

Shariah Issues on Short Selling Practice in Pakistan Stock Exchange: A Way Forward

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Abstract

Short selling is an important leveraged product of Pakistan Stock Exchange (PSX). Short selling is governed and regulated by the Securities Act 2015, Regulations for Short Selling under Ready Market 2002, Margin Trading System (MTS) Regulations 2002, Clearing House (Licensing and Operations) Regulations 2016, Securities Lending and Borrowing Regulations 2016, National Clearing Company of Pakistan Limited Regulations 2018, Pakistan Stock Exchange (PSX) Regulations 2022, Brokers and Agents Registration Rules 2001 and Securities (Leveraged Market and Pledging) Rules 2011. Under the prevailing legal regime, the practice of short selling is allowed where the traders and investors sell shares without first owning them at the time of executing trade, borrowing arrangement of shares from some stockbrokers, and delivering of sold shares on settlement date, purchasing of shares from market and paying them to the lender on specified date. Thus, this article intends to investigate whether the current short selling practices are in conformity with Shariah. The study intends to follow mixed methods of research by using analytical and comparative study of the issue. It analyzes the current regime on short selling and its compatibility with Shariah or otherwise. It identifies the Shariah issues involved in short selling practice. The study concludes that the practices concerning short selling have various Shariah issues such as it is a sale without ownership, borrowing involving shares as a subject-matter, borrowing with interest, and borrowing with undue benefit to the lender. The study suggests that to mitigate the Shariah issues the Securities and Exchange Commission of Pakistan (SECP), as regulator should take steps. The SECP should follow and benefit from Malaysian model of Islamic Securities Selling Borrowing Negotiated Transactions (ISSBNT) introduced by Bursa Malaysia with the approval of Shariah Advisory Council (SAC) of the Security Commission.

Keywords: Short Selling, Securities Borrowing and Lending, *Shariah* Issues, Settlement.

Introduction:

Short selling is a popular trading tool and mode practiced in Pakistan Stock Exchange (PSX). It is a sale of shares by a broker on account of his client or on his own account even though he does not own the shares that he intends to sell, but he has a borrowing arrangement from some brokers enabling him to deliver the shares on settlement date. The investor sells borrowed stocks at current market price that is high and then buys later stocks when the price is low.¹ Thus, it is “Sell high now” and “Buy

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¹ Advantages of the short selling are that it is an easy way to earn profit by selling the borrowed stocks. The investor generates profit by selling at high price and purchasing borrowed securities from the market when the price goes down. Its disadvantage is that the short seller can incur huge losses when the price of the stock rises against his expectations. In that case he buys stocks at high price and returns those stocks to the lender. Thus, it is mere a speculative activity. The frequent practice of short selling promotes speculative activities in the market instead of real trading.

low later. Therefore, this article aims to analyse the concept of short selling and its practice in PSX, its legal regime in Pakistan together with Shariah issues for the purpose of ensuring the practice of short selling in PSX complies with the Shariah principles.

Concept of Short Selling and Its Practice in Pakistan Stock Exchange:

Short selling is a trading strategy involving an arrangement to sell something in the form of shares in the future which the seller thinks he can buy for less than the agreed selling price.² It is defined as a: “sale by a securities broker, on its proprietary account or on client’s account, when the securities broker or client does not own securities respectively at the time of sale or the sale does not constitute a sale with pre-existing interest, but the securities broker or the client, as the case may be, has SLB Contract³ (securities lending and borrowing) executed through SLB Market⁴ at National Clearing Company Pakistan Limited in accordance with NCCPL Regulations and Procedures to meet delivery requirements on the settlement date”.⁵ This indicates that there are three main activities involved in the short selling. They are selling shares without owning them by a broker on his own account or on account of his client, executing securities lending and borrowing contracts through SLB market and delivering them on settlement date.

Short selling can be understood with the following example. An investor anticipates that value of the shares of PSO (Pakistan State Oil), an oil marketing company will fall in near future by 20% to 30%. Suppose the current value of PSO share is Rs. 50 per share. He instructs his broker to sell on his behalf 10 shares of PSO company. In compliance with his instructions, the broker sells 10 shares to a party. He simultaneously makes a borrowing arrangement with some brokerage firm. He may himself lend these shares to him if he possesses requires shares. After some time say, one month if the value of PSO shares declines to Rs. 20 per share, he asks his broker to purchase 10 shares and deliver

² Jane Russell, Dictionary of Banking and Finance, London: A & C Black, 2003, 3rd Edition, p. 326.

³ The SLB Contract is a formal agreement between two parties – the lender and the borrower of securities. In short selling, the borrower is the short seller who aims to sell securities they do not own, with the expectation of repurchasing them at a lower price later. The lender, typically an institutional investor or entity, owns the securities and agrees to lend them to the short seller. The SLB contract outlines the terms of the securities lending arrangement, including the duration of the borrowing, the fee or interest rate paid to the lender, and the collateral provided by the borrower to secure the borrowing. This contract provides legal clarity and protection for both parties involved in the securities lending process.

⁴ The SLB Market is a specialized financial marketplace designed to facilitate securities lending and borrowing transactions. It serves as the platform where borrowers (short sellers) can access the securities they wish to borrow, and lenders can offer their securities for lending. The market is often managed by clearinghouses or financial institutions that act as intermediaries, ensuring the smooth functioning of the lending and borrowing process. The National Clearing Company Pakistan Limited (NCCPL) manages the SLB market in Pakistan. The market typically operates under its own set of rules, procedures, and regulations to govern the lending and borrowing of securities, ensuring transparency and fairness for all participants.

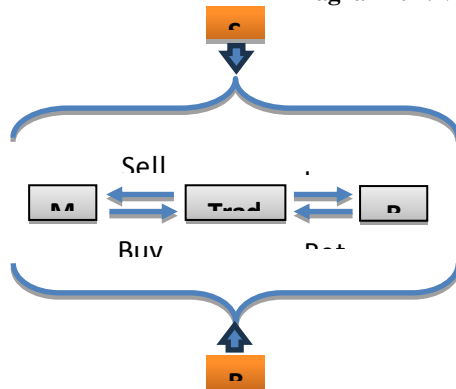
⁵ The Stock Exchange Regulations 2022, Chapter 2.4. on General Definitions.

those shares to the lending party. Here we observe that the trader has earned a profit of 300 rupees. He sold shares for 500 rupees while has paid only 200 for the purchase of those shares. However, this trade involves risks as well. There is likelihood that the value of shares may rise from Rs. 50 to Rs. 100 in the near future. In that case, the borrower will have to buy 10 shares for Rs.1000, suffering a loss of 5 hundred rupees.

