

# REPLICATION OF SHORT SELLING IN ISLAMIC FINANCE

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## **ABSTRACT**

*This paper discusses short-selling and its implication in Islamic capital markets as this has always been a subject of debate. The practice of short-selling in capital markets is considered a tool for providing liquidity and better price discovery to the traders. The use of short-selling in Islamic capital markets is objectionable. The factors that make short-selling non-Shari'ah compliant are: (i) speculation that mostly verges on gambling, (ii) interest, and (iii) its contraven maslahah (public interest), that is, it may result in market manipulation and could potentially wreak havoc on the market. Therefore, the main objective of this paper is to review the structure of short-selling from the Shari'ah perspective. There are mainly six Shari'ah contracts discussed in this paper that can conveniently be used for structuring Shari'ah compliant short-selling. These Shari'ah contracts are: *urbun*, *wa'ad*, *wakalah*, *mudharabah*, *bai' salam* and *musharakah*.*

**Keywords:** Short-selling, Islamic capital market, speculation, Public interest, *urbun*, *wa'ad*, *wakalah*, *mudharabah*, *bai' salam* and *musharakah*

## Introduction

According to the International Shari'ah Research Academy (ISRA), short-selling refers to the practice of the sale of securities not absolutely owned by the selling party at the time of sale<sup>1</sup>. Therefore, a short seller borrows security from a broker to meet the delivery obligation after selling the security, and then purchase an equivalent security to return to the broker that lent the security to the short seller. A typical short-sell transaction would have three parties: the original owner or the lender, the short seller, and the third party or the new buyer.

Short-sell transactions are of two types: naked and covered. In naked short-selling, the seller sells shares he does not own, without having set aside any shares to settle the transaction. While, covered short-selling usually involves a series of transactions. In the first stage, the short-seller normally borrows the number of shares that are for short-selling so that they can be delivered to the buyer at settlement. The short-seller will normally get cash on delivery of the stocks. In the second stage, the short-seller will sell the shares. In the third stage, which occurs at some point in the future, the short-seller buys the same number of shares so as to return them to the original lender. The last stage is the replacement of shares, wherein shares are returned to the original lender and the series of transactions completed. From a financial and economic viewpoint, short-selling has its advantages and disadvantages.

From an Islamic perspective, *gharar* or uncertainty about the subject matter and terms of contracts is prohibited. This includes a prohibition on selling or leasing something which one does not own, and hence excludes the practice of speculative short-selling from an Islamic financial system. There are numerous hadith forbidding *gharar* sales and specific thereof. One commonly cited hadith was narrated by Muslim, Ahmad, Abu Dawud, Tirmidhi, al-Nasa'i, al-Darimi and Ibn Majah on the authority of Abu Hurayrah that: "The Prophet (s.a.w) prohibited *bai al-husat* (i.e. sale by means of pebbles) and *bai al-gharar* (uncertainty sale)". Moreover, a good

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<sup>1</sup> International Shari'ah Research Academy, *Islamic Financial System Principles and Operations* (Malaysia: Pearson Custom Publishing, 2012), 468.

interpretation of *gharar* is made by Professor Mustafa Al-Zarqa<sup>2</sup>, et al. They stated that the nature and characteristics of probable items are risk due to the existence of uncertainty. Hence, it makes the transaction seem like gambling.<sup>3</sup>

Hence, much of the earlier work on the subject emphasized against short-selling. Gerard Al-Fil pointed out that selling a stock short lets the investor gain profit while the underlying company loses value<sup>4</sup>. It is clear violation of the ban of unjust deeds, stated in the Al-Quran, Surah Al-Baqarah, “Deal not unjustly, and you shall not be dealt unjustly”<sup>56</sup>. Therefore, short-selling trigger unjust activity in Islamic Finance. Likewise, the practice of short-selling has brought about strong criticism in the West with some politicians saying it has helped to fuel crushing share price declines, particularly for banks and other financial institutions reeling from the global credit crisis.

On the other hand, some scholars have allowed for the use of *salam* in short-selling provided that it is used to purchase a share. With this change, Shari’ah institutions would be able to short-sell a limited number of stocks<sup>7</sup>. Nonetheless, the primary obstacle to the development of Islamic Hedge Funds was seen to be the lack of a short-selling mechanism. There are mainly three methods for short-sale that will be discussed in this study: First is short-sale by *salam*. Second is short sale by *urbun* (down-payment sale) and third is short sale by promise (*wa’ad*). In addition, this study will touch on three alternative mechanisms for short sale: *wakalah*, *mudharabah* and *musharakah*.

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<sup>2</sup> Kamal Khir, Lokesh G, and Bala S, *Islamic Banking: A Practical Perspective* (Selangor: Pearson Malaysia Sdn. Bhd, 2008).

<sup>3</sup> Ibid.

<sup>4</sup> Gerard Al-Fil, “Why Short-selling is Haram.” *AMEinfo*, 8th October 2008, accessed on November 2nd, 2012, <http://ameinfo.com/finance-and-economy/banking/archive-banking/why-short-selling-is-haram/>.

<sup>5</sup> Al-Mubarakpuri, Sheikh Safiur-Rahman, trans, *Tafsir Ibn Kathir: Abridged* (Riyad: Maktaba Dar-us-Salam, 2003), Chapter 2, Verse 279, p- 680.

<sup>6</sup> Gerard.

<sup>7</sup> Securities Commission Malaysia, *Managing Fun Flows, Risks and Derivatives: Applications in Islamic Institutions*, (ed:AbdulKader Thomas), (Selangor: Perpustakaan Malaysia Negara, 2012), p. 260

### **Historical Development For Constructing A Shariah- Compliant Short Sale In Malaysia:**

Short-selling is not a new phenomena. It has been around ever since the origin of the stock market. According to Venardos, at the end of 1995, Malaysia first introduced conventional regulated short-selling using securities borrowing and lending (SBL). Shortly thereafter, the Malaysia Securities Commission (SC) laid out to make short-selling comply with Shariah rules in Malaysia. Through the mid-1990s, it worked with Shariah scholars to develop an alternative based on *ijarah* (lease). Next, at the end of 1997, the government of Prime Minister Mahathir Mohamad suspended all short-selling at the end of 1997 because of volatile the stock market and capital flight. Nonetheless, the SC's Shariah board officially endorsed an *ijara*-based form of SBL in March 1998, even with the possibility that it would not be implemented because all forms of SBL had been banned<sup>8</sup>.

