion of informed traders by driving out more relatively uninformed than informed traders from the pool of short sellers. Based on this notion, Diamond and Verrecchia (1987) argue that short sale restrictions increase the information content of short sale transactions and actually increase informational efficiency. On the contrary, short sale prohibition (or a short sale ban) eliminates short selling by informed and uninformed traders alike, which, Diamond and Verrecchia (1987) argue, leaves the proportion of informed traders in the pool of short sellers unchanged. As a result, it reduces informational efficiency, especially with respect to bad news, which can be interpreted as a reduction in market quality.

Hong and Stein (2003) develop a theory stating that short sale constraints prevent bearish investors from participating in the market, and that, with bearish investors' signal concealed, only bullish investors' information is revealed in the stock price. They argue that, if some bullish investors start bailing out, then the original bearish group may become "support buyers", and more bullish investors will suddenly become aware of the bearish group's earlier concealed bearish signals, causing the market to decline or even crash. Bai, Chang, and Wang (2006) theorize that short sale constraints result in marginal investors, who are rational but risk-averse, perceiving a higher risk to be associated with constrained stocks. This perception of higher risk causes the risk-averse investors to reduce their demand for the stocks, hence depressing the stock price and increasing the stock volatility.

The majority of the empirical evidence with respect to the price effect of short sale constraints is tilted in favor of Miller's (1977) overpricing hypothesis. The proxies for short sale constraints, however, are very diverse, including the level of short interest or the short interest ratio (Figlewski, 1981; Asquith and Meulbroek, 1995; Desai, Ramesh, Thiagarajan and Balachandran, 2002; Asquith, Pathak, and Ritter, 2005), the introduction of options trading (Figlewski and Webb, 1993; Danielsen and Sorescu, 2001), the stock lending supply (D'Avolio, 2002; Geczy, Musto, and Reed, 2002; Jones and Lamont, 2002), the percentage of institutional ownership (Chen, Hong, and Stein, 2002; Asquith, Pathak, and Ritter, 2005; Nagel, 2005), and the designated or "allowed-to-short" list (Chang, Cheng, and Yu, 2007). Multi-country studies are adopted by Charoenrook and Daouk (2005) and Bris, Goetzmann, and Zhu (2007) to investigate the effect of short sale restrictions on market quality in each country. Charoenrook and Daouk (2005) find that when short selling is possible, the aggregate stock return is less volatile and liquidity is higher. Similarly, Bris, Goetzmann, and Zhu (2007) report that countries that allow short selling tend to have reduced capital inflows, implying higher market efficiency.

Empirical studies of short selling ban can be seen as direct tests of Miller's (1977) overpricing and Diamond and Verrecchia's (1987) no-overpricing hypotheses as well as the lower market efficiency (or market quality) hypothesis. Frino, Lecce, and Lepone (2011) investigate the effect of short-selling bans on stock prices and market quality in 14 countries. Specifically, they compare the price effects and market quality of eleven countries where a ban was imposed against three countries without a ban. Generally, they find a positive price effect for most countries, including the UK, and worsening market quality for all countries that imposed a ban, following its imposition. Beber and Pagano (2013) study the impact of a short-selling ban on market quality and stock prices in 30 countries, treated as a group. They report deterioration in market quality for the banned stocks and find no evidence to support Miller's overvaluation hypothesis, except in the case of the US. Boehmer, Jones, and Zhang (2008), Boulton and Braga-Alves (2010), and Kolasinski, Reed, and Thornock (2013) all study the impact of a short-selling ban on market quality and prices in the US market. The studies all agree that a short-selling ban in the US results in lower market quality, evidenced by increasing volatility, deteriorating liquidity, and a widening bid-ask spread, as well as a positive price effect.

3. SHORT SELLING AND ITS POTENTIAL USE WITHIN THE ISLAMIC PARADIGM

The ability to short sell is one of the central assumptions of Sharpe's (1964) and Lintner's (1965) Capital Asset Pricing Model. Short selling is not well thought of in the eyes of Muslim scholars, however, because they believe that a sales transaction should not proceed if the seller does not own or possess the item in question. It is worth noting that, from a risk management point of view, the ability to short is desirable. In a developed financial market, short sellers are welcome as they can perform any one of the following three roles: hedgers, arbitrageurs or even speculators. Hedgers short in the market so as to protect their original long position. Thus, hedgers actually have two positions, one long and one short, in either the same or different markets. One could ask: Why do hedgers have to short? Is it not better to just close the position if they are bearish? The answer is that sometimes it is better for some portfolio managers not to close out their positions but rather to protect (hedge) their positions with shorts so that they can still earn dividend payments from being long in the stocks.

On the other hand, arbitrageurs short because they see an opportunity to make a profit, at almost zero risk. For example, in the event of futures doing a huge discount to the cash market on the expiration day, a good arbitrageur with sharp eyes will long futures and short a basket of stocks. At the expiration, there can be only two scenarios, futures will go up to catch up with the basket stocks or the basket of stocks will drop to the level of the futures. Either way, the arbitrageur will make money in this riskless venture.