The above discussion shows that the short selling is different from the ordinary sale⁶ in a sense that, the investor owns the stocks that he intends to sell and delivers sold stocks on settlement date, whereas in short selling he owns not. Furthermore, in ordinary sale a trader buys stocks for a lower price and sells those stocks when these prices rise but in short selling, a trader sells stocks at higher price, and buys at lower price.

It is also different from blank sale⁷ in such a way that it is a sale of stock which the seller does not have at the time of trade, nor does he have prior commitment or having arrangement of securities borrowing and lending contract to meet delivery obligations on settlement date, whereas the short selling takes place with prior borrowing arrangement to meet delivery obligations on settlement date.

Diagram 01: What is short selling?



⁶ Ordinary stock trading also known as ready delivery transaction refers to a transaction where stocks are bought or sold "on the spot". If a buyer buys a share, he receives delivery, and if he sells the share, he has to deliver the shares to the clearinghouse on the day of settlement. In Pakistan, more than 70% of the total market trade takes place on the Ready Board. The settlement cycle in Pakistan's ready market is T+2, which means the trade has to be settled on Trading plus two-day cycle. The seller in this transaction already owns the stocks that he intends to sell. See, Savings and Capital, p.19.

⁷ Blank sale or naked shorting is defined as: A sale by a broker on its proprietary account or on client's account when the broker or client does not own shares respectively at the time of sale or is a sale without entering into a securities lending and borrowing contract to meet delivery requirements on settlement date; See, *Rule Book of Pakistan Stock Exchange Limited (PSX)*, Chapter 2.4, General Definitions, p. 3.

Diagram Source: Short Selling, Article by Wallstreetmojo Team:

In practice the short selling follows the following steps:

Step 1: Opening Trading Account:

To engage in short selling, the investor, short seller opens trading account with a registered brokerage firm in Pakistan.

Step 2: Margin Account:

After opening the trading account, the investor opens a margin account with brokerage firm. In this account, he deposits a certain amount of cash or securities that serve as collateral for short selling transactions.

Step 3: Borrowing Agreement:

After opening the margin account to short sell, a specific stock, the investor, short seller enters borrowing agreement with brokerage firm or some other lender to borrow the shares. This agreement usually involves name, quantity of stocks, period of borrowing, paying a fee, known as the borrowing cost, to the lender, and collateral for the security of debt.

Step 4: Placing the Sell Order:

After borrowing arrangement, the investor places a sell order through his brokerage. This order is typically labeled as a "short sell" or "sell to open" order. He places this order in leveraged market, not in ready or cash market, leveraged market is designated for securities borrowing and lending. He instructs the broker to sell, say, 100 stocks of certain company designating the transaction as 'Short selling'. The broker sells one hundred shares as per the instruction of his investor in open market and credits sale proceeds into margin account of short seller.

Step 5: Delivery of Borrowed Stocks:

After placing the sell order the investor has to deliver the borrowed shares within two trading days after the trade date (T+2).

Step 6: Buying Back the Shares:

After delivery of borrowed stocks, to close out short position and realize a profit (or loss), the investor buys back the same number of shares that he initially borrowed. This is called "covering" short position. The investor buys stocks from the market and returns the borrowed stocks to lender on the day specified in the borrowing agreement. The investor may place a buy order through his own brokerage firm.

Step 7: Return Borrowed Shares:

After buying back the shares, the investor, short seller returns borrowed shares to the lender, usually his own brokerage firm. The profit or loss is determined by the difference between the selling price and the buying price minus any transaction costs and borrowing fees.

The clear picture on process flow of short selling is given in the following diagram:

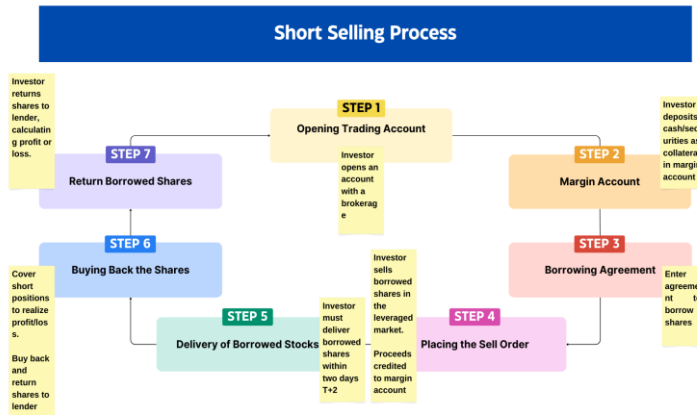


Diagram 02: Short Selling Process :

In short, the short selling can be referred to a sale of shares by investor who has a trading account and a margin account with the registered brokerage firm and has a borrowing arrangement from some broker enabling him to deliver the shares on settlement date and buying back the shares from the market for returning to the lender on specified date.

3.0. Legal Regime on Short Selling in Pakistan:

Short selling is governed and regulated by the Securities Act 2015, Regulations for Short Selling under Ready Market 2002, Clearing House (Licensing & Operations) Regulations 2016, Securities Lending and Borrowing Regulations 2016, and National Clearing Company of Pakistan Limited Regulations 2018.⁸

i- The Securities Act 2015:

The Securities Act 2015 is the primary legislation governing securities and capital markets in Pakistan. Its primary objective is to protect the interests of investors participating in the PSX.⁹ It empowers the SECP to regulate and oversee various aspects of the securities industry and, to implement rules and regulations that prevent market manipulation and abusive practices including short selling.¹⁰

The Act 2015 obliges the broker and traders engaging in short selling to provide comprehensive information to investors regarding the potential risks and benefits

⁸ All the stock exchange regulations have been compiled by the Karachi Stock Exchange in the book form titled: *Rule Book of Pakistan Stock Exchange Limited (PSX)*

⁹ Securities Act 2015, Preamble

¹⁰ Ibid, Part II

associated with short selling. By doing so, it upholds the principles of transparency and investor protection in the short selling process.¹¹

It also empowers the SECP to ensure that short selling activities do not disrupt the orderly functioning of the market and that such activities are conducted within the framework of market integrity. This regulatory control is essential to maintain the fairness and transparency of the securities market, ensuring that short selling does not undermine its integrity.¹²

ii- The Regulations for Short Selling under Ready Market 2002:

The Regulations for Short Selling under Ready Market 2002 is a set of regulations which specifically deal with short selling activities conducted on the ready market of the PSX.¹³ It provides various guidelines and requirements for short selling transactions in the PSX such as eligibility criteria of parties engaging in short selling and certain categories of market participants, such as institutional investors or individuals who fulfill the specific financial criteria.¹⁴

The Regulations 2002 also provides rules for the amount of collateral (margin) that short sellers must maintain to cover potential losses. These requirements are often set to ensure that sellers have adequate funds to cover their short positions.¹⁵

Moreover, it requires the short sellers to provide detailed reports and disclosures, including the quantity of securities sold through short selling, the rationale for the short selling, and the terms and conditions of borrowing the securities. It also covers rules for borrowing and lending securities for short selling that govern the process of borrowing securities from lenders and returning them at a later date.¹⁶

iii- The Clearing House (Licensing & Operations) Regulations 2016:

The Clearing House (Licensing & Operations) Regulations 2016 provide framework for the clearing and settlement of all types of securities transactions, including short selling.¹⁷ Since the settlement process for short selling is more complex than for traditional long positions, the Regulations 2016 ensures that the necessary steps are in place to facilitate the delivery of securities and funds in short selling transaction.

The process of clearing and settlement of short selling transaction follows the steps below:

¹¹ Ibid, Section 96.

¹² Ibid, Section 7.

¹³ The Regulations for Short Selling under Ready Market 2002, Preamble.

¹⁴ Ibid, Section 8.

¹⁵ Ibid, Section 3.

¹⁶ Ibid, Section 6.

¹⁷ The Clearing House (Licensing & Operations) Regulations 2016, Preamble.

- a) On the trade date, the short seller places an order to sell the securities through a broker. The broker validates the order and forwards it to the stock exchange. The stock exchange matches the order with a buyer and executes the trade. The trade details are sent to the clearing house for clearing and settlement.
- b) On the same day also, the clearing house novates¹⁸ the trade and replaces it with two contracts: one between the clearing house and the buyer, and one between the clearing house and the seller. The clearing house becomes the counterparty to both the buyer and the seller and assumes the risk of default by either party.
- c) On the same day, the short seller borrows the securities from a lender, usually a broker or a custodian, and pays a borrowing fee. The lender transfers the securities to the short seller's securities account. The short seller authorizes the clearing house to debit the securities from his or her account and deliver them to the buyer's account on the settlement date.
- d) On the settlement date (T+2), the clearing house debits the securities from the short seller's account and credits them to the buyer's account. The clearing house also debits the funds from the buyer's account and credits them to the short seller's account. The clearing and settlement process is completed.
- e) On a later date, the short seller buys back the securities from the market at a lower price and returns them to the lender. The short seller pays back the borrowing fee and any interest charges. The short seller keeps the difference between the selling price and the buying price as profit.¹⁹

Furthermore, the Regulations 2016 also provides risk management measures to mitigate risks associated with the short selling such as the risk of failing to deliver the borrowed securities at the agreed-upon settlement date. These measures include margin requirements and mechanisms to address failed settlements.²⁰

In the margin requirement the short seller is required to deposit a certain percentage of the value of the securities as collateral with the clearing house. The margin acts as a buffer in case the price of the securities rises and the short seller incurs a loss. The clearing house monitors the margin level and may issue a margin call if the margin falls

¹⁸ Novation is a legal process that transfers the rights and obligations of a contract from one party to another, with the consent of all parties involved. In the context of clearing and settlement, novation means that the clearing house steps in between the original buyer and seller of the securities and becomes their new counterparty. This way, the clearing house guarantees the performance of the trade and eliminates the credit risk between the buyer and seller.

¹⁹ See, <https://www.nccpl.com.pk/en/products-services/clearing-settlement-services>, Accessed on 9-12-2023.

²⁰ The Clearing House (Licensing & Operations) Regulations 2016, Section 12

below a certain threshold. The short seller has to top up the margin within a specified time frame or face the risk of having the position closed out by the clearing house.²¹

While in mechanisms to address failed settlements the clearing house takes appropriate actions in case the short seller fails to deliver the securities on the settlement date. These actions may include imposing penalties, buying the securities from the market and delivering them to the buyer, or closing out the position and settling the difference with the short seller. The clearing house may also suspend or terminate the short seller's clearing account if the failure is repeated or severe.²²

iv- The Securities Lending and Borrowing Regulations 2016:

The Securities Lending and Borrowing Regulations 2016 allows the traders and investors to sell shares without first owning them at the time of executing trade and to borrow securities from willing lenders, which could include brokerage firms, institutional investors, or other market participants. This borrowing process is essential for short sellers as it provides them with the securities, they need to execute their short positions.²³

Moreover, the Regulations 2016 regulates a temporary transfer of ownership of securities from the lender to the borrower when the securities are borrowed. This transfer is facilitated by the securities lending and borrowing agreements. As a result, the lender retains certain rights and obligations, including the right to receive any dividends or interest payments during the lending period.²⁴

4.0. Shariah Issues relating to Short Selling in Pakistan Stock Exchange:

On the basis of above-mentioned discussion, it seems that the practices concerning short selling in PSX have some Shariah issues such as it is a sale without ownership, borrowing involving shares as a subject-matter, borrowing with interest, and borrowing with undue benefit to the lender.

i. Sale of a thing without ownership:

In short selling there is a Shariah issue of sale of a thing without ownership, as the short seller does not own or possess the shares that he sells. The majority of Muslim jurists such as Hanafis, Malikis, Shafi'is and Hanbalis prohibit the sale of a thing without ownership based on the *hadith* of the Prophet (S.A.W.): "It is narrated by Hakim ibn Hizam (RTA) that he asked the Prophet (S.A.W.) that a man comes to me and wants me to sell him something which is not in my possession, I buy the goods for him from the market and sell it to him. The Prophet (S.A.W.) replied: Do not sell what you do not possess".²⁵ Based on

²¹ Ibid, Section 15.

²² Ibid, Section 8.

²³ The Securities Lending and Borrowing Regulations 2016, Section 1.

²⁴ Ibid, Section 5.

²⁵ Ibn Maja, *Sunan*, Kitab al-Tijarat, Hadith No. 2187.

this view short selling of shares is not allowed because it involves selling a thing which is not owned and possessed by the seller thus, it is prohibited in Shariah.