Through the 2000s, Islamic finance became popular worldwide. In 2001, hedge-fund manager, Eric Meyer, met in the United States with Shariah scholar, Shaykh Yusuf Talal DeLorenzo, and discussed the possibility of an Islamic hedge fund. Shariah Capital provides technologies and advisory services to support hedge funds and other financial institutions seeking to be Shariah-compliant. Then, Shariah Capital together with prime broker Barclays Capital, launched the Al-Safi Trust Platform for hedge funds in 2008. At the same time, several Dubai-based funds were launched, and the Al-Safi platform employed an *urbun*-based short-selling mechanism. At the same time, Fimat, the prime-brokerage arm of France's Societe Generale, launched some of the earliest Islamic hedge funds at the end of 2006, employing a *salam*-based short-selling mechanism. In the next year, Amiri Capital introduced a short-selling replication structure based on *waad*<sup>9</sup>. Below is the summary of the history of efforts to construct a Shariah-complin short sale in Malaysia (Figure 1).<sup>10</sup>

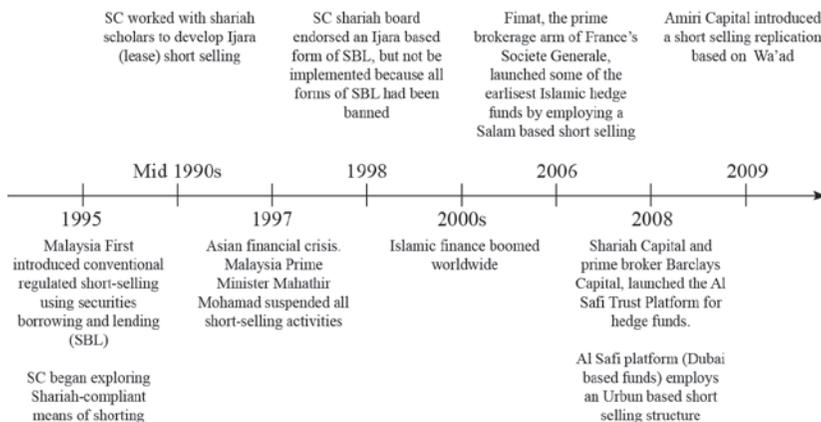
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<sup>8</sup> Angelo M Venardos, *Current Issues in Islamic Banking and Finance: Resilence and Stability In The Present System* (Singapore: World Scientific, 2010), 209.

<sup>9</sup> Ibid.

<sup>10</sup> Ibid.

**Figure 1: History of efforts to construct a Shariah-compliant short-sale in Malaysia<sup>11</sup>**



## 2. Literature Review

The study on short-selling has been sizeable because it is considered an important factor leading to better price discovery, greater liquidity, and market efficiency, the topic was a significant interest to researchers and financial professionals from the perspective of regulation and market practice. There are some specific studies which has researched on the existence and regulation system of short-selling in various countries such as Taiwan<sup>12</sup> and the United Kingdom<sup>13</sup>.

In a typical study of this topic, Max and Payne have examined the effects of the ban on short-selling on market conditions in general. According to them there was no strong evidence found that shows that conditions in the market for financial stocks were any

<sup>11</sup> Ibid, p.289-291.

<sup>12</sup> Martin T. Bohl, Badye Essid and Pierre L. Siklos, "Do short-selling restrictions destabilize stock markets? Lessons from Taiwan," *The Quarterly Review of Economics and Finance*, Working Paper – 11, 52(2) (2011):198–206, accessed on 20<sup>th</sup> November, 2012, [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1824102](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1824102).

<sup>13</sup> I. W Marsh, & R. Payne, "Banning short sales and market quality: The UK's experience," *Journal of Banking & Finance* 36(7) (2012):1975–1986.

different to conditions for control group stocks in the period to the ban on short-selling<sup>14</sup>.

Some researches have focused on the linkage between hedge funds investors and short-selling. Accordingly, Haggard, Hao and Zhang found that issuers of deals with hedge funds investors experienced less pre-deal short-selling than issuers of deals without hedge funds in the investor group. In short, pre-deal abnormal short-selling is not significantly different, between hedge-fund invested deals and non-hedge-fund invested deals<sup>15</sup>.

Some studies, however, have taken a different approach by looking so much at *fiqh* issues in short-selling. There are five important *fiqh* issues in a short-selling transaction. First argument, is on the issue of selling something which is not in the seller's possession. The main argument is this practice will lead to the incidence of *gharar* due to the probability that the seller may not able to deliver the subject matter. This argument may be disputed because in the practice of short-selling, fulfilment of delivery, settlement of contract and payment of financial obligations are always guaranteed, monitored and regulated by the Exchange Authority. Second, the issue of whether stocks can be a subject matter of a loan contract<sup>16</sup>, the paper argued that stocks satisfy the homogeneity properties in which all jurists, including the Hanafis, deem it as an important criterion for objects to be eligible for lending. As long as the underlying subject matter that the stock represents is lawful (*halal*) from the *Shari'ah* purview, the stocks can be a subject matter of a loan contract<sup>17</sup>.

Dusuki and Abozaid raised a further issue: whether it was possible for a person to benefit from a loan contract or not. With the exception of the Malikis' school, a majority of jurists permit gifts or benefits derived from the loan contract if it was voluntarily and not stipulated as a condition based on convention (*'uruf*).<sup>18</sup> In addition,

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<sup>14</sup> Ibid.

<sup>15</sup> K. Stephen Haggard, Q. Hao & Y. J. Zhang, "Are hedge funds guilty of manipulative short-selling?" *Managerial Finance* 38(11) (2012):1048–1066.

<sup>16</sup> Dusuki and Abozaid

<sup>17</sup> Ibid.

<sup>18</sup> Ibid.

(Islamic Banking and Finance Institute Malaysia n.a.) touched on issues With reference to short-selling, it was based on an educated guess of speculation and gambling and violation of certain aspects of *maslahah* of the market. With regard to the issue of speculation and gambling, some scholars drew a distinction between commercially valid speculation and that which was tantamount to gambling and transgression.<sup>19</sup> that stocks will either move up or down in value in the near future. As a result, they argued that speculation in short-selling was lawful under *Shari'ah* principles, provided that proper evaluation had been carried out prior to purchasing stocks, and the intention to trade was not the same as the case of gambling.

(Securities Commission Malaysia 2012) found the alternative short-selling strategies, such as *urbun*, *wakalah*, *mudharabah* and *musharakah*.<sup>20</sup> (International *Shari'ah* Research Academy 2012) documented that the Shariah Advisory Council of Security Commission permits short-selling on the basis of *istihsan* with *maslahah* (It provides a clear advantage to the original shareholder and provides liquidity to the market.) and *istihsan* with '*urf khas* ('*urf iqtisadi khas*), given that, short-selling is a customary practice accepted in economic activities<sup>21</sup>. However, Islamic Banking and Finance Institute Malaysia (n.a.) asserted that based on the principles of *maslahah* and *sadd al-zarai'*, banning short-selling or imposing constraints on its operation are necessary or desirable<sup>22</sup>.

To recapitulate, short-selling has become a key topic of concern across all major Islamic finance. Not suprisingly, this has led to a rapid growth of academic papers on the subject over recent years. However, there are limited studies on Islamic finance. Thus, this study is set to present another look at this empty space because there are some aspects that need to be addressed on short-selling in Islamic finance.

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<sup>19</sup> "Short-Selling, Securities Borrowing and Lending: Shariah Perspective (Part II),

<sup>20</sup> Abdulkader Thomas, Securities Commission Malaysia, *Managing Fun Flows, Risks and Derivatives: Applications in Islamic Institutions*.

<sup>21</sup> International Shari'ah Research Academy, *Islamic Financial System Principles and Operations* (Malaysia: Pearson Custom Publishing, 2012), 468.

<sup>22</sup> "Short-Selling, Securities Borrowing and Lending: Syariah Perspective (Part II)."

### 3. Alternative Short-Selling Strategies

#### 3.1. *Bai' Salam Contract In Short-selling:*

##### 3.1.1. Definition And Legality of *Bai' Salam:*

*Bai' al-salam* has been defined by the four most influential Islamic schools of thought (*mazhabs*) in the same way, though they differ in its arrangement of words and sentences. *Salam* (forward payment) is the sale of a deferred item in exchange for an immediate (forward) price. In other words, it is the sale of a liability whose characteristics are described in exchange for a price or capital-sum paid in advance<sup>23</sup>. The definition given by Shafiis and Hanbalis is as follows: “*Salam* is a contract over a *mazhab* described commodity sold as a deferred liability on one party, in exchange for a price that is received during the contract session”. The Malikis defined it as “A sale in which the capital sum (price) is paid in advance and the object of sale is deferred to a specified term”.

While according to the Accounting and Auditing Organisation for Islamic Financial Institutions’ definition, a *salam* transaction is the purchase of a commodity for a deferred delivery in exchange for an immediate payment. It is a type of sale in which the price, known as the *salam* capital, is paid at the time of contracting while the delivery of the item to be sold, known as *al-muslam fih* (the subject matter of a *salam* contract), is deferred. The seller and the buyer are known as *al-muslam ilhayhi* and *al-muslam* or *rabb al-salam* respectively. *Salam* is also known as *as-salaf*<sup>24</sup>.

*Bai' salam* contract derives the legitimacy from the Quran, the *sunnah* and consensus of *ijma'*. Surah Al-Baqarah (2:282) mentions that it is permissible in accordance with the permissibility to trade which involves future obligation at a fixed period<sup>25</sup>. The Prophet Muhammad (s.a.w) mentioned that “Whoever engages in a *salam*

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<sup>23</sup> Wahbah Al-Zuhayli, *Financial Transactions in Islamic Jurisprudence*, 4th Edition. Translated by El Mahmoud A. Gamal. (Beirut: Dar al-Fikr al-Mouaser, January 2003), Vol. 1, p. 238.

<sup>24</sup> Accounting and Auditing Organisation for Islamic Financial Institutions, *Shari'ah Standard: Salam and Parallel Salam* (Manama: AAOIFI, 2010), 176.

<sup>25</sup> Sheikh Safiur-Rahman, p.686.

contract, let him specify a volume or weight for the object of sale, and a definitive term of deferment.”<sup>26</sup>. Thus, all jurists of all schools considered the valid forward sale of fungible commodities (measured by weight, volume, length/size or a number of homogenous units) with full prepayment of the price.

### **3.1.2. Legality (Conditions) of Bai’ al-Salam:**

The jurists of various schools of thoughts agreed that *salam* is valid if it satisfies certain conditions that are as follows:

1. The price of goods must be specified at the initial stage at which the contract is concluded. This is agreed to by the majority of mazhabs except Malikis who give the parties a three-day delay, but not in deferment of the price of the *salam* contract. The opinion is based on the application of the Shariah maxim which says “What is similar to something gets the same ruling applied to it”. The International Jurisprudence Council OIC and the *Shari’ah* Council AAIOFI accepted the view of the Maliki mazhab.
2. The capital or the price of the goods has to be specified in monetary form (e.g. gold and silver coins or equivalent), items measured by volume (e.g. wheat and barley) or items measured by weight (e.g. cotton, iron, etc).
3. It is impermissible to make the debts owned by the third party to the seller as the capital to pay the payment of *salam* contract because it creates a new forbidden contract i.e. debt selling.
4. Goods or commodities which are purchased through the *salam* contract should be identified and specified. Thus forward sales are not permissible if the object of sale is gold or silver coins which are not identifiable.

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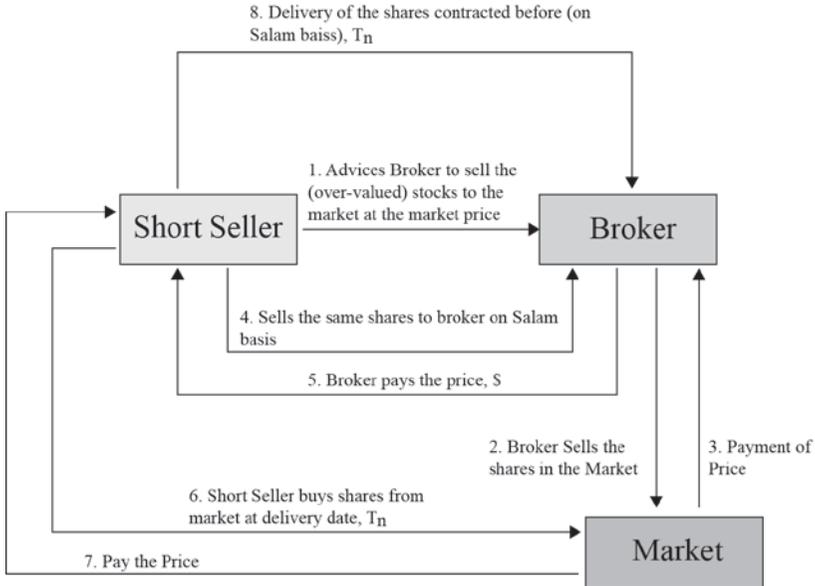
<sup>26</sup> Abdullah Bin Baz and Syaikh Abdul Aziz., trans, *Fath al-Bari Syarah Sohih Al-Bukhari* no 2240 (Jakarta: Darussalam, 2002), 4/541.

5. *Salam* is not permitted for any specific e.g. “this house”. Also, it is not permitted to stipulate that the subject matter must be from a specific piece of land. For example, a person intending to purchase by a *salam* contract was made on Mr. Ahmad’s paddy field only. This type of purchase is forbidden. The purchase must be on the detailed specifications of paddy only which enables the seller to come out with any paddy that suits the desired specification. Whilst gold, silver and any currency cannot be purchased via a *salam* contract because they are of *ribawi* items which are impermissible to be delivered on a deferred basis.
6. The genus of goods and commodities purchased must exist in the market according to a specified type and characteristic continuously, from the contract time until the delivery time. For example, if one ton of paddy is purchased via the *salam* contract, the same type of paddy of the same amount must be available in the market. Therefore, if the seller fails to harvest his own paddy, amounting to one ton, he is allowed to get some of them in the market.

The place of delivery should be determined at the initial stage when the contract is concluded.

**3.1.3. Bai' Salam Based Short-Selling Model:**

**Figure 2:** Structure of *Bai' salam* contract in Short-Selling<sup>27</sup>



The structure of *salam* contract in short-selling is based on the illustration above, which involves three parties: the Short-seller, the broker and the market.

1. The Short-seller advises the broker to sell the (over-valued) shares to the market at the market price.
2. The broker sells the shares in the market.
3. The market buyer executes the payment of the price of the shares.
4. The Short seller sells the same shares a broker on *salam* basis.
5. The broker then pays the price to the broker upon the conclusion of the contract.
6. The short-seller buy shares from the market at delivery date, at  $T_n$ .

<sup>27</sup> Abdulkader Thomas, *Managing Fund Flows, Risks And Derivatives: Applications in Islamic Institutions* (Kuala Lumpur: Thomson Reuters, July 24<sup>th</sup> 2008).

7. The market buyer pays the price of the shares a Short- seller.
8. Finally, the Short seller delivers the shares contracted before (on *salam* basis) to the broker, at  $T_n$ .

### **3.1.4. Issues with the Salam Structure:**

There are a few issues to be highlighted for the *salam* structure that is, to be implemented in short-selling. The issues are as follows:

- **Ownership:**

During the *salam* contract is to be concluded, when the seller asks the broker to sell the shares then to whom do the shares belong to? This is in contradiction to the condition of *salam*, whereas the shares (commodities) must be owned by the seller. If the share belongs to the third party, it is impermissible to sell the shares that belong to someone else.

The conventional short-selling practice is to sell the shares which the seller does not own. The shares belong to a third party, and the short seller sells the shares on behalf of the real owner.

- **Payment Upfront:**

In Shariah principle of *salam*, it is required that payment be executed upon the conclusion of the contract of short-selling. This condition is a must that has to be fulfilled in order to have a valid *salam* contract.

It is a different practice in conventional short-selling, where a payment upfront is not required. The payment of short-sale can be executed later. If the practice of *salam* is to be replicated in the market, it could be a challenge to its adoption on the stock exchanges market. The market participants may not be used to such the *salam* model. Furthermore, the existing of infrastructure of information technology (IT) system and regulatory frameworks might have trouble adapting to it. The whole stock exchange market may have resistance to apply the concept of *salam* if the requirement of payment upfront is to be executed.

- **Subject of salam contract:**

The main issue with the *salam* contract in short-selling is the subject of the sale. The scholars of Islamic finance have argued on the

permissibility of stocks to be the subject of the *salam* contract. The AAI OFI Sha'riah Board gave the decision that the stock cannot be accepted as the subject of a *salam* contract.

While in conventional short-selling, the subject is the “stocks”. Thus it oppose to the condition of *salam* contract and cannot be applied in short-selling.

### **3.2. *Urbun Contract In Short-Selling:***

In the previous section we have discussed the usage of Salam contract in short-selling, that is, to what extent does it complies with the *Shari'ah* law. Does short-selling based on Salam contract is permissible and so on. In this section also we are going to conduct similar analysis of short-selling which would be based on another Islamic exchange contract called *urbun* (also called as Arboon). The discussion would be focusing on the general concept of *urbun*, its legality and its implementation in short-selling.

#### **3.2.1. *Definition of Bai' Al-Urbun:***

According to (Dirir 2010), *bai' al-urbun* is a sale contract wherein the buyer is to pay the portion of the price in advance which is looked upon as a down payment and a settlement for the remaining amount for a future date as stipulated in the contract. If the buyer executes the sale the down payment, it would be considered a part of the price. In case if the buyer does not execute the sale, he cannot claim the *urbun* amount (down payment)<sup>28</sup>. Obaidullah has defined *bai' al-urbun* as “a sale in which the buyer deposits earnest money with the seller as a partial payment of the price [,] but agrees that if he [was to] fail to ratify the contract, he [would] forfeit the deposit money which the seller can keep.”<sup>29</sup>. Venardos has asserted “*urbun* is a situation whereby a person buys a commodity and pays some dirhams, with a

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<sup>28</sup> Abdirahman Sh. Mohamed Omer Dirir, “SH1002 Shariah Rules In Financial Transactions: Bai Al-Arboon,” *Academia, International Centre for Education in Islamic Finance*, September 2010, Accessed on November 18th, 2012, <https://inceif.academia.edu/abdirahmansheikhmohamedomer/Papers>.

<sup>29</sup> Mohammed Obaidullah, “Financial Engineering with Islamic Options,” *Islamic Economics Studies* Vol. 6, No. 1 (November 1998), Accessed on 18th November, 2012, <http://www.irti.org/English/Research/Documents/IES/122.pdf>.

condition built in the contract that if he continues, the deposit [would] be considered [a] part of the purchase price, or otherwise, a gift to the seller.”<sup>30</sup>.

### 3.2.2. *Legality of Bai’ Al-Urbun:*

In terms of the legality of *bai’ al-urbun*, classical jurists differ in their opinions. According to the Malaysia International Islamic Financial Centre (MIFC), the majority of jurists have disallowed the practice of *bai’ al-urbun*. Their ruling was based on the analogy that the *urbun* contract have the elements of *gharar*, *maysir* and the unlawful acquisition of property; therefore it should be prohibited. They quoted the hadith in which Prophet (s.a.w.) had prohibited *bai’ al-urbun*. However, some jurists like Mujahid, Ibn Sirin, Nafi’ bin Haris, Zaib bin Aslam and scholars of the Hanbali mazhab were not convinced with this ruling. They had denounced this argument stating that the quoted hadith had a weak chain of narration and therefore had permitted an *urbun* contract based on Umar bin Khattab’s practice<sup>31</sup>:

He once appointed Nafi’ to be his representative to buy a house from Safwan bin Umaiyah in Mecca to be converted into a prison. Safwan asked Omar for a deposit and laid down the condition that the deposit would be his if Omar terminated the contract. Omar agreed to the condition.<sup>32</sup>

(Darir 2010) had also stated that most of the classical jurists like Shafi’, Maliki, Abu Hanifa, Ishaq ibnu Rawia, ibn Abbas (Allah bless him), Al-Hassan and others had forbidden *bai’ al-urbun* based on the same grounds as mentioned above, and those who had

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<sup>30</sup> Angelo, 209.

<sup>31</sup> Malaysia International Islamic Financial Centre, “Bai’ `Urbun.”, January 12th 2012, Accessed on November 18th, 2012, [http://askprof.mifc.com/index.php?ch=menu\\_know\\_ftw&pg=menu\\_know\\_ftw\\_reso&ac=524&mode=view](http://askprof.mifc.com/index.php?ch=menu_know_ftw&pg=menu_know_ftw_reso&ac=524&mode=view).

<sup>32</sup> “Resolutions of the Securities Commission Shariah Advisory Council,” 2nd ed, 36, Securities Commission Malaysia, 2006, Accessed on November 18th, 2012, [http://www.sc.com.my/wpcontent/uploads/eng/html/icm/Resolutions\\_SAC\\_2ndediti on.pdf](http://www.sc.com.my/wpcontent/uploads/eng/html/icm/Resolutions_SAC_2ndediti on.pdf).

approved it are Mujahid, Ibn Sirin, Nafi' bin Haris, Zaib bin Aslam and the Hanbali mazhab. He further stated that among contemporary scholars Al-Qaradawi, Wahab Al-Zuhaily, Dr. Rafiq Al-Masri, Dr. Al-Sanhoori had also allowed *bai' al-urbun* with the conditions as stipulated by Hanbalis pertaining to the waiting time, that is, both the parties must specify the waiting time to avoid uncertainty. He also quoted Ibnu Bas is ruling (former Mufti of Saudi Arabia) that according to him *bai' al-urbun* is permissible, whereas, Wahab Al-Zuhaily approved this sale in accordance with custom (*ur'f*). According to him, both *hadith* quoted by the proponent<sup>33</sup> as well as the opponent,<sup>34</sup> had a weak chain of narration. Therefore, he had approved this based on custom. Al-Qardawi had permitted this sale in order to remove hardship and facilitate<sup>35</sup>. Therefore, based on custom (*ur'f*) and public interest (*maslaha `ammah*) the contract of *bai' al-urbun* is permissible. (Dusuki and Abozaid 2008) stated that "Securities Commission (SC) of Malaysia has legalized short-selling transaction, under a strict securities borrowing and lending (SBL) regulation", according to the *Shari'ah* Advisory Council (SAC) of SC, regulated short-selling (RSS) eliminates the element of *gharar* which makes *urbun* contract *Shari'ah* compliant<sup>36</sup>. Now let us discuss how the sale contract of *urbun* be used to facilitate short-selling in Islamic capital market.

### **3.2.3. Implementation of Bai' Al-Urbun in Short-Selling:**

Indeed, based on the necessity, as well as to maintain competitiveness against conventional counterparts, contemporary jurists have not only permitted *bai' al-urbun* but also have allowed its implementation in short-selling. According to Mohamad and Tabatabai (2008), "as Islamic investments grow, so do[es] the need to protect and hedge such investments and Islamic financial instruments

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<sup>33</sup> Hassan Sa'eed bin Aslam (RA) narrated that "Prophet (saw) was asked about down-payment sale and he permitted it. This hadith is (mursal hassan), and its mursal is to Hassan Zaid bin Aslam.

<sup>34</sup> Amar ibnu Shui'ab narrated from his father and from his grandfather that, Prophet (saw) had prohibited *bai' al-urbun*.

<sup>35</sup> Abdirahman.

<sup>36</sup> Dusuki and Abozaid.

would have to be as good as if not better than their conventional counterparts if they were to really attract more “performance sensitive investors.”<sup>37</sup> For this reason (DeLorenzo 2008) has quoted that the “Jeddah-based OIC Fiqh Academy which reviewed the urban transaction... found it acceptable for use by modern banks and investment houses”<sup>38</sup>. Therefore, for the purpose of facilitating modern days complex investment instrument the *al-urbun* contract has been used for short-selling wherein the investor (fund manager) takes the ownership of the stocks by executing the “Master Securities Urbun Sale Agreement”, before he sells in the market. Unlike, in conventional short-selling, the investor borrows the securities from the owner under the “Master Securities Lending Agreement”, and sells it in the market<sup>39</sup>. According to Dirir, “the Urbun Sale equivalent is structured with a specified ‘date of ultimate settlement of purchase and sale’ at which time the unpaid portion of the purchase price has to be paid.” He further states that the specification of date in the contract fulfils the condition stipulated by the OIC Fiqh Academy. It is an alternative transaction which replicates the economic results of a conventional short sale without using “the borrow and sell” method of short-selling employed by conventional prime brokerages. The investment manager instructs the prime broker to purchase the stocks that are required to close the *al-urbun* sale from the market and return the stocks to the original seller<sup>40</sup>.

### 3.2.4 Analysis:

*Al-urbun* is one of the various types of sale contracts (in Arabic term *bai*). In the Quran, Allah (s.w.t.) has permitted trade and forbidden

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<sup>37</sup> Saadiah Mohamad and Ali Tabatabaei, “Islamic Hedging: Gambling or Risk Management”, (Paper presented at the Australian Finance and Banking Conference, 18th November 2008) : 5, Accessed on 18th November 2012, [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1260110](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1260110)

<sup>38</sup> This decision is documented in the *Journal of the Islamic Fiqh Academy*, 1993, vol.1, number 8, p.641.

<sup>39</sup> De Lorenzo and Shaykh Yusuf Talal, “The Arboon Sale: A Shariah Compliant Alternative To Selling Short With Borrowed Securities,” *Shariah Capital Inc*, July 24th 2008, Accessed on 18th November, 2012, [http://www.shariahcap.com/staging/pubs/shariah/the\\_arboon\\_sale\\_english.pdf](http://www.shariahcap.com/staging/pubs/shariah/the_arboon_sale_english.pdf).

<sup>40</sup> Abdirahman.

*riba*<sup>41</sup>. In one of the hadiths Prophet (s.a.w.) said, “A sale is by mutual consent, and options are implemented after mutual agreement.”<sup>42</sup> According to Al-Zuhaily, jurists have consensus that sales are permissible, “as it allows each individual to meet his needs in cooperation with others trying to meet their own.” In case of an *urbun*-based short-selling, it meets all the basic condition of a valid sale, that is, *sighah*, subject matter, format and parties to the contract<sup>43</sup>.

1. The fund manager or investor expresses his willingness (offer) to buy a certain category of securities. The fund manager or investor approaches the primary broker<sup>44</sup>. According to Al-Zuhaily, “brokerage (*al-samsara*) is the intermediation between a buyer and a seller to conclude a sale and it is admissible” as this is the compensation for the broker’s work and effort. The prime broker finds a suitable party (Original seller) who is ready to sell similar securities as requested by the fund manager or investor. The seller agrees to sell the required amount of share to the trader based on down payment (*bai’ al-urbun*).

Coming to the subject matter, it is the securities of any one company or the pool of varied companies’ securities that is one of the requirements of a valid contract, the time of concluding a contract except for *salam* and *istisna*. In the case of the *urbun* based short-selling, the subject matter, which is basically securities, does exist at the time of concluding a contract (which is of *Shari’ah* compliant in nature), though it is sometimes termed similarly to *istisna*. Upon signing of the contract the subject matter (which is basically securities) is transferred to the fund manager or investor with the partial payment paid to the original seller in the form of down payment. In general, under the *urbun* contract, the buyer will be given an option, that is, if the buyer does not find the subject matter suitable or due to any

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<sup>41</sup> Sheikh Safiur-Rahman.

<sup>42</sup> Wahbah, 6.

<sup>43</sup> Ibid.

<sup>44</sup> According to the rules and regulation of capital markets the traders can buy and sell securities only through the registered brokerage firm.

other reason and cancels the sale, he will have to forfeit the down payment paid to the seller. Obaidullah describes that this is similar to the conventional call option with some minor differences<sup>45</sup>. As discussed above, the seller does not return the down payment if the buyer does not exercise the purchase option. If the buyer exercises it, the down payment would be considered as part of the price amount. Whereas, in a conventional call option, irrespective of whether the buyer exercises the purchase option or not, he will have to forfeit the option premium paid to the seller. Besides, it meets other conditions of a subject matter like it must be owned, and it must be in the possession of the seller and the underlying subject matter must be deliverable.

With regards to the format, at the time of concluding a contract, the original seller and fund manager/investor is to sign an agreement called a Master Securities *urbun* Sale Agreement in which all the terms and conditions are clearly stipulated, that is, the payment amount, period of exercising the option, etc. This is in accordance and compliance with the Quranic verse, “O you who believe! When you contract a debt for a fixed period, write it down. Let a scribe write it down [justify] between you.”<sup>46</sup>

2. Coming to the ownership of the subject matter, in *urbun*-based short-selling upon signing a contract, the trader owns the right to absolute ownership with which he can sell those securities to the third party. This is not much of a debatable issue as this depends on the understanding and mutual consent of both parties as Allah (s.w.t.) said: “O you who believe! Eat not up your property among yourselves unjustly except it be a trade amongst you, by mutual consent.”<sup>47</sup>

According to al-Zuhaily, one of the reasons for not allowing *bai al-urbun* is that *bai al-urbun* will lead to taking money from another person without proper compensation. This argument, in fact, is disputable because when the parties enter into this transaction, both of them know about the arrangement and

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<sup>45</sup> Mohammed Obaidullah.

<sup>46</sup> Sheikh Safiur-Rahman, p.686.

<sup>47</sup> Ibid, Chapter 3, verse-29, p-747.

consent to it. The claim that the seller takes money from the buyer without proper compensation is also not true. This is because during the waiting period of *bai al-urbun*, the seller cannot sell the subject matter to anybody, even though he finds a genuine buyer during that time. Hence, taking the money is to compensate him for losing a potential buyer during the waiting period of *bai al-urbun*.<sup>48</sup>

3. Besides, another argument of the opponents of the *urbun* contract is the presence of uncertainty (*gharar*), that is, absence of a specific time duration within which the buyer should exercise the option. However, Hanbali jurists allowed this with the condition that the seller had to stipulate the time of exercising the option. It may be argued that in certain practices, there is a time limit for the buyer to exercise the option. If the buyer wants to exercise the purchase option, he should settle the price of the securities with the proceeds he gets after selling them to the third party (buyer). If he does not want to exercise the purchase option then he should purchase the same securities from the market, that is, from the second seller and return it to the original seller. In this case the fund manager or investor would buy the securities for a price which is lesser than that he bought it for from the original seller. This is usually monitored under regulated short-selling, that is, whenever the fund manager or investor buys the securities from the original seller, his status will be shown as “open position” and under regulated short-selling, the trader must close the position with the time stipulated in the contract.

In the end, implementation of the *urbun* contract in short-selling is justifiable. Based on the above discussion the current practice of *urbun*-based short-selling does not involve any serious *Shari'ah* issue. However, in practice this is not the only *Shari'ah* model used for short-selling. In addition to this model another model that is used is the incorporation of the *bai'* (sale) and the *Wa'ad* (promise) model. In the next section the discussion would be based

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<sup>48</sup> Wahbah.

on this model focusing on its feasibility and applicability for short-selling.

### **3.3. Short-Selling Using the Bai' And the Wa'ad Model:**

In the previous section we have seen that for the *urbun* based short-selling, the point of contact for the fund manager or investor, as well as the primary seller of the securities, is common, that is, the primary broker but this process flow has slightly changed in the case of the *bai'* and the *wa'ad* based short-selling model. Based on the literature review it has been found that this model (i.e., *bai* and *wa'ad* based short-selling) is structured based on the conventional model which is termed as stock borrowing and lending (SBL). Before we move on to the discussion of the *bai'* and the *wa'ad* based short-selling model, it is essential to discuss the conventional model in order to get a clear understanding of short-selling.

#### **3.3.1. Stock Borrowing and Lending (SBL):**

According to Thomas, in late 1995, the Malaysian Securities Commission had introduced the concept of Stock Borrowing and Lending (SBL) in Malaysian capital market, which was later in September, 1996 formulated with the guidelines on Regulated Short-Selling (RSS). Initially, the SBL involved lending and borrowing securities based on interest wherein securities were borrowed on interest for carrying out short-selling activities in the capital market.<sup>49</sup> According to the Securities Commission (2008), "SBL refers to borrowing securities listed on Bursa Malaysia", wherein the following parties are involved<sup>50</sup>:

1. Lender
2. Lending agent (local brokers)
3. Central lending agency (CLA) also known as [Bursa Malaysia Securities Clearing Sdn Bhd.]

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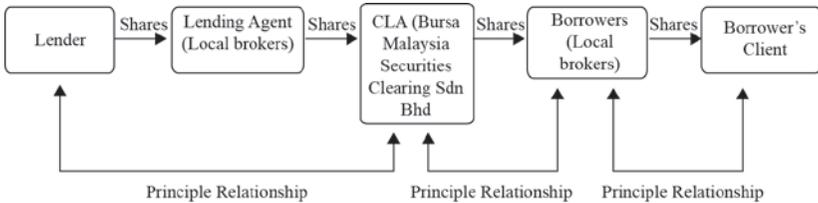
<sup>49</sup> Abdulkader Thomas.

<sup>50</sup> Securities Commission, Malaysian Islamic Capital Market, Vol 3, No 4 (Kuala Lumpur: Securities Commission Malaysia, November 2008), 2, Accessed on November 20th, 2012, [http://www.sc.com.my/wp-content/uploads/eng/html/icm/0811\\_msianicm.pdf](http://www.sc.com.my/wp-content/uploads/eng/html/icm/0811_msianicm.pdf).

4. Borrower (local brokers)
5. Borrowing client

In short, the Bursa SBL system is a facility offered by Bursa Malaysia Securities Clearing that functions as a central lending agency. It specifies the shares which are eligible to be borrowed. Only approved local licenced dealers may borrow securities from CLA as principal. This borrowing shall be subjected to the provision of a collateral up to the required margin. Any other person who wishes to borrow the eligible securities has to borrow them from a borrower under a contract based on their mutual agreement.

**Figure 3:** Modus Operandi for Conventional Securities Borrowing and Lending<sup>51</sup>



In the above process flow the Bursa Malaysia Clearing House borrows securities from the lender through the local agent (usually known as a broker). Later it lends those securities to the client through another broker. It has been said that short-selling based on the SBL model involves uncertainty as the buyer at the time of selling the securities does not own them. The seller takes an open position hoping that he would buy the securities later at a price lower than the price he short sold them.

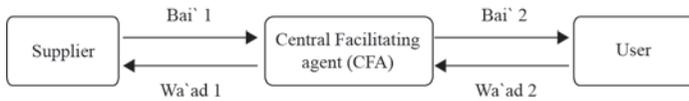
### 3.3.2. Bai' And Wa'ad-Based Short-Selling:

Under this model the process flow is similar to the conventional SBL; however, it does not involve any interest element as securities are exchanged on sale rather than borrowing, that is, unlike the

<sup>51</sup> Ibid.

conventional system here the primary seller (securities owner) sells the securities to the Bursa Malaysia Clearing House (SBL), which would later be sold to the client through respective brokers. Thomas (2012) had quoted that “SAC has declared that SBL would be Shariah compliant if it incorporates the principles of *bai’* and *wa’ad*.”<sup>52</sup> Let us have a look at the process flow of this *Shari’ah* compliant short-selling.

**Figure 4:** Structure of *Bai’* and *Wa’ad* Contract in Short-Selling<sup>53</sup>



1. According to the above diagram, the supplier sells the securities to the Central facilitating Agent (CFA) which basically acts like an SBL. This sale is usually takes place along with the unilateral wa’ad to buy the securities again from the CFA whenever it sells the securities.
2. The right of the seller to recall the sold securities to the CFA is usually protected through the embedded rules and regulations of Shariah compliant replicated SBL.
3. CFA later sells those securities to the buyer (fund manager) immediately with a purchase undertaking (*wa’ad 2*), that is, whenever CFA asks for the securities, the fund manager should sell them to CFA either the same securities or other securities of nature.
4. Like the supplier’s rights, the buyer’s (fund manager) right is also protected under the same law, according to which CFA shall buy the securities from the fund manager whenever he intends to sell.

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<sup>52</sup> Abdulkader Thomas.

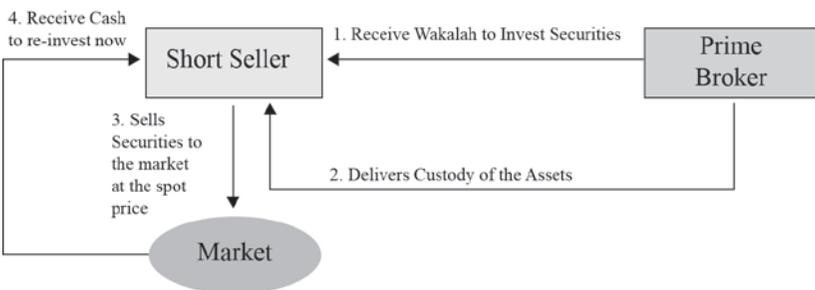
<sup>53</sup> Securities Commission Malaysia, “Malaysian Islamic Capital Market”.

5. Therefore, in order to avoid any uncertainty the rights and interests of both the supplier, as well as the buyer has been stipulated in the law and made known to all parties upfront. This has helped in avoiding potential *Shari'ah* issues that may have arisen if it had not been done accordingly.

### 3.4. Other Alternative 1: *Wakalah*

The other theoretical alternative to explore further is by applying the concept of *wakalah*. In the short-selling strategy, the owner of the security grant, the investor, has the right to “participate” in or apply the security in a sales process. In this case, the investor can take the custody of the security as *wakeel* to use it for the economic benefit of the owner of *muwakkil*.

**Figure 5:** Structure of *Wakalah* in Short-selling<sup>54</sup>



The flow of the *Wakalah*-based system as follows:

1. The owner of the security is to grant the investor the right to “participate” in the sales process.
2. The investor takes custody of the security as *wakeel* to use it for the economic benefit of the owner of the *muwakkil*
3. The *wakeel* (short seller) receives custody of the security. The custody agreement is executed and specifies bonus/fee to the

<sup>54</sup> Abdulkader Thomas, 307.

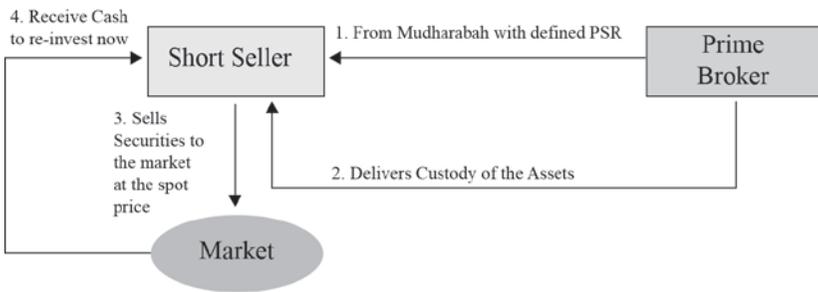
*wakeel*. The agreement allows the *wakeel* to sell securities so long as they are replaced at the *wakeel's* expense prior to the end of *wakalah*.

4. If the position of the money (ITM), the *wakeel* will purchase the security in the market and return it to the *muwakkil* at the maturity of the *wakalah* and custody agreement. The *muwakkil* will have suffered a book loss on the value of the securities, but would receive a cash payment
5. If the position is out of money (OTM), the *wakeel* must replace the securities at his own expense from the market. The *muwakkil* run a capital risk, and the *wakeel* will not earn any money (*wakeel* may lose capital in the replacement exercise).

### 3.5. Alternative 1: Mudharabah

The second theoretical model for short-selling is by applying the concept of *mudharabah*.

**Figure 6:** Structure of *Mudharabah* in Short-Selling<sup>55</sup>



The flow of the structure is as follows:

1. The short-seller as *mudharib* contributes a strategy and will manage the operation (sell the securities).

<sup>55</sup> Abdulkader Thomas, p.308

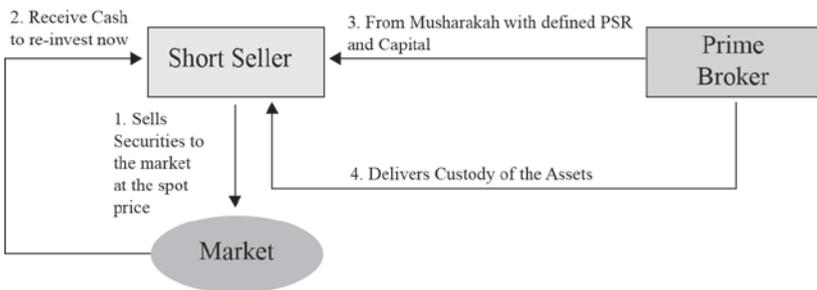
2. The prime broker as *rab al-mal* will contribute the capital/securities.
3. If the position is ITM, the PSR rewards the two parties, and the *mudharib* returns the securities to the *rab al-mal*.
4. If the position is OTM, the *rab al-mal* is the sole party at risk of capital loss according to *mudharabah*.
5. This *mudharabah* approach would be more problematic as the party contributes the equity in the form of securities (*rab al-mal*/prime broker) is exposed to the risk of loss.

In the *mudarabah* structure, the big risk is held by the *rab al-mal* in the event of OTM. The *rab al-mal* is the sole party at risk of capital loss according to the rules of *mudarabah*. Thus, this model is not favorable among investors and probably difficult to adopt real practice.

### 3.6. Alternative 2: Musharakah

In the third alternative of short-selling, the *Musharakah* model may theoretically align the interests more closely to the conventional short-selling process.

**Figure 7:** Structure of *Musharakah* in Short-Selling<sup>56</sup>



<sup>56</sup> Abdulkader Thomas, 309.

The flow of *Musharakah* arrangement is as follows:

1. The short-seller as a partner (*musharik*) contributes specified labour and services
2. The prime broker as a partner (*musharik*) contributes securities and custody.
3. The profit sharing is skewed to the prime broker. The value of services for the short-seller may be structured to preserve the prime broker's capital.

#### **4. Conclusion**

To sum up, the subject of short-selling has become a topic of debate and discussion. This paper reviews the meaning, types and structure of short-selling. With respect to the short-selling facility, this paper highlights and discusses six alternative short-selling strategies in Islamic Finance: *salam*, *urbun*, *wa'ad*, *wakalah*, *mudharabah* and *musharakah*. In fact, the *Shari'ah* Advisory Council of Securities Commission of Malaysia permits the structure of *salam* in short-selling transaction. Essentially, short-selling has issues and conflicts, and it can vary greatly across countries. Therefore, the *Shari'ah* validity of short-selling is still debated nowadays.