The third group, speculators, short because they expect the stock price to drop. For some people, speculation carries bad connotations, while for others, speculation means taking a calculated risk. We would argue in favor of the latter definition. Speculators are traders who execute their long or short positions based on their expectations of the market. Perhaps not many people are aware that speculators are one of the most desirable components in an efficient market, providing liquidity and depth that enable the market to become more internally efficient. An efficient market should have a greater volume of transactions, lower bid-ask spreads, and hence lower transaction costs for those players, i.e., hedgers and arbitrageurs, who want to participate in the market.

Generally speaking, short selling is deemed undesirable in the eyes of most Muslim scholars, with the exception of Kamali (2007). Most hold something of a consensus that short selling is illegal for two reasons: a) the seller does not own the item, so the seller cannot transfer ownership, and b) the seller, in the futures market in particular, does not meet the requirement of taking possession of the items (*qabÌ*) prior to resale. This line of argument is generally shared by Sulayman (1982), Mahmassani (1983), al-Basit (1985), Khan (1988), and Usmani (1999).

Most Muslim scholars and commentators arrived at their judgments on short selling based on the HadÊth *lÉ tabiÑ mÉ laysa Ñindaka*, which, directly translated, means *sell not what is not with you*. The complete version of the Hadith is as follows:

> JaÑfar ibn AbÊ Wahshiyah reported from YËsuf ibn MÉhak, from ×Ékim ibn ×izÉm (who said): “I asked the Prophet: ‘O Messenger of God. A man comes to me and asks me to sell him what is not with me. I sell him (what he wants) and then buy the goods for

> him in the market.’ The Prophet replied: Sell not what is not with you.

Sulayman (1982) examines the issues of the sale of objects that a seller does not own. He is of the view that futures transactions which involve short selling are not valid. He reiterates that *SharÊÑah* only validates the future delivery of *salam* contracts, but deems any other futures contracts as invalid.

In a similar vein, Mahmassani (1983) argues that contracts concerning future delivery are invalid, due to the none-existence of goods at the time of contract. *Salam* and *IstisnÉÒ*, however, are the only exceptions. He further argues that a postponement of transfer of ownership, like selling short, in proprietary contracts is a form of gambling and must therefore be prohibited.

Al-Basit (1985) also holds that futures contracts which involves short selling are not permissible since they do not fulfill the requirements of *salam* – sales in which both payment and delivery of goods are deferred to a future date are rightly considered as null and void.

According to Khan (1988), futures trading (which involves short selling) is alien to *SharÊÑah* as it involves trading without actual transfer of commodity to the buyer. He relies on the verbatim meaning of the Hadith *lÉ tabiÑ mÉ laysa Ñindaka* and declares that futures transactions are explicitly prohibited by the Prophet S.A.W.

Similarly, Usmani (1999) argues that all futures and forwards contracts (which involve short selling) are impermissible in *SharÊÑah* as the delivery takes place in the future and these contracts are not permissible regardless of the purpose, i.e., for hedging or speculation activities.

However, according to Kamali (2007), there are three different interpretations of this Hadith given by renowned Muslim jurists. First, “sell not what is not with you” carries an interpretation “do not sell what you do not own at the time of the sale”. The seller must own the item of sale when selling, and failing to do so will result in the sale not being concluded, even if the seller acquires ownership later. The Muslim jurists that hold this view are Al-ØanÑÉnÊ, Ibn al HumÉm, and Ibn QudÉmah. Secondly, “sell not what is not with you” is also interpreted as only applying to the sale of specified objects (*aÑyÉn*) and not to the sale of fungible goods. Fungible goods are standardized or identical goods that can easily be replaced or substituted. This view is held by the HadÊth jurists Al-BaghawÊ, MullÉ ÑAlÊ QÉrÊ and al-KhaÏÏÉbÊ. al-KhaÏÏÉbÊ (1949) and al-QarÌÉwÊ (1987) reiterate that this Hadith seeks to prevent *gharar* in sales that involve uncertainty over delivery. Finally, “sell not what is not with you" carries the meaning of not selling what you cannot deliver. This view is held by Ibn Taymiyyah and al-BĒjĪ, the MĒlikĪ jurist. Here, the HadĪth is interpreted as emphasizing the seller's ability to deliver, which certainly involves risk and uncertainty, rather than their ownership or possession of the object of sale.

With regard to short selling, this paper inclines toward the second and third interpretations. Modern-day short selling mostly involves covered short selling, whereby, in order to short, investors must first locate and borrow the stocks from the clearing house, which, as the central depository, keeps all the deposited stocks. The clearing house will then inform the lender that their stocks have been lent out. The lenders can call the lent stocks at any time, and the clearing house will then inform the borrower that they must return the stocks to the house. In the event of settlement failure (failure to return the borrowed stocks), the clearing house will borrow from somebody else so as to return the stocks to the original lender. It is worth noting that a clearing house does not have to return the exact stocks to the lender, just an equivalent security with the same ISIN. This clearly implies that stocks loaned for the purpose of short selling are fungible goods, and therefore fall under the second interpretation of the HadĪth given above.