However, Ibn Taymiyyah and Ibn al-Qayyim to the certain extent allow the sale of a thing without ownership as Ibn al-Qayyim interpreted the above *hadith* as inability to deliver.²⁶ He says:

“There is nothing in the Qur’ān nor in the *Sunnah* that asserts the view that contracting over a *ma’dum* (non-existing object) is disallowed. What is available in the *Sunnah* regarding transactions involving existent commodities is contained in the *hadith* “do not sell what is not with you (i.e., not in your possession)”. The *hadith* indicates that the ‘*illah* (legal effective cause) here is not ‘*adam* or non-existence but *gharar* (uncertainty). The uncertainty is due to the inability to deliver the subject matter of the contract, for instance a runaway camel (*al-ba’ir al-shārid*). Whenever the ‘*illah* is removed the *hukm* too stands removed, for are you not aware that the Lawgiver has permitted ‘*ijarah* and *al-musaqah* because of the absence of uncertainty? The Lawgiver, instead, disallowed the sale of a runaway camel because of the element of *gharar* inherent in it even though it is in existence”.²⁷

The Mālikī jurist al-Bājī holds the same interpretation that the emphasis in the *hadith* is on the seller’s inability to deliver, which entails risk-taking and uncertainty. If the *hadith* were to be taken on its face value, it would prohibit *salam* and a variety of other sales, but this is obviously not intended. It is quite possible that the seller owns the object and yet is unable to deliver it or that he possesses the object but does not own it, in either case he would fall within the purview of this *hadith*. The emphasis in the *hadith* is, therefore, not on ownership, nor on possession, rather it is on the seller’s effective control and ability to deliver. Thus, the effective cause (‘*illah*) of the prohibition is *gharar* on account of inability to deliver.²⁸

Many contemporary Muslim scholars like Taqī Usmani,²⁹ Amin Shinqīti,³⁰ Towfiq Ramadan al-Buti,³¹ Siddiq al-Darir,³² Yousuf al-Shubaili³³ subscribed to the majority’s view and held that selling shares before owning them is not permissible because it, to certain extent involves *gharar* (uncertainty), deception, and may lead to disputes and conflicts.

²⁶ Ibn al-Qayyim, *I’lām al-Muwaqqi’in* (Cairo: Maktabah al-Kulliyah al-Azhariyyah) 1968, vol. 1, p. 358.

²⁷ *Ibid*, vol. 1, p. 358.

²⁸ Abū al-Walīd Muhammad Ibn Rushd, *al-Muqaddimat*, (Cairo: Matb’ah al-Sa’adah, 1325/1907).

²⁹ Taqī Usmani, *Islam aowr Jadid Ma’ashi Masa’il*, Islam and Contemporary Economic Issues, (Karachi: Idarah Islamiyyat, 2008), vol. 3, p. 25.

³⁰ Amin Shinqīti, *Dirasah Shari’yyah li Ahamm al-U’qud al-Mustahdashah*, Al-Madinah al-Munawwarah, (Matba; ah al-Ulum wa al-Hikam, 1992), p. 671.

³¹ Towfiq Ramadan al-Buti, *Al-Buyu’ al-Sha’ah* (Demascus: Dar Al-Fikr, 1998), p. 382.

³² Darir, *Al-Gharar wa Asaruhu fi al-Tatbiqat al-Mu’asirah*, (Jeddah: Islamic Development, 2009).

³³ Yousuf al-Shubaili, *Al-Istismar fi Al-Ashum wa al-Sanadat*, p.9, www.shubili.com. Accessed on 9-12-2023.

The Shariah standard setting bodies, such as the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), the International Islamic Fiqh Academy (IIFA), the Council of Islamic Ideology of Pakistan (CII), and the Shariah Advisory Council of Bank Negara Malaysia (SAC), also favour the view of majority Muslim jurists. The AAOIFI has also prohibited short selling of shares and stated: “It is not permissible to sell shares that the seller does not own (short selling) and the promise of a broker to lend these at the time of delivery is of no consequence”.³⁴ It also declares *salam* of shares unlawful. It has declared concluding *salam* contract on shares as an impermissible contract and explained the Shariah basis of this impermissibility in the following words:

The basis for the impermissibility of *salam* in shares is that the subject-matter of *salam* is a debt and not an ascertained thing while in shares of corporations nothing works except ascertainment. This is done by mentioning the name of the corporation whose shares are desired through *salam* thereby rendering the shares an ascertained thing and not a liability for a debt share cannot, therefore, essentially be the subject-matter of the contract of *salam*. Further, *salam* in shares implies the sale of ascertained things that are not owned and this is not permitted. In addition to this, the constant availability of specified shares in the market and the ability of the buyer to deliver them at the end of the period is something that cannot be guaranteed.³⁵

The IIFA also forbids selling of shares without owning them and states: “It is not permissible to sell shares that are not owned by the seller, whether the seller is a broker or a customer, and whether the sale is for cash or on credit, and whether the seller intends to buy the shares before the settlement date or not”.³⁶

The CII also endorses the prohibition of selling of shares without ownership and states: “Short selling of shares is not allowed in Islam because it involves selling something that is not in one’s possession and ownership”. The council argued that short selling involves deception and uncertainty as the seller does not own the shares and does not know whether he can buy them back at a lower price.³⁷

The SAC of Bank Negara Malaysia also rules that selling of shares without ownership is not permissible in Shariah and states: “Short selling of shares is not allowed as it involves selling something that is not owned by the seller and may cause harm to the market and the shareholders”. The SAC based its resolution on the Shariah principles that prohibit *gharar*, *maysir* (gambling), and *zulm* (injustice).³⁸

³⁴ AAOIFI Shariah Standard (21) Financial Papers (Shares and Bonds) Article no. 3/6.

³⁵ See, Art. 3/4, *Shariah Standard No. 12: Financial Papers*, p. 566.

³⁶ See, <https://iifa-aifi.org/en?s=riba&lang=en>, Accessed on 9-12-2023.

³⁷ See, <https://cii.gov.pk/Publicationss.aspx>, Accessed on 9-12-2023.

³⁸ See, <https://www.bnm.gov.my/-/sac-176th-meeting>, Accessed on 9-12-2023.

From the above discussion it may be concluded that although short selling is a sale of shares which are not owned by the short seller at the time of sale, and thus, it is a case of “Do not sell what you do not have”, but practically, it is a sale of a thing which is within the control of seller. He has the ability to deliver shares to the buyer. Thus, as per interpretation of Ibn Taymiyyah, Ibn al-Qayyim, and al-Baji, the prohibition in the *hadith* does not apply to short selling. It appears that emphasis of IIFA, and AAOIFI, has been on literal interpretation not on rationale and wisdom behind the *hadith*.

ii. Borrowing Involving Shares as a Subject Matter:

Another Shariah issue in short selling is issue of borrowing (*qard*) involving shares as a subject matter. Is borrowing of shares permissible in Islamic law? What are the things in which borrowing is allowed in Shariah?

The Muslim jurists have divergent views regarding the eligible subject matter of borrowing. The Hanafis hold the view that borrowing is allowed in fungible goods (*mithliyyat*) i.e., identical goods that have their substitute available in the market. In their view, borrowing is not allowed in non-fungible things like animals, property, precious stones, because of the impossibility of returning its similar to the lender.³⁹ They base their argument on the verse of the Qur’an that says: “And if you are on a journey and cannot find a scribe, then a security deposit [should be] taken. And if one of you entrusts another, then let him who is entrusted discharge his trust [faithfully] and let him fear Allah, his Lord. And do not conceal testimony, for whoever conceals it - his heart is indeed sinful, and Allah is Knowing of what you do”.⁴⁰ They interpret this verse to mean that the subject matter of borrowing must be something that can be secured and entrusted, and that non-fungible things cannot fulfil this condition. According to this view, shares cannot be the subject matter of borrowing, as they are not homogenous and cannot be returned in the same or equivalent form.

The Malikis⁴¹ and Shaf’is⁴² maintain that borrowing can be affected on all things that are eligible for *salam* contract. This implies that everything that can be minutely described, can be the subject-matter of borrowing, because the borrower has the ability to return its equivalent to the lender. Thus, everything that can be established as liability on borrower, is a valid object of borrowing, regardless of whether the object of borrowing is fungible thing or non-fungible thing.

This implies that non-fungible things, such as animals, can also be the subject matter of borrowing, as evidenced by the *hadith* of the Prophet (S.A.W.): “It is narrated by Hadhrat Rafi’ that Prophet (S.A.W.) borrowed a young camel, and then received camels in charity. He ordered Rafi’ to give borrowed camel to the lender. Hadhrat Rafi’

³⁹ Ibn ‘Abidin, Muhammad Ameen. *Radd al-Muhtar ala al-Durr al-mukhtar*, vol.4, p.171.

⁴⁰ *Al-Qur’ān, Al-Baqarah*:283

⁴¹ Dardir, *Al-Sharh al-Kabir*, vol.2, p.222; Ibn Juz’a’I, *Al-Qawanin al-Fiqhiyyah*, p. 288.

⁴² Muhammad ibn Khatib al-Sharbini, *Mughni al-Muhtaj*, vol. 2, p. 118.

said that he did not find equivalent to borrowed camel, however, the closest he Hadhrat' Rafi (May Allah be pleased with him) could find was a six-year camel. Upon that the Prophet (S.A.W) ordered him to give it to the man and added that "the best among you is the best in repaying his debts".⁴³ From this *hadith* it can be established that non-fungible can also be subject matter of borrowing.

The Hanbalis, maintain that everything can be a subject matter of borrowing regardless of whether it is fungible or non-fungible or whether it is eligible for *salam* or not.⁴⁴ They base their argument on the *hadith* of the Prophet (S.A.W.): "Whoever takes the money of people with the intention of repaying it, Allah will repay it on his behalf, and whoever takes it in order to spoil it, then Allah will spoil him". They argue that this *hadith* does not specify any condition or restriction on the type of money or property that can be borrowed, and that it applies to all kinds of borrowing. According to this view, shares can be the subject-matter of borrowing, as they are a form of property that can be given and taken back.

The contemporary Muslim scholars have different views as regards the permissibility of borrowing of shares. Yusuf al-Qaradawi, maintains that borrowing of shares is permissible, as long as certain conditions are met. He contends that shares are a form of property that can be borrowed, as they have a clear and identifiable value and ownership. He also asserts that the changes in the assets and value of the company do not affect the validity of the borrowing, as the borrower is only liable to return the same number and type of shares that he borrowed, regardless of their market value or underlying assets. He, however, stipulates that the borrowing of shares must not be used for short selling or other speculative or manipulative purposes, but rather for genuine and legitimate needs, such as hedging or liquidity management. According to this view, shares can be the subject matter of borrowing, as long as they do not involve any prohibited elements or objectives.⁴⁵

However, according to Mubarak ibn Sulaiman Al-e-Uthman, "borrowing of shares is not permissible because a share represents assets, cash, debts and receivables. A share also represents value of company in stock market. The borrowing of share requires that the borrower should know in detail the quantity of assets and cash of company so that he could return and repay its equivalent to the lender. And since, this is impossible to know and determine, the borrowing of shares is unlawful."⁴⁶

⁴³ Muslim, *Sahih*, Kitab al-Musaqat, Bab man Ista'afat Shay'anfa Qad Khayran minha, Hadith No. 1600.

⁴⁴ Ibn Qudamah, Al-Mughni, vol. 4, p. 314.

⁴⁵ See, <https://fiqh.islamonline.net/en/wisdom-behind-prohibition-of-riba/>. Accessed on 19-12-2023.

⁴⁶ Sulayman, *Abkam al-Ta'amul fi al-Aswaq al-Maliyyah al-Mu'asirah*, Riyadh, Kunuz Ashbailiyah li al-Nashr wa al-Touzi' 1426H, p. 918, pp.771-775; Sha'ban Muhammad Islam, *Burasah al-Awraq al-maliyyah min Manzur Islami*, (Damascus: Dar al-Fikr al-Mu'asir ed. 1, 2002), p. 193.

Furthermore, Muhammad Taqi Usmani argues that borrowing of shares is not permissible, because a share represents a mix of assets, cash, debts and receivables, as well as the value of the company in the stock market. He further argues that the borrowing of shares requires that the borrower should know in detail the quantity and quality of the assets and cash of the company, so that he can return and repay its equivalent to the lender. And since this is impossible to know and determine, the borrowing of shares is unlawful. He also contends that the assets that are behind the share do not remain static and unchanged from the time of borrowing till the time of repayment, as the company changes and substitutes its assets continuously. It is quite possible that at the time of repayment, the assets are not the same as they were at the time of borrowing. This implies that the borrower would not be returning the asset that he had borrowed.⁴⁷

The Shariah standard setting bodies, such as AAOIFI, IIFA, CII, and SAC, have different views in this regard. AAOIFI declares the borrowing of shares as impermissible except in cases of necessity or need, such as to avoid default or penalty, or to fulfil a contractual obligation, and that the borrower must return the same number and type of shares that he borrowed, without any delay or increase. AAOIFI prohibits using of shares as subject matter of borrowing in the following words:

“The basis for the impermissibility of lending the shares of corporations is that the share at the time of repayment in consideration of what it represents does not represent the same thing that it did at the time of lending due to the constant change in the assets of the corporation”.⁴⁸

On the other hand, CII holds the view that the borrowing of shares is permissible, as long as the borrower does not sell the shares or use them as collateral, and that he returns the same number and type of shares that he borrowed, without any delay or increase. It also states that the borrower is entitled to the dividends and capital gains of the shares, and that he is liable for any losses or damages that may occur to the shares during the period of the borrowing.⁴⁹

SAC of Bank Negara Malaysia have resolved that the borrowing of shares is permissible, as long as it is done for the purpose of facilitating the settlement of securities transactions, and if it does not involve any *riba*, *gharar*, or *maysir*.⁵⁰ It is worthy to note that according to Allamah Ibn al-Qayyim, sale of a thing which the seller does not own but has the ability to deliver, is a valid sale. SAC’s resolution, has followed this popular interpretation of the Hadith: “Do not sell what you do not have”. The *gharar* in short selling exists only when the short seller does not have prior

⁴⁷ Taqi Usmani, *Islam aowr Jadid Ma’ashi Masa’il*, Islam and Contemporary Economic Issues, (Karachi: Idarah Islamiyyat, 2008), vol, 3. p. 25.

⁴⁸ See, Art. 3/4, Shariah Standard No. 12: Financial Papers, p. 566.

⁴⁹ See, <https://cii.gov.pk/Publicationss.aspx>, Accessed on 9-12-2023.

⁵⁰ See, <https://www.bnm.gov.my/-/sac-176th-meeting>, Accessed on 9-12-2023.

borrowing arrangement, which is a blank or naked sale in the instant case no *gharar* exists as per interpretation of Ibn al-Qayyim.

From this it may be concluded that short selling involves borrowing of shares. In other words, shares are the subject-matter of the borrowing. In the classical jurisprudence, the jurists have different views regarding borrowing involving shares as a subject-matter. Some jurists allow borrowing of fungible things only and some others hold the opinion that borrowing can be affected on both the fungible and non-fungible goods. Another view suggests that borrowing is permissible on all such things which are eligible for *salam* transaction. The study reveals that the opinion of modern Muslim scholars and *fiqh* bodies is divided on the issue whether borrowing of shares is allowed or not. The predominant view on the issue is that borrowing of shares is not permissible because it does not belong to the class of fungibles. The preferred opinion is that borrowing of shares is not permissible in Shariah as AAOIFI has ruled. The reason being that its value does not remain the same between the time of borrowing and the time of its return to the lender.

iii. Borrowing with Interest:

Another Shariah issue in short selling is borrowing with interest whereby the shares are borrowed on interest from a broker or original owner who charges interest from the short seller for lending the shares to him.⁵¹ From Shariah perspective it is considered as *riba*.⁵² The Muslim jurists are unanimous that any borrowing that entails a benefit for the lender or the borrower is *riba* and is prohibited by the Qur'an and the Sunnah. The only permissible borrowing in Islam is a benevolent borrowing (*Qard-e-Hassan*) that does not involve any increase or benefit, and only requires the repayment of the principal amount.

According to Imam Abu Hanifah and his two disciples, Imam Abu Yusuf and Imam Muhammad, any borrowing that involves an increase or a benefit is prohibited. The only exception is if the increase or the benefit is given voluntarily by the borrower as a gesture of gratitude, without any prior condition or

⁵¹ Under SLB (securities lending and borrowing) Regulations, the borrower of stocks pays to the lender a pre-determined interest, i.e. KIBOR+ 8% per annum of the current market value of the securities borrowed.

⁵² *Riba*, is defined as any unjustified or predetermined increase or benefit that accrues to the lender or the borrower as a result of a borrowing or a sale transaction. *Riba* is prohibited in the Qur'an and the Sunnah, as well as by the consensus of the Muslim jurists, as it involves injustice, exploitation, and oppression of the weak and the poor. *Riba* also contradicts the Islamic principles of risk-sharing, known as *Al-Kharaj bil Daman* (Entitlement to profit depends upon liability for loss). The Appellate Bench of the Supreme Court of Pakistan has defined *riba* in the following words: "Any amount big or small over and above the principal amount of borrowing or debt, is *riba* prohibited by the *Qur'an* and *Sunnah* regardless of whether the borrowing is contracted for consumption or production". Thus, drawing any pre-stipulated benefit from the borrower is prohibited in Islam.

expectation from the lender. The basis of this ruling is the verse of the Qur'an that says: "But if you repent, you may have your principal - [thus] you do no wrong, nor are you wronged".⁵³ and the *hadith* of the Prophet (S.A.W.): "Every borrowing that brings a benefit is *riba*".

Hanafi jurist Kasani writes:

"One of the requirements, of a valid borrowing contract, is that it should not entail benefit, such as he (the creditor), gives *borrowing*, on a condition that the borrower gives some extra benefit to him. Such borrowing contract is unlawful, because Prophet (S.A.W.) has prohibited a borrowing that entails benefit. The reason for its unlawfulness is that such an increase is without any equivalent counterpart".⁵⁴

Al-Muwatta, a prominent book of Maliki school explains the view of Imam Malik in the following words: "There is no harm, if the creditor receives better in quality, then what he had lent, provided, it is not a condition in the contract, or a promise, or a common practice. In such case, the increased payment would be unlawful".⁵⁵

Al-Shirazi a jurist of Shafi school says:

"A borrowing that brings benefit is not permissible. It is not allowed to lend, on the condition that the borrower will sell his house to the creditor, or he will return the amount with increase, or he will pay the borrowing in some other country, with a view to avoid the risk of journey. The basis of the impermissibility is a *hadith* of Prophet (S.A.W.) that the Prophet (S.A.W.) prohibited from combining lending and selling, in one contract. It is also narrated by Obayy Ibn-e-Ka'b, Ibn Abbas and Ibn-Masud, that they have prohibited a borrowing which entails some benefit. The reason is that borrowing is basically a transaction of benevolence, and goodness. If benefit is stipulated in such contract, then it does not serve the purpose of benevolence and goodness. However, if the borrower by his own initiative, voluntarily pays some increase, on the amount of borrowing, or sells his house, then such transaction is permissible".⁵⁶

Ibn e Qudamah, a Hanbali jurist says: "Every borrowing contract, where it is stipulated that the debtor will pay more than what he had borrowed, is an unlawful contract. However, if he advanced borrowing, without any condition of increase, and the debtor paid his debt, in the best manner voluntarily, then such act is permissible".⁵⁷

⁵³ *Al-Qur'an, Al-Baqarah*:279

⁵⁴ Kasani, *Al-Badai al Sanaie* I vol.7, p. 305.

⁵⁵ *Dirasat Hawla al-Riba wa al-Fawa'id wa al-Masarif*, p., 31.

⁵⁶ Shirazi, *Al-Muhadhdhab* vo.1, p. 304.

⁵⁷ Ibn Qudamah, *Al-Mughni*, vol.6, p. 438.

The contemporary Muslim scholars also endorse the above position on this issue. Muhammad Taqi Usmani argues that interest-based borrowing is not permissible under any circumstances, as it involves *riba*, which is one of the gravest sins in Islam.⁵⁸ He further argues that interest-based borrowing is unjust, exploitative, and oppressive, as it transfers the risk and the burden of the borrowing from the lender to the borrower and creates a cycle of debt and poverty. He contends that interest-based borrowing contradicts the Islamic principles of risk-sharing, social welfare, and economic development, as it discourages productive investment and encourages speculative and wasteful consumption. He also maintains that interest-based borrowing is harmful to the individual, the society, and the environment, as it leads to moral decay, social inequality, and environmental degradation.⁵⁹

The Shariah standard setting bodies, such as AAOIFI, IIFA, CII, and SAC, also favour the above views. AAOIFI states that interest-based borrowing is prohibited, except in cases of extreme necessity or need, such as to save one's life, honour, or property, or to fulfil a contractual obligation, and that the borrower must repent, seek forgiveness, and pay *zakat* on the interest amount.

SAC of Bank Negara Malaysia maintains that interest is a form of *riba*, and that it is prohibited in all types of financial transactions and contracts, whether they are related to lending, borrowing, investing, saving, or exchanging. It also states that interest is not a legitimate or fair compensation for the use of money or capital, and that it does not reflect the actual value or risk of the transaction or contract.⁶⁰

From the above discussion it may be concluded that short selling involves a Shariah issue of borrowing with interest and all the Muslim jurists are unanimous that any benefit on the borrowing amount drawn by the lender is *riba* and thus prohibited in Shariah.

⁵⁸ Taqi Usmani, *Islam aorw Jadid Ma'ashi Masa'il*, Islam and Contemporary Economic Issues, (Karachi: Idarah Islamiyyat, 2008), vol, 3. p. 25.

⁵⁹ It is worthy to mention that in, Pakistan while pleading the case of conventional banks infamous *riba* case, some lawyers contended that *riba* does not apply to commercial interest. It is applied only to the borrowing obtained from consumption and personal needs. Moulana Muhammad Taqi Usmani, a member of appellate bench of the Supreme Court of Pakistan refuted this claim. He referred to the famous juristic principle: "Shariah rulings (Ahkam) are based on Illah (Effective Cause) not on Hikmah (The rationale and wisdom behind the law). He maintained that this is the increase on the principal amount of borrowing which makes the transaction invalid not the *Zulm* or injustice inherent in the transaction. This means that according to Moulana Muhammad Taqi Usmani, *riba* is deemed to have taken place when certain predetermined increase on the principal amount of borrowing is charged, regardless of whether it amounts to injustice to the borrower or not. In the above case, the mere charging increase on the original amount of lent securities, is sufficient to make it a *riba* transaction. Consideration will not be given to the presence or non-presence of *Zulm* and injustice in the transaction. Thus, pre-determined increase is *illah* while injustice is Hikmah.

⁶⁰ See, <https://www.bnm.gov.my/-/sac-176th-meeting>, Accessed on 9-12-2023.

iv. Undue Benefit to the Lender:

Another Shariah issue in short selling is undue benefit to the lender, who lends the shares to the short seller on a condition that the short seller must deposit the proceeds of the sale of these shares in the lender's account. The deposit by the short seller in the lender's account is treated as security by the borrower against the borrowing of shares whereby the lender is entitled to any return arising from the deposit but not the short seller even though, the deposit principally belongs to him. From the Shariah perspective the security in the form of deposit is considered as mortgage (*rahn*). The issue is whether the lender is entitled to benefit from mortgage that results in undue gain and enrichment to him. The classical Muslim jurists have divergent views on this issue.

According to Hanafis, a mortgagee or pledgee (lender) can benefit from *rahn* only with the permission of mortgagor (borrower).⁶¹ The Shaf'is hold the view that the creditor cannot benefit from pledged property because a *hadith* says that the both the benefit and liability of *rahn* is for its owner.⁶² The Malikis differentiate between the debt arising from sale or *ijarah* contract and the debt arising from borrowing contract. The former is allowed if permitted by the mortgagor and its period is fixed. They, however do not allow benefit from if it results from borrowing contract because of the *hadith* that every borrowing that brings benefit for lender is *riba*.⁶³ The Hanbalis hold the opinion that benefit from mortgaged property is not allowed by the lender even with the permission of mortgagor.⁶⁴ It is worth mentioning that the contract of *rahn* is basically meant for the security of debt, and not for investment and profitable use. Any profitable use of pledged property is regarded usury in Islamic law, because of the *hadith* that "any borrowing which brings some benefit (for lender) is a kind of *riba*".⁶⁵ Thus, if he earns any profit out of it, he is bound to return it to its owner. It is a borrowing from the borrower to the lender.

The contemporary jurists, such as Muhammad Taqi Usmani,⁶⁶ Abdullah Saeed,⁶⁷ and Monzer Kahf,⁶⁸ have adopted the Hanafi view that the lender can benefit from the mortgaged property with the permission of the borrower, as long as the benefit is not stipulated as a condition in the contract. They have also allowed benefitting from the mortgaged property against borrowing of share, as long as the borrower has the right to use the property and the lender does not interfere with it.

⁶¹ Ibn Abidin, *Radd al-Muhtar*, vol. 5, p. 343.

⁶² Muhammad Al-Khatib al-Shirbini, *Mughni al-Muhtaj*, vol. 2, p. 121.

⁶³ Dardir, *Al-Sharh al-Kabir*, vol. 3, p. 246.

⁶⁴ Ibn Qudamah. *Al-Mughni*, vol. 4, p. 385.

⁶⁵ San'ānī, *Subul al-Salām*, vol.3, p. 53.

⁶⁶ Taqi Usmani, *Islam aowr Jadid Ma'ashi Masa'il*, Islam and Contemporary Economic Issues, (Karachi: Idarah Islamiyyat, 2008), vol. 3, p. 25.

⁶⁷ Abdullah Saeed, *Islamic Banking and Interest: A Study of the Prohibition of Riba and Its Contemporary Interpretation*, (Leiden: Brill, 1996), p. 23.

⁶⁸ Monzer Kahf, *Islamic Finance Contracts*, Al Manhal, 2013, p. 45.

The Shariah standard setting bodies, such as AAOIFI, IIFA, CII, and SAC, have different views in this regard. The AAOIFI has constructed its opinion on the Hanbali view and provided:

“The mortgagor can benefit from the mortgaged asset on permission of the mortgagee whereas the mortgagee has no right at all to enjoy free of charge benefit from the mortgaged asset with or without the permission of the mortgagor”.⁶⁹

CII of Pakistan prohibits benefiting from the mortgaged property without the permission of the owner. The council further states that the lender of shares cannot charge any interest, fee, commission, or any other form of benefit or compensation for lending the shares.⁷⁰

SAC of Bank Negara Malaysia has adopted the Hanafi view that the lender can benefit from the mortgaged property with the permission of the borrower, as long as the benefit is not stipulated as a condition in the contract.⁷¹

From the above discussion it may be concluded that short selling involves undue benefit by the lender, since the short seller deposits the sale proceeds in the account of lender from which he benefits in the form of interest. The study establishes that the proceeds of sale deposited with the lender are in nature of *rahn* or mortgage. According to preferred opinion which has been upheld by AAOIFI as well, that the mortgagee cannot benefit from the mortgaged property.

Solving Shariah Issues on Short Selling Practice – Lessons for Pakistan:

The Shariah Advisory Council (SAC) of the Securities Commission Malaysia (SC) provides guidance on Shariah-compliant practices within the capital market.⁷² Short selling is generally considered problematic from a Shariah perspective due to the common and prevailing concept that selling something that one does not own, is prohibited.

However, to facilitate certain market activities while adhering to Shariah principles, the SAC has approved a product known as Islamic Securities Selling Borrowing-Negotiated Transactions (ISSBNT).⁷³ This product serves as a Shariah-compliant alternative to conventional borrowing and short selling. ISSBNT is structured on two outright *bay'* transactions, two *wa'd* (two unilateral promises or undertakings), *khiyar al-shart* (stipulated option to cancel the contract within specified time) and

⁶⁹ See, Article 3/2/9 of Shariah Standard No. 39: “Mortgage and Its contemporary *Applications*”

⁷⁰ See, <https://cii.gov.pk/Publicationss.aspx>, Accessed on 9-12-2023.

⁷¹ See, <https://www.bnm.gov.my/-/sac-176th-meeting>, Accessed on 9-12-2023.

⁷² See, Quarterly Bulletin on Malaysian Islamic Capital Market by the Securities Commission Malaysia, <https://www.sc.com.my/api/documentms/download.ashx?id=69b97f5c-ddb8-4f30-a4d4-03fd3a8a03d1>, Accessed on 01-09-2023

⁷³ [ISSBNT Introduction-Bursa Circular-1-2017.pdf](#)

provision of *rahn* or collateral as security for indebtedness under ISSNT, the approved supplier (lender in conventional short selling) sells certain Shariah compliant stocks (required for the purpose of short selling) at certain price on deferred payment basis. He simultaneously gives an undertaking that he will buy or accept stocks when the approved user (borrower in conventional lending) sells them or delivers upon occurrence of the agreed upon trigger events. Thus, it is a promise to buy stocks from the user on expiry of credit sale period. The approved user (borrower in conventional short selling) gives undertaking to the supplier that he will execute Leg 2 sale transaction upon recall by the supplier or upon the occurrence of the agreed upon trigger events; and adjust the value of pledged collateral in accordance to the market price of the securities on a marked to market basis. Pursuant to this undertaking, he executes sale of stocks as agreed in the promise or undertaking. By virtue of *wa'd* no 1, the supplier is bound to buy those stocks from the user. *Khiyar al-shart* gives the user the right to cancel the contract within the period of *khiyar al-shart*. He may invoke this right especially on occurrence of certain event such as the security is declared Shariah non-compliant or happening of certain another unforeseen event. Provision of *rahn* is meant for the security of debt in favor of supplier, the seller on credit in first leg.

If we examine this product from Shariah perspective, we observe that this is a Shariah compliant transaction for the following reasons:

- 1- Two *Bay'* Transactions: In the above structure, the supplier of stocks, instead of lending stocks to borrower on interests, makes *bay'* transaction, which is a lawful transaction. He sells on credit, so that the user or borrower could use them for short selling without committing his own funds. This sale is absolute and unconditional. It is not dependent or contingent on second sale. By this way *bay' al-Inah* is avoided.
- 2- Two *Wa'ds*: These are unilateral promises. Unilateral promises are allowed in Shariah. Bilateral promises are not permissible because they amount to contract, and a sale contract attributed to future date is not permissible. Here each promise is unilateral. Every party gives unilateral undertaking or commitment to Bursa not to the other party. So, these are not face to face promises.
- 3- *Rahn* or collateral: An important feature of this product is the treatment of *rahn* or collateral in cash by the user (borrower in conventional system) to secure the debt of creditor, the supplier. In conventional lending and borrowing, this collateral is used by the lender. He may place it in the bank and earn interest on it. He also benefits from the proceeds of sale executed by the short seller. In conventional short selling, the short seller transfers proceeds of sale in the account of lender. Under ISSBNT, this amount is invested on profit and loss sharing basis and both the supplier and user share profit or loss arising from investment of collateral money. This arrangement saves the transaction from becoming an interest-based transaction where the lender charges fixed lending fee or fixed interest on lending throughout lending period.

- 4- *Khiyar al-shart* is an accepted Islamic principle, established from authentic *ahadith*. *Khiyar al-shart* is invoked where the user believes that transaction is not in his favour or on occurrence of some unfavourable event. In such case he returns the purchased securities. This option may be availed by the supplier as well.

The product also does not include any provision of interest. The Pakistani regulator may consider this product while developing Shariah compliant alternatives to the current practice of short selling.

5.0. Conclusion:

The practice of short selling in the PSX raises significant Shariah issues, which need to be addressed to ensure compliance with Shariah. These issues include absence of ownership of shares at the time of sale, shares being subject matter of borrowing, interest-based borrowing transaction and undue gains by lenders. Addressing these Shariah issues is crucial to ensure financial transactions within the PSX align with Shariah. To resolve these issues, it is proposed that ISSBNT model as practiced in Bursa Malaysia may be considered by the SECP in Pakistan.