Further, a clearing house that acts as a central depository for all stocks assumes counter-party risk. The clearing house becomes the buyer for every seller and the seller for every buyer. This is also known as the novation principle. It means that, when a short seller wants to borrow a stock for the purpose of shorting, the clearing house will borrow it from the lender. In doing so, the clearing house acts as a middleman, borrowing from the lender and lending to the borrower. One important implication of the novation principle is that there is no counter-party risk for the borrower or the lender. The clearing house guarantees delivery of the stocks, hence we can safely say, in this instance, that the element of *mukhtĒrah wa gharar* (delivery risk and uncertainty) is almost zero.

We have laid out the reasons why modern-day covered short selling should be read according to the second and third interpretations given above. However, we make no such arguments for naked short selling, for several reasons. First, in naked shorts, there is no borrowing of stocks involved, and hence there is no involvement from the clearing house to minimize risk and uncertainty. Here, the short seller creates an open position by shorting a particular stock, and subsequently closes out the position by reversing it or going long in the stock. If the seller is able to buy back at a lower price, they are able to make a profit on the short and vice versa. Secondly, not many investors would want to get involved in naked short selling because, in naked shorts, sellers have to buy back the stocks on the same day. Thus, unless the investors are extremely confident that the stocks are going to drop on that particular day, they will not think of engaging in naked short selling since it entails higher risk and requires deeper pockets. It is worth noting that when naked short sellers are not able to cover their shorts on the same day, they have to borrow the stocks from the clearing house as a form of forced covering; the naked shorts now become covered shorts.

Recently, a report by the governor of Bank Negara, Tan Sri Dato' Sri Dr. Zeti Akhtar Aziz, has revealed that personal financing as a proportion of household debt has increased from 14.8% in 2010 and 16% in 2011, to 17% in 2012 (Bank Negara Financial Stability and Payment Systems Report, 2013:17). Although Bank Negara reiterates that Malaysia's household debt is not yet a "systemic risk", there are real concerns that it is outpacing GDP growth. We have suspicions that personal financing is being used by households to buy property. As the property prices have soared so high, households need to resort to personal financing to pay for the 10% down-payment on a property. In the case of a subsale, the household may need to find a 20% down-payment. A good landed property in a suburb of Kuala Lumpur will cost at least RM600,000. Therefore, if the property is a subsale, the household has to come up with RM120,000 and the best way of obtaining the money is through personal financing.

Perhaps the main reason for the bubbling property prices in Malaysia is the fact that the property market is a one-way market. The only way to make a profit in a one-way market is through buying; one sells only to cash in on these profits. Some proponents of markets argue that a complete market must be a two-way market so that one should be able to take advantage of both the upside and the downside. In a one-way market, everyone buys until the market is almost cornered and becomes heated. Then, bubbles will happen and burst, and the market will then crash and finds its equilibrium. In a two-way market where short selling is allowed, however, the market will not overheat so easily as the presence of short sellers can lower the asset price (recall Figure 1).

In summary, we argue that short selling that is carefully regulated by a clearing house is desirable and falls within an Islamic paradigm if it obeys two conditions: a) the underlying stocks / assets to be shorted must be borrowed first before being shorted (covered short selling); b) the underlying stocks / assets to be shorted must be *SharÊÑah* compliant. With these two conditions in place, we believe short selling to be a suitable instrument for bringing asset prices to an affordable level.

4. CONCLUSION

Short selling has long been considered undesirable in the eyes of the majority of the Muslim scholars. Dissenting judgments on short selling come from the interpretation of the HadÊth *lÉ tabiÑ mÉ laysa Ñindaka* (sell not what is not with you). In this paper, we contribute to the existing literature on short selling, and with regard to its potential use in the Islamic paradigm. There is more than one interpretation of the above Hadith; one may look at it verbatim or choose to read it in line with Hadith scholars who say that it only applies to the sale of specified objects and not to fungible (standardized) goods, as in the case of stocks or futures. The other interpretation of the HadÊth is to *not sell what you cannot deliver*, which emphasize the seller's ability to deliver rather than the ownership of the object of sale. In the case of modern-day covered short selling, the clearing house assumes the counter-party risks and guarantees delivery, thus the element of risk and uncertainty is eliminated.

The biggest benefit of the ability to sell short is to manage risk, and protecting property (the value of property) is one of the objectives (*maqÉÎid*) of the *SharÊÑah*. The short-selling facility is certainly desirable to all market participants, regardless of whether they are hedgers, arbitrageurs or speculators, as they can use this facility to manage their risks and also profit from their expectations. One should not single out speculators or traders in the markets as evil, as they provide much-needed liquidity and depth to an otherwise inefficient market. Finally, one of the biggest potential uses of short selling that is unseen by many is its ability to stabilize asset prices. In times of soaring property prices, when most people cannot afford to buy, short selling can be used effectively in the real estate and property sector to bring down property prices to a more sensible level. Creating a two-way market via short selling may be beneficial to consumers in an Islamic market.